Inside a Hostile Takeover Battle

Examining Valeant and its unprecedented bid for Allergan.

BY STEPHEN DAILY, NEWS EDITOR

Allergan and Valeant Pharmaceuticals International are two major companies that are similar in size but have very different backgrounds, business models, and philosophies. Both are successful in their own way.

By all accounts, Valeant's hostile takeover attempt of Allergan this summer is one of the most high profile and controversial ever. The animosity between the two companies—and the number of accompanying lawsuits—continues to grow. Like a closely contested political race, executives on both sides have an agenda, as they elevate their pleas to shareholders from explanations of why a merger is a good or bad business move to personal attacks and accusations of broken federal securities laws.

This takeover bid is challenging traditional corporate practices. If successful, it may ultimately serve as a blueprint for how mergers and acquisition deals get done in the future.

FOCUSED ON THE BOTTOM LINE

To readers who have been following Valeant over the past decade, the tactics and effort the company employed this summer to complete the takeover should come as no surprise.

Besides being shrewd, creative, and forward thinking, perhaps the most important prerequisite for being a member of Valeant's management team is having a tough skin. In their quest to grow the company and keep shareholders happy, the Valeant management team, led by former drug industry consultant Michael Pearson, may have taken more criticism in the past 5 years than most executives do during a career. That is because, with every acquisition, comes attrition and, with every boost in revenue, comes a cut in research. With a laser-sharp focus on growing the bottom line, Valeant has stuck to its philosophy: grow through serial deal-making, cut costs aggressively, and stop spending exorbitant amounts of money on risky research.

The secret to the company's success is no secret at all. Mr. Pearson and members of Valeant's management team do not shy away from the company's acquire-and-cut philosophy. In fact, it is the promise they make to shareholders when making an acquisition.

It is "a business model that gets rid of the value-destroying part of pharmaceutical companies and keeps all the pieces that are value sustaining," Mr. Pearson said in an interview with *The Wall Street Journal*.[1]

In an investor conference meeting in May 2014, on the same day that the company raised its bid to acquire Allergan, Mr. Pearson and his colleagues spent 3 hours touting the success of Valeant's several business units—a direct attempt to win the votes of Allergan's shareholders.

"I hope days like today help reassure Allergan's shareholders that the quality of the currency they're getting is a very high-quality currency, that our business will continue to grow organically, volume-led, and that we have a unique operating model that is an operating model for the future, not for the past," Mr. Pearson said during the May conference.

Some see such a cutthroat, acquire-and-cut strategy as harsh and myopic, but the results speak for themselves, at least from a financial perspective.

From 2008, the year Mr. Pearson took over as CEO, to 2013, shares of Valeant have been in rocket mode as the company acquired one company after another, slashed duplicating costs, and boosted revenue. At the end of 2008, shares of Valeant were $9.65 per share. By the end of 2013, they were $117.40—more than 1,000% higher. Annual sales during that period rose sixfold to $5.8 billion. That growth continued into 2014, and by late February of this year, the stock was trading for $148 per share.

The uncertainty surrounding the current acquisition attempt, however, is affecting the value of the company. Excluding a boost in share price after the

initial announcement to buy Allergan in April, Valeant's shares have been in a slow but steady decline. Whereas Allergan's shares have remained mostly unchanged since jumping after the initial offer on April 22, Valeant stock has declined 14%. Each rejection, lawsuit, and delay tactic from Allergan has served as a bump in the road, creating uncertainty among Valeant's shareholders.

"We believe increased clarity on a path forward (either with or without Allergan) represents a key catalyst for Valeant shares," Chris Schott, an analyst at J. P. Morgan who covers both Allergan and Valeant, noted in an August 6 investor research report. "We increasingly believe the uncertainty of outcome on the company's bid for Allergan represents a significant overhang on Valeant shares. While Valeant's stock appears to reflect little value for a successful Allergan bid, Valeant is also unable to pursue larger business development opportunities or a share repo so long as it continues to pursue its bid for Allergan."

At press time, shares of Valeant are trading at about $118, around the same level as they were at the beginning of 2014, even though the stock indices are up sharply. This is of particular interest to Allergan's shareholders, because the more Valeant's shares decline, the more the value of the cash-and-stock bid drops.

A HISTORY OF GROWTH THROUGH ACQUISITION

Valeant's origins date back to 1960, when California-based business tycoon Milan Panić founded ICN Pharmaceuticals. In the 1990s, ICN Pharmaceuticals, ICN Biomedicals, SPI Pharmaceuticals, and Viratek merged into a single global pharmaceutical company—ICN Pharmaceuticals—based in Costa Mesa, California. The company continued to operate as ICN Pharmaceuticals until 2003, when it changed its name to Valeant Pharmaceuticals International to signify a new strategic focus.

In the early 2000s, Valeant made a series of acquisitions in the specialty neurology market, and later that decade, it added more assets in dermatology and cosmetics. In 2008, Mr. Pearson was hired as CEO, replacing Timothy C. Tyson. Soon afterward, the company entered an era of fast-track growth. In 2010, Biovail, a Canadian-based pharmaceutical company, purchased Valeant for $3.2 billion. The Valeant name was retained, and the company's headquarters were moved to Mississauga, Ontario, Canada. Mr. Pearson was kept on as CEO and vowed to transform Valeant into a diversified, specialty pharmaceutical company focused on growth and cash flow generation. That same year, Valeant entered the ophthalmology space by acquiring

VALEANT AND ALLERGAN EXECUTIVES ADDRESS BUSINESS MODELS, GROWTH STRATEGIES

Cataract & Refractive Surgery Today *interviewed executives from Valeant Pharmaceuticals International and Allergan to get their perspectives on various topics related to the business models and philosophies of their respective companies.*

Calvin Roberts, MD, chief medical officer of Bausch + Lomb, which was purchased by Valeant in May 2013, spoke on behalf of Valeant. Scott M. Whitcup, MD, executive vice president, research and development, and chief scientific officer of Allergan, provided Allergan's perspective.

What is the business model of your company, and what makes it successful?

Roberts: The key feature of the Valeant business model is decentralization. Rather than the global, centralized, highly tiered corporate structures of traditional "big pharma" companies, Valeant moves decision making to the individual businesses and to the geographical regions. Thus, those leaders who are closest to the customers and the needs of the local businesses make the majority of decisions for each business. We believe that smarter, quicker, and more nimble decisions are made by empowering those who are closest to the business.

Whitcup: Our success depends on innovation. My philosophy has been that research and development (R&D) at Allergan needs to be science based and specialty focused and that creativity and innovation depend on internal people with scientific expertise across multiple disciplines that work together on cross-functional teams and do so on a daily basis. We have been successful because we understand the basic science and physiology of the diseases in the areas that we serve like ophthalmology and dermatology. We have focused on activities, including preclinical models, understanding how to formulate drugs, and clinical development. Also, expertise in regulatory science really helps us get the drugs from the bench to the patient.

What is your R&D philosophy?

Roberts: Valeant believes that true innovation is occurring at universities and at startups, not in the laboratories at big pharma. In order for a university or a startup to be able to commercialize great innovations, [it needs] to have partners who embrace research that was not done in house, and that is the type of partner that Valeant aspires to be. Valeant loves research. They just do not think it should be happening at big pharma companies. There is no way that any pharma company could be able to have fully capable laboratories in each of these areas of research, so therefore, it is so much more efficient to allow and support research that is going on elsewhere.

Whitcup: Although partnerships are important, and we have many working relationships with academic institutions, physicians, and small companies, the ultimate success depends on internal expertise that can take the bulk of ideas both internally and externally and get them through the clinical development and regulatory hurdles to the patient. We have lots of examples of where we would not have had a treatment come to market if we did not have internal basic research. Also, it is difficult to assess and get across the finish line some of the technologies from smaller companies or academic institutions without these internal research capabilities.

What are some examples of drugs that benefitted from the R&D approach of your company?

Roberts: The track record is pretty clear that big pharma companies are not generating real innovations. When you look at the top products in ophthalmology, for example, the number-one–selling drug in ophthalmology is Lucentis (ranibizumab; Genentech). Where did Lucentis come from? Lucentis came from cancer research. Then, some really smart academicians realized that the same process that stops tumors from growing because of new blood vessels might stop macular degeneration, and so Lucentis is a repurposed drug. Ophthalmology took the basic discovery research done elsewhere and then did the necessary development. It was just repurposing. Same with Restasis (cyclosporine ophthalmic emulsion 0.05%; Allergan). Restasis is a drug that is used to prevent organ rejection. Then, someone had this idea that maybe the same process that stops organ rejection would then decrease the amount of inflammation in the lacrimal gland. No research done there, either, just really good development work.

At Valeant, we believe very strongly in doing this type of clinical development in house. Throughout Valeant, there are huge development projects going on in order to bring new drugs to the market. That's why I separate R (research) from D (development). Valeant does great D, and in ophthalmology, great D leads to great products.

Whitcup: One good example is Lumigan (Allergan). At the time, we were looking for innovative IOP-lowering drugs. There really was not a lot on the outside. Having an internal chemistry group who could discover and synthesize novel molecules was critical to our pipeline. Bimatoprost, which became Lumigan, was a drug that came out of internal basic science and chemistry from our R&D group. There was nothing at that time that we could have in-licensed on the outside that would have been of value to patients.

Most of the other drugs that we in-licensed still required a huge amount of internal R&D work to be commercially successful. Probably the best example is Botox (onabotulinumtoxinA). Botox was in-licensed but initially was approved for very small indications of blepharospasm and strabismus. Obviously, without the tens of millions of dollars of investment into everything from formulation and manufacturing to clinical development, it would not be the blockbuster that has helped thousands and thousands of patients today. All of that required additional and smart investment in R&D. Otherwise, we would have been left with an indication that is probably 1% or so of the sales and value to patients.

Even a drug like Restasis, which we also in-licensed, had significant R&D work on the formulation part. It was a drug very difficult to formulate, to have the right bioavailability, and to make it effective for patients. So, a lot of that work was done at Allergan alone. Dry eye is a very difficult clinical development challenge, and having internal expertise was also critical to getting the drug approved in order to have it available to patients.

These are great examples where having internal expertise to discover and synthesize your own molecules in the case of Lumigan, to having formulation and clinical development expertise in the case of Restasis, or manufacturing and clinical development vision in the case of Botox were all critical to success. None of those medications was fully developed by other companies. Although there is innovation in smaller companies and academic institutions, I believe that success in the specialty pharma arena comes from companies that have the capability all the way from the bench to the bedside and make good investments in research both internally and externally. I think that is the R&D organization that will lead to a pipeline for sustained growth over time.

Why is the business model of your company more sustainable over the long term?

Roberts: We believe that Valeant's business model is more sustainable than other pharma companies', because we are less dependent on global blockbuster drugs that are subject to patent cliffs. Rather, our focus on local and regional businesses allows us to continually reorient each business to the evolving needs of doctors and patients.

Whitcup: Our philosophy has always been that, in the long term, becoming totally dependent on other companies for growth could lead to decisions that do not lead to long-term stockholder value. The best business model maintains having the right resources so that you can develop internal ideas where they exist as well as having the capabilities to acquire early technologies from the outside and get them across the finish line. We know that the regulatory hurdles are increasing on an ongoing basis, and I think that we have a strong track record of success. We have had well over a dozen approvals over the last several years, and that comes from having a strong internal R&D group that really understands how to discover and develop drugs.

Aton, the maker of preservative-free Timoptic (timolol) in Ocudose and Lacrisert (hydroxypropyl cellulose). In 2011, Valeant purchased PharmSwiss ($483 million), Dermik ($425 million), and iNova ($615 million).

Despite the company's fast expansion, 2011 was not without its setbacks for Valeant. In March 2011, it attempted to purchase Cephalon for about $5.7 billion, which would have been Valeant's largest acquisition yet. The offer was rebuffed by Cephalon's board of directors, and just 2 months later, the company was purchased by Teva Pharmaceuticals for $6.8 billion. In December of that year, Valeant made a hostile $314 million bid for Ista Pharmaceuticals, maker of Bromday (bromfenac) and Bepreve (bepotastine besilate). After multiple rebuffed offers, Valeant withdrew its offer. Shortly thereafter, in March 2012, Bausch + Lomb purchased Ista for about $500 million.

Undeterred, Valeant expanded its presence in ophthalmology in 2012 by acquiring Eyetech, which markets Macugen (pegaptanib sodium) in the United States; the drug is the first antivascular endothelial growth factor inhibitor approved for the treatment of wet age-related macular degeneration. That same year, Valeant also acquired OraPharma ($312 million) and Medicis ($2.6 billion), a major player in the medical cosmetics market. In May 2013, Valeant reshaped the eye care market when it announced its largest acquisition to date, Bausch + Lomb, for $8.7 billion from private equity firm Warburg Pincus. Afterward, Mr. Pearson hinted in a conference call what the next year would bring.

"We certainly continue to explore, continue to have discussions and we hope [mergers of equals] will eventually be part of the playbook," Mr. Pearson said.

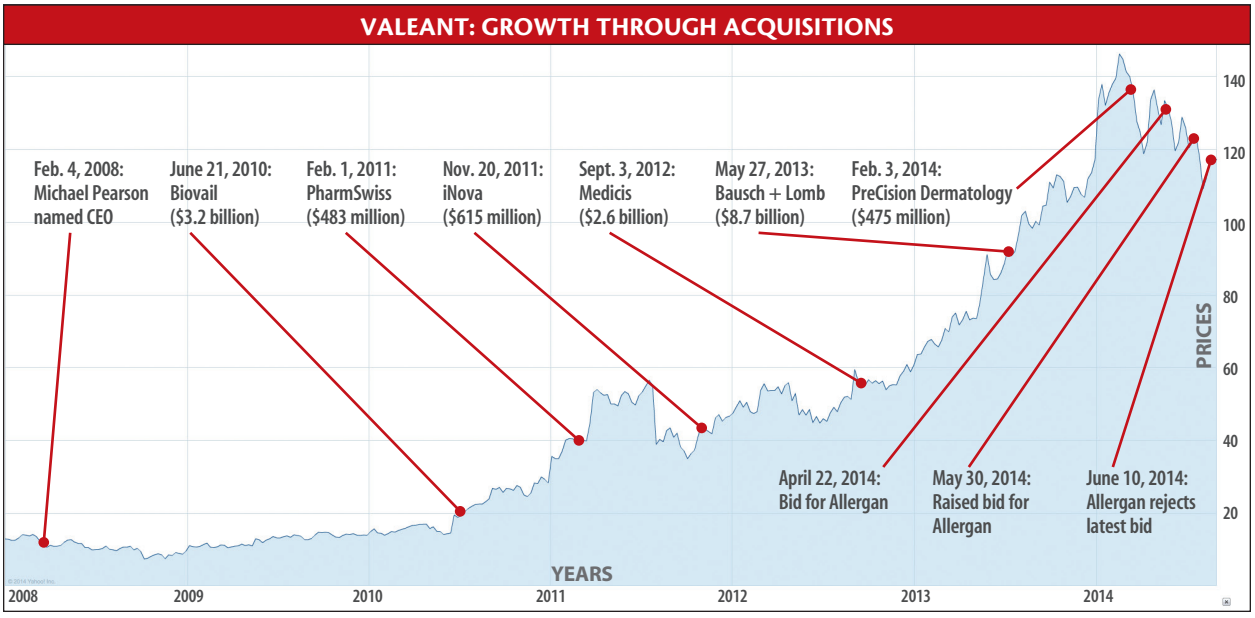
In early 2014, Valeant completed a few medium-sized acquisitions, such as PreCision Dermatology ($475 million) and Solta Medical ($250 million), but its sights were set on a much bigger prize.

AN UNLIKELY PAIRING

Hedge fund activist William Ackman, principal of Pershing Square Capital Management, is no stranger to bold steps. In December 2012, he made national headlines when he waged a public battle against nutrition and weight loss company Herbalife. He made a $1 billion short bet on the company's stock and called Herbalife's business model a pyramid scheme.

In February 2014, Mr. Ackman made another highly unusual move when he approached Valeant and suggested he would help the Canadian company acquire Allergan with the backing of his hedge fund. Several reports soon surfaced revealing that Valeant had been trying to court Allergan for over a year but had been turned away repeatedly. That is when Mr. Ackman and his $13 billion hedge fund became involved. From February to April, Pershing Square bought Allergan stock in a series of transactions—building a nearly 9.7% stake worth about $4 billion.

On April 21, with Pershing Square's financial backing strategy complete, Valeant made public its plans to acquire the maker of Botox (onabotulinumtoxinA) and Restasis (cyclosporine ophthalmic emulsion 0.05%) for about $47 billion. In the initial offer, each Allergan share would have been exchanged for $48.30 in cash and 0.83 shares of Valeant common stock. The company said the



(Image adapted from Yahoo Finance.)

TIMELINE: VALEANT'S TAKEOVER BID FOR ALLERGAN

KEY DATES

February to April 2014: In a series of purchases of Allergan stock totaling almost $4 billion, activist investor William Ackman's hedge fund, Pershing Square Capital Management, builds a position of 9.7% of Allergan stock.

April 21: In an unusual pairing, Valeant Pharmaceuticals International and Mr. Ackman team up in an effort to buy Allergan for $47 billion. Under the initial offer, each Allergan share would be exchanged for $48.30 in cash and 0.83 shares of Valeant common stock.

May 12: Saying the proposal is too risky and undervalues the company, Allergan formally rejects Valeant's $47 billion takeover offer. Allergan CEO David Pyott questions how Valeant would achieve the level of cost cuts it is proposing without harming the long-term viability and growth of the company.

May 21: Allergan releases portions of letters of support from physicians, patient advocacy groups, and medical associations after Valeant's unsolicited proposal to acquire the company. Allergan says it received more than 500 letters.

May 27: Allergan files an investor presentation with the US Securities and Exchange Commission detailing the company's concerns about the sustainability of Valeant's business model.

May 28: During a meeting with investors, Valeant sweetens its merger proposal by raising the cash portion of its offer by $10 per share, a 21% increase from its previous offer. The new bid is worth about $49.4 billion plus a potential contingent payment for a DARPin (designed ankyrin repeat protein) age-related macular degeneration drug candidate.

May 28: Valeant announces that it has entered into an agreement with Nestlé to sell all rights to Restylane, Perlane, Emervel, Sculptra, and Dysport owned or held by Valeant for $1.4 billion in cash.

May 30: Valeant once again increases its bid to buy Allergan with an offer of about $53.3 billion in cash and stock.

June 4: Seeking to increase the pressure on Allergan to negotiate a sale, Valeant and Mr. Ackman call for a special shareholder meeting to remove most of Allergan's board.

June 10: Allergan once again rejects the revised unsolicited proposal, setting the stage for a lengthy hostile takeover battle.

June 12: Pershing Square and Valeant's joint venture, PS Fund 1, sues Allergan in a Delaware Chancery Court. Pershing Square asks the court to rule that its call for a special shareholder meeting to remove most of the Allergan's board will not trigger a "poison pill" antitakeover defense

June 16: Allergan releases an e-mail message from Morgan Stanley with potentially damaging remarks about Valeant's sustainability. The e-mail message reveals that Morgan Stanley pitched its services to Mr. Pyott on May 13 as Allergan was fighting the takeover bid, and in the e-mail message, Morgan Stanley called Valeant "a house of cards and your investors should not want to take their stock." In an ironic twist, Morgan Stanley has since been hired by Valeant in an advisory role to assist its attempt to take over Allergan.

June 19: Valeant announces that it has commenced an exchange offer for the common stock of Allergan, which allows Valeant to take the unsolicited bid directly to Allergan's shareholders.

June 27: Allergan agrees with Pershing Square that a call for a special shareholder meeting to replace part of the Allergan's board will not trigger a "poison pill" takeover defense.

June 30: As it attempts to fend off the takeover, Allergan announces that it has received FDA approval of Ozurdex for the treatment of diabetic macular edema. The company provides updates on several of its pipeline products.

July 7: Pershing Square proposes six new directors for Allergan and calls for a special meeting of Allergan's shareholders that will include a vote on the board expected to be held by the end of 2014.

July 14: After repeatedly questioning the sustainability of Valeant's business model, Allergan— in an investor presentation—publically questions Valeant's transparency policy, specifically when it comes to the financial statements of its top-selling products.

July 17: In a letter to Allergan's board, Mr. Ackman criticizes Allergan's directors for their "scorched-earth response" to Valeant's takeover proposal. He accuses board members of violating their fiduciary duties for not entering into negotiations and for driving down Valeant's stock price by "spreading false and misleading information."

July 22: In a move to boost value for its shareholders, Allergan announces a restructuring deal that will cut

TIMELINE: VALEANT'S TAKEOVER BID FOR ALLERGAN (*CONTINUED*)

1,500 jobs, as it tries to position itself to fend off the hostile takeover bid. Allergan says the job cuts, which represent 13% of its global workforce, will save the company about $475 million in 2015 and drive a major increase in earnings per share.

August 1: Allergan sues Valeant, Pershing Square, and Mr. Ackman in a California federal court. The lawsuit alleges a violation of federal securities laws prohibiting insider trading, engagement in other fraudulent practices, and a failure to disclose legally required information. Valeant responds by calling the lawsuit "baseless" and accusing Allergan of bringing the litigation in an attempt to interfere with shareholders' efforts to call a special meeting.

August 5: Glass Lewis & Co., an investor advisory firm, says Allergan's shareholders should support a special meeting and calls Allergan's deal defense "obstructive."

August 6: Allergan claims that Valeant's second-quarter earnings results contain several "inconsistencies and omissions." Allergan specifically calls attention to Valeant's failure to provide quantitative price/volume sales analysis and market share statistics for its Bausch + Lomb business.

August 14: According to a report in *The Wall Street Journal*, federal regulators are looking into whether Valeant and Mr. Ackman's joint venture to acquire Allergan violates securities laws. The civil probe by the US Securities and Exchange Commission is focused on potential breaches of insider trading laws.

August 15: Valeant extends its offer to purchase Allergan until the end of 2014, after an initial deadline for its tender offer was scheduled to expire.

August 20: Reports surface that Allergan has approached Salix Pharmaceuticals about a potential acquisition that could thwart the $53 billion hostile bid. Salix, of Raleigh, North Carolina, specializes in drugs for gastrointestinal conditions.

August 23: Valeant and Pershing Square say 31% of Allergan's shareholders support their effort to call a special meeting as part of Valeant's takeover bid.

August 26: Allergan confirms that Pershing Square has delivered written requests from Allergan's stockholders in connection with Pershing Square's request to call a special meeting of stockholders.

August 27: Allergan seeks an order from California federal court barring Valeant, Pershing Square, and Mr. Ackman from exercising any rights or benefits associated with Allergan shares that have been acquired unlawfully. In addition, Allergan announces that it will hold a special meeting of stockholders on December 18, 2014.

August 27: Valeant and Mr. Ackman win their request for an expedited trial over the timing of a special meeting of Allergan's shareholders. Delaware Court of Chancery Chancellor Andre Bouchard orders a 3-day trial to begin on October 6, which could lead to a special meeting to oust Allergan's directors in mid-November.

merger would create more than $2.7 billion in annual operating cost synergies.

After a 3-week period of review, Allergan formally rejected Valeant's offer and said that the proposal was too risky and undervalued the company. The rejection, although expected, ignited a series of back-and-forth attacks, lawsuits, accusations, and maneuvering that could last into 2015.

In his May 12 rejection letter directed to Mr. Pearson, Allergan's CEO, David Pyott, pulled no punches when expressing his opinion of Valeant's business model and philosophy.

"In addition to substantially undervaluing our company, your proposal includes a large stock component, which we believe is a risk for Allergan stockholders due to the uncertainty surrounding Valeant's long-term growth prospects and business model," he stated. "Valeant's strategy runs counter to Allergan's customer-focused approach. In particular, we question how Valeant would achieve the level of cost cuts it is proposing without harming the long-term viability and growth trajectory of our business. For those reasons and others, we do not believe that the Valeant business model is sustainable."

Anticipating a lengthy, drawn-out battle with Valeant, Allergan proactively filed an investor presentation with the US Securities and Exchange Commission on May 27 in which the company detailed its concerns about the sustainability of Valeant's business model. Among other things, Allergan attacked Valeant's transparency in reporting its financial results.

On May 28, during a meeting with investors, Valeant sweetened its merger proposal by raising the cash portion of its offer by $10 per share, a 21% increase from its previous offer. The new bid was worth about $49.4 billion. Valeant also announced that it had entered into a major deal with Nestlé to sell all rights to Restylane (hyaluronic acid), Perlane (hyaluronic acid),

Emervel (hyaluronic acid), Sculptra (poly-L-lactic acid), and Dysport (abobotulinumtoxinA) owned or held by Valeant for $1.4 billion in cash. Mr. Pearson said the sale "dovetails well with our announced plans for a transaction with Allergan." Two days later, Valeant further increased its bid, now offering about $53.3 billion in cash and stock. Under the latest bid at press time, each Allergan share would be exchanged for $72 in cash and 0.83 shares of Valeant common stock.

BRILLIANT BUSINESS MODEL OR HOUSE OF CARDS?

With Valeant's sale of many of its high-profile cosmetics products, along with its subsequent revised takeover offer, if it was not clear before, it was now that the company had no intention of backing off its acquisition plans.

At the same time, Allergan was poised for a fight and made clear it would exhaust every measure necessary to avoid the takeover. In perhaps its strongest defensive move to date, on August 1, Allergan sued Valeant and Pershing Square in a California federal court. Allergan alleges a violation of federal securities laws prohibiting insider trading, engagement in other fraudulent practices, and a failure to disclose legally required information. The lawsuit called into question the relationship between Mr. Ackman and Valeant.

"Between February 2014 and April 2014, Pershing Square purchased Allergan stock and securities then valued at over $3.2 billion from unknowing company stockholders while fully aware of Valeant's nonpublic takeover intentions, thereby securing for itself and depriving the selling stockholders of value appreciation worth approximately $1.2 billion upon Valeant's announcement of its initial offer on April 22, 2014," a portion of a statement by Allergan read.

Valeant responded by calling the lawsuit "baseless" and accused Allergan of bringing the litigation as an attempt to interfere with shareholders' efforts to call a special meeting.

In the lawsuit, Allergan also took the opportunity to highlight what it views as the flaws of Valeant's business model.

"Valeant has reported a compounded annual revenue growth rate of over 42% in the past six years, by acquiring more than one hundred companies since 2008—resulting in a staggering debt load of $17.3 billion," Allergan stated in the lawsuit. "Valeant's business model depends on constantly making new and larger acquisitions of companies with successful products and strong cash flows and balance sheets, using these acquired assets to offset the debt burdens of the previous acquisitions, and then cutting research and development efforts in order to reap the profits of the acquired companies' revenue streams without incurring expenses for the research and development—before Valeant's entire enterprise eventually collapses for lack of the next acquisition."

Whatever effect someone thinks the takeover will have on drug development and innovation, the ultimate success of Valeant's bid is most likely tied to the impact the deal will have on shareholders in the short and long term. Whereas Valeant's supporters say Mr. Pearson's approach should be a blueprint for the pharmaceutical industry's future, others question whether the company can sustain its fast-paced growth without finding new products through research.

"It's just basic mathematics," David Steinberg, an analyst at Jefferies & Co., who covers both Valeant and Allergan, said in an interview with *Cataract & Refractive Surgery Today*. "The larger you get, to grow at a reasonable clip, you have to purchase larger and larger assets. So, as you move up the food chain, there's just fewer and fewer options to buy. They're not large enough that there's not, at least for 2 to 3 years, reasonably sized assets to buy. There's a large enough pool of assets they could buy, which would be helpful to growth. This could certainly continue for another 2 to 3 years."

Although most pharmaceutical acquisitions come with a reduction of the workforce—usually due to duplicating business units—the deals typically involve potential drugs farther out in the pipeline that, while expensive, present long-term opportunities for the development of new products and markets. Valeant targets products that are generating revenue today and cuts assets requiring more investment. In a presentation rejecting Valeant's latest offer, Allergan said that its 2013 research and development (R&D) costs were equal to about 17% of its revenue, whereas Valeant's R&D spending was equal to a miniscule 2% of revenue.

Mr. Steinberg said that Valeant is not the only large pharmaceutical company to focus on acquisitions as the main fuel of growth, but the broad level of spending cuts—specifically in sales—is what makes Valeant unique.

"If you think about the pharmaceutical industry, just about every large company there is has grown through acquisitions," Mr. Steinberg said. "[Valeant] hasn't done much research, but they've made the numbers work largely to cut the SG&A [selling, general, and administrative]—where they laid off thousands of sales representatives. Pfizer's effectively a series of large acquisitions. They get it done largely by keeping R&D but cutting more sales and marketing. Valeant's more severe in their cutting, so that makes it more unique, because they cut both SG&A and R&D very substantially. But, of course, Valeant has a very tax-advantaged capital structure, so

the acquisitions are more accretive than other companies' purchases have been."

According to data from tax advisory firm KPMG, Canada's corporate tax rate was about 26.5% compared to about 40% in the United States, providing Valeant with another advantage in its ability to be a serial acquirer.

A FOCUS ON R&D

Allergan is a global, multispecialty health care company with portfolios in eye care, neurosciences, medical dermatology, medical aesthetics, and urologics. Although it has made significant acquisitions such as Inamed in 2006, which added breast aesthetics and dermal fillers to Allergan's portfolio, its business model is more traditional than Valeant's. The model relies on internal and external, science-based R&D to bring products through all clinical stages of development. It also emphasizes the importance of sales and marketing to help facilitate the process of bringing products to patients. Allergan therefore has a long history of consulting and research relationships with physicians across a number of specialties. The company says it employs more than 50% of its workforce in either R&D or sales.

Shortly after the company's first rejection of the takeover offer in May, Allergan released portions of more than 500 letters of support that the company said it had received from physicians, patient advocacy groups, and medical associations. One of those letters came from Nathan Radcliffe, MD, director, Glaucoma Service, and clinical assistant professor, NYU Langone Ophthalmology Associates. In an interview with *CRST*, Dr. Radcliffe spoke about the importance of the company's track record of expanding indications for molecules.

"When Allergan undertook the first and only phase 3 clinical trial to test the ability of a potential neuroprotective agent (memantine) to stop or slow glaucoma progression, it represented a significant investment in the future of glaucoma therapy," he said. "While the study did not have a positive result, the lessons learned from the trial have had a major impact on the field of neuroprotection and have ultimately paved a road map toward finding the first neuroprotective agent—an event that could profoundly alter the landscape of glaucoma management."

Dr. Radcliffe continued, "While I cannot claim to know the specific plans that Valeant would have for Allergan, it seems unlikely from their statements that they would continue to support Allergan as it currently exists."

Another letter came from Eric Donnenfeld, MD, professor of ophthalmology at NYU and a trustee of Dartmouth Medical School in Hanover, New Hampshire. Dr. Donnenfeld is also chief medical editor of *CRST*. In a recent editorial for this publication, he stated that a lot of the focus on wasteful R&D spending at Allergan and other large pharmaceutical companies is not a reflection of poor management but rather a poor regulatory environment.

"Valeant asserted that money spent by Allergan has resulted in the FDA's approval of very few medications during the past 5 years," Dr. Donnenfeld wrote. "I do not believe that Allergan's spending on R&D is evidence of poor management. Rather, I would argue that the FDA approval process is unconscionably difficult. If Valeant takes over Allergan, I will blame in part the FDA for forcing pharmaceutical companies to devote an inordinate amount of their resources to research for an approval process that could be more expeditious."[2]

The takeover bid is being watched closely by physicians in the dermatology and cosmetics markets as well. Joel Schlessinger, MD, FAAD, FAACS, is a dermatologist and cosmetic surgeon at Skin Specialists in Omaha, Nebraska, and the president of LovelySkin.com. Dr. Schlessinger said that, historically, dermatology has largely been an insulated specialty in which physicians and industry lived in a collegial world, maintaining a familial relationship, but he noted that trend is changing.

"Until recently, it was unusual to see a dermatology company that had greater than $500 million in revenues, and it was a big deal when Allergan and Medicis crossed the billion dollar threshold, but now the landscape is full of huge companies with many moving parts," Dr. Schlessinger said.

Despite the trend toward bigger companies' controlling more money in the dermatology and cosmetics industries, Dr. Schlessinger believes innovation will still happen, but he said the research process will have to change.

"Innovation will still happen," he commented. "The pace of innovation may slack off a little bit due to challenges in funding and lack of support for independent trials. But make no mistake; there's going to be innovation in dermatology due to the cosmetic nature of the specialty. Having said that, innovation may also occur in the medical practice of a dermatology center or in academia as opposed to the corporate process that we have been more associated with for the past 50 years. That may be a good thing, and it may end up leading to more significant advances as opposed to some of the relatively modest improvements that have occurred over the past 20 or 30 years." ■

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