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Bylined Article

Is Valeant's Offer for Allergan the New Roadmap for Biopharma Acquisitions?

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Earlier this year, Valeant Pharmaceuticals International, Inc. teamed up with the hedge fund Pershing Square Capital Management, L.P. to acquire Allergan, Inc. in a hostile transaction. It is the first time that a major strategic acquirer has been known to team up with a major activist hedge fund in this way. The arrangement provided Valeant with a way to advance its agenda after its repeated friendly overtures to Allergan had been rebuffed. Does this provide a blueprint for future acquisitions in the biopharma industry? It is too early to tell whether Valeant and Pershing Square will prevail. However, there are reasons to doubt that other biopharma acquirers will rush to do copycat deals, even if the hedge fund industry embraces the new technique.

By way of background, Valeant and Pershing Square formed a limited liability company and entered into a letter agreement to formalize their joint venture arrangement. The JV entity was used to purchase a 9.7% toe hold position in Allergan common stock, as a preliminary step in the acquisition of Allergan through a mixed cash/stock exchange offer to be commenced by Valeant (not the JV entity). Valeant contributed $75.9 million to the JV entity (the maximum amount without triggering a Hart-Scott-Rodino antitrust filing), and Pershing Square contributed the balance of the funds for the 9.7% position, totaling more than $3 billion. The letter agreement provides that the income, gain and loss on the $75.9 million will be allocated to Valeant, and the remaining net profit of the JV entity will be allocated to Pershing Square. However, 15% of the remaining net profits will also be allocated to Valeant under circumstances where a third party makes an acquisition proposal for Allergan. If Valeant ends up acquiring Allergan, Valeant can obligate Pershing Square to purchase shares of Valeant common stock prior to closing at a 15% discount to the market price for aggregate proceeds of $400 million. The JV entity is also obligated to exchange its Allergan shares for shares of Valeant common stock in connection with the exchange offer. Pershing Square must hold, directly or indirectly (which presumably includes through the JV entity), at least $1.5 billion worth of Valeant common stock at the time of closing of Valeant's acquisition of Allergan, and must continue to hold at least that value of

Valeant common stock for a one-year period thereafter. At the time of writing, Valeant's exchange offer is pending. Allergan has a poison pill in place with a 10% trigger. Pershing Square has commenced a consent solicitation to call a special meeting of stockholders in order to gain control of the Allergan board and redeem the pill.

It is easy to see how the arrangement is good for Pershing Square. Hostile M&A is squarely within its core competency as an activist hedge fund. In the typical activist situation, the hedge fund takes a toe-hold position in the target of around 10%, and then attempts to force the sale (or other event-driven transaction) of the company in order to profit from any appreciation in the share price. The fund needs not only to overcome any target company defenses, but also to run a process that results in an acquirer surfacing, who is willing to purchase the target company for a premium. There are many situations where an acquirer has not emerged. In the Allergan situation, Pershing Square entered the process with a willing acquirer, Valeant, already in hand. Instead of Pershing Square having to convince the target's stockholders that the target company should be put up for sale, it has the easier job of convincing them to accept a concrete proposal from a known bidder. If a third party emerges to outbid Valeant, Pershing Square will also make a profit on its 9.7% position. Pershing Square incurs risk associated with being required to hold $1.5 billion worth of Valeant stock for a year if the deal is completed. However, on balance, as long as Valeant proves to be a good partner and does not, for example, have internal problems that Allergan can use to defeat Valeant's offer, the campaign seems less risky for Pershing Square than its typical activist campaigns. It is quite likely that other activist hedge funds are already out in the market place trying to identify the next Valeant to partner with in copycat campaigns.

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For Valeant, the calculation is more complex. The arrangement facilitates its acquisition of Allergan in a number of ways. Teaming up with Pershing Square gives Valeant a way to acquire Allergan after it failed in its attempt to acquire Allergan on its own. Valeant is benefiting from Pershing Square's expertise in outmaneuvering management in hostile transactions. The 9.7% toe-hold position, which was almost all paid for by Pershing Square, gives Valeant a leg up in the transaction. Pershing Square's commitment to purchase $400 million of Valeant common stock, and to have the JV entity exchange its Allergan shares for Valeant shares, will help Valeant to finance the acquisition. If Valeant ends up being acquired by a third party and Pershing Square cashes out its position, Valeant will walk away with about 15% of Pershing Square's profit.

However, the arrangement has a number of significant downsides. First, the goals of Valeant and Pershing Square are not aligned in the long term, which creates execution risk for Valeant. Valeant's aim is to acquire Allergan as part of its publicly announced goal of becoming one of the world's top five drugmakers by the end of 2016. Pershing Square's goal, on the other hand, is to maximize its rate of return. One of the ways that their interests could diverge is if a third party bidder appears. It could be in Pershing Square's financial interest to support the third party bidder and cash out its position, as opposed to supporting an increase in Valeant's offer price and remaining exposed to execution risks and the risks of holding $1.5 billion of Valeant stock for a year after closing. Hedge funds also sometimes discontinue campaigns for reasons unrelated to the merits of the campaign, such as finding better opportunities to deploy capital elsewhere, or because of a need to generate liquidity in order to satisfy fund redemptions. The letter agreement between Pershing Square and Valeant does not foreclose Pershing Square from shifting its loyalties away from Valeant in this way. For example, the letter agreement does not obligate Pershing Square to assist Valeant in funding an increase in its offer price, or foreclose Pershing Square from assisting another bidder. In addition, most of the rights and obligations of the letter agreement terminate if Valeant has not entered into a definitive agreement with Allergan by February 25, 2015, or in certain circumstances following Valeant's failure to match or top a third party offer for Allergan.

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Valeant also has risks in partnering with an activist hedge fund. Two qualities frequently sought when selecting a minority co-investor for an acquisition are patient capital and passivity. Hedge fund activists are the opposite of that. They agitate for change according to their own agendas. Pershing Square is committed to hold $1.5 billion in Valeant common stock until 12 months after completion of the Allergan acquisition. If Valeant's stock declines during that period, will Pershing Square agitate for change at Valeant? The letter agreement does not contain the type of standstill provision frequently found where a new investor takes a large position in a public company. Partnering with a hedge fund also has risks at the hostile offer stage. Hedge fund activists are subject to the criticism that they are just interested in a short term gain at the expense of the long term prospects of their targets. Valeant's hostile exchange offer for Allergan has taken on that flavor. Allergan is criticizing Valeant for threatening to take steps that will be detrimental to the long term interests of Allergan, such as slashing R&D expenditures. Allergan's stockholders care about the long term health of Allergan because approximately 60% of the deal consideration will consist of Valeant stock. Having Pershing Square as a partner makes it more difficult for Valeant to deflect that sort of criticism.

The transaction also presents many of the risks to Valeant that hostile acquisitions typically present. Premiums in hostile deals tend to be larger than premiums in negotiated transactions, and there is therefore the risk of overpaying. Diligence is problematic with an uncooperative target. Targets can also fight back in a number of ways. Allergan has raised allegations about Valeant's business model, including its reliance on serial acquisitions, lack of organic growth, reliance on unsustainable price increases, and unusual tax structure, among others. If these criticisms stick, it could cause long term damage to Valeant's share price and its shareholder support, in addition to potentially causing the takeover attempt to fail. Engaging in hostile deals also runs the risk of damaging Valeant in the M&A market. Hostile deals do occur in biopharma, but they are rare. Serial acquirers, like Valeant, can gain a lot of traction by approaching potential targets on a friendly basis and gaining a reputation among the target community for being trustworthy and easy to work with. Targets are less likely to engage in initial conversations with acquirers who have a reputation for turning hostile. The hostile offer has also spawned the typical flurry of litigation, including a claim that Pershing Square acquired its toe hold position in violation of insider trading laws. If the claims are successful, Valeant is unlikely to escape unscathed.

On balance, the risks seem likely to outweigh the benefits for most biopharma players. But time will tell.

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