April 05, 2016

US plays break-up artist as panic envelops Pfallergan

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While it was unable to stop every US company from migrating overseas to lower taxes, President Obama's Treasury Department has bagged one big pharma trophy and now has another in its sights.

Killing AbbVie's play on Shire was significant, but now the biggest-ever pharma acquisition is in jeopardy thanks to a new tax proposal that could effectively give Allergan a US domicile for up to two more years, ruining Pfizer's plans to knock eight points from its 25% tax rate. Allergan shares dropped 16% in early trading today as investors feared a repeat of the Shabbvie break-up (*Shabbvie is dead; long live Shire, October 16, 2014*).

The big reason to worry: while the new Internal Revenue Service-proposed regulations might never be implemented, and indeed might not withstand a court challenge, the sentinel effect might just give Pfizer cold feet about the deal.

It took AbbVie about a month to realise that a set of tax regulations made its abortive Shire takeout less beneficial, and without a Pfizer statement confirming its intent to follow through on Allergan investors fear a repeat of this scenario (*New US anti-inversion rules spark investor flight, September 23, 2014*). Pfizer can buy itself some time by pointing to its need to read through all 340 pages of the regulations before commenting, but sooner or later investors will demand a response.

The size of the break fee will offer some consolation to Pfizer if this scenario comes to pass. At $400m it is small compared with the $1.6bn AbbVie paid out to Shire, which turned the UK-headquartered company from prey to predator, allowing it to pursue Baxalta.

Look back

What the government has proposed is a change in the foreign ownership thresholds that would allow for a legal overseas "inversion" of a US-based company. Effectively, the IRS is tightening up how it calculates the ownership share of the combined company that is seeking an overseas domicile and lower tax rates.

This involves ignoring the overseas acquired entity's own acquisitions made less than three years ago. Evercore ISI analyst Umer Raffat said this three-year lookback eliminated from the calculation all deals since Warner Chilcott, putting Allergan below a 20% ownership threshold.

This threshold is important since, to discourage inversions, the IRS has for some time already required that shareholders in the overseas acquirer must own a certain amount of the combined company before freeing it from US tax laws.

Originally the threshold was 20%, but it has been tightened to 40% in instances in which companies do not have a big enough business presence in their country of domicile – in Allergan's case, Ireland – a standard that few companies meet.

When the Allergan acquisition was announced its shareholders were estimated to constitute 44% of the combined company's new owners, thus qualifying Pfizer for an inversion (*All hail Pfallergan, November 23, 2015*). Yesterday's IRS proposal raises the bar even higher.

Treasury Secretary Jacob Lew referred to the practice of "serial inversions", and is squarely targeting the Pfizer-Allergan deal.

Allergan gained its overseas domicile through a complicated set of transactions. It was a company once known as Actavis, which bought Warner Chilcott in 2013, giving it a corporate home in Ireland. It then added bulk with takeouts of Forest Laboratories in 2014, and in 2015 with the company called Allergan, from which it now takes its name.

The last two transactions were worth nearly $100bn combined, and Allergan today is valued at $109bn versus Pfizer's $190bn.

Plan B

The narrative underlying Pfizer has been its need for strategic decisions to fill its pipeline or unlock value by splitting the group into three companies. The New York-based company's M&A manoeuvres of the last couple of years – an attempt on AstraZeneca failed in 2014 – have been assumed to be an effort to strengthen the divisions it will eventually cleave off, and not incidentally boost the bottom line of each by re-domiciling and lowering taxes.

There have been sceptics who believe that this strategic outcome will never come to pass as Pfizer's history has been almost exclusively one of acquisition. In any case, the group has signalled its desire to lower its tax rate, meaning that big pharma targets, and ones without the baggage of recent inversions, become attractive once again. AstraZeneca re-enters the frame, as well as GlaxoSmithKline, which is re-mapping its own strategic course for a future without the acquisition-averse Sir Andrew Witty at its helm.

If Pfizer likes Allergan's offerings, regardless of the tax rate, it is not saying. It owes its own investors and those of its target a yes or no answer. Today's sole press release discussing new Xeljanz data only makes the silence more foreboding.

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