Mergers and acquisitions: Corporate inversions

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Plastic surgery has been awash in a recent trend toward consolidation. Such transactions have implications for plastic surgeons as both customers and investors. On the customer side, every time a merger or acquisition is posited, there are reverberating consequences for sales, marketing and loyalty programs. In addition, the suite of goods and services that can be provided by a larger agglomeration are often altered relative to those provided by the predecessor. Furthermore, many plastic surgeons invest in the companies that supply to our industry. Product knowledge can place some plastic surgeons in a unique position to develop sensible perspectives on company valuations with insight into future financial performance.

Allergan Inc has been the recent target of many mergers and acquisitions (M&A). Its most recent deal surrounded the failed merger with Pfizer, which was set to represent the largest merger in the history of the pharmaceutical industry. The impetus for this deal and the genesis of its undoing have important implications. Our impression is that most plastic surgeons believe that the current trend in consolidation stems from corporate strategy. However, this case illustrates that esoteric factors have a significantly larger role to play.

The deal

In November 2015, Pfizer and Allergan announced a merger. Pfizer was capitalized at \$200 billion while Allergan was capitalized at \$120 billion. Allergan is a large pharmaceutical and medical device company with a corporate headquarters in Dublin, Ireland. Pfizer is a huge company with a corporate headquarters in New York City (USA). The deal was structured to be a largely equity-based transaction. Shareholders in Allergan would receive approximately 11.3 shares in the combined company while shareholders in Pfizer would receive a single share in the combined company. This was based on the share valuations at the time. As a result, shareholders in Allergan would own 44% of the combined company while shareholders in Pfizer would receive 56% of the value. Furthermore, shareholders had the option to divest from the security and take the payments in cash, subject to some restrictions.

The CEO of the merged entity was to be the CEO of Pfizer while the CEO of Allergan would assume the role of President and Chief Operating Officer of the new corporation. Furthermore, there were no immediate plans to alter the businesses of either corporation. There was some suggestion that lower performing units from each participant could be divested over time. For example, generic drug divisions within the companies were rumoured to be divested to increase efficiencies and streamline core competencies.

This was an amicable deal, with the boards of directors of both corporations supporting the agreement. Due diligence was largely supportive. The result of the negotiation would be that the corporate headquarters of the new entity would be in Dublin. As a result, the primary jurisdiction of taxation would be in Ireland. At the time of the merger, the effective rate of taxation for Pfizer was approximately 25% while the result of the deal would drop the rate to between 17% to 18%. This would translate into annual tax savings of \$1.5 billion to \$2 billion per year. Furthermore, a significant advantage would also accrue because cash held offshore could be redeployed through the Irish-based headquarters without incurring tax penalties as cash is repatriated to the United States.

The problem

The United States government has become increasingly skeptical of these deals as large American corporations shift their corporate headquarters overseas in an effort to mitigate taxation. Corporations argue that such a strategy is required to compete in the global marketplace. They assert that corporate taxation in the United States places American corporations at a significant disadvantage. This taxation has a higher corporate tax rate than many other jurisdictions around the world and results in a strong disincentive to realize profits in the United States.

The difficulty is that corporations are not able to simply move their corporate headquarters offshore and thereby discharge their American tax liability. This would be a contravention of the American tax code. As a result, corporations have sought alternative structures that would permit a strategy of changing their jurisdiction for taxation to a more favourable locale: one of these locations is Ireland. Other locations have included various small European islands, the Caribbean and, in some cases, Canada.

These types of M&A transactions, which result in a change of jurisdiction for taxation, have been termed 'corporate inversions'. They require that the two firms that merge meet certain fundamental criteria. The first is that they must be of relatively comparable size. The second is that the resultant entity needs to be able to reincorporate in the jurisdiction of one of the parties. In this case, the intent would be to reincorporate the combined entity in Ireland.

The demise

The Obama administration sought to minimize the incidence of corporate inversions. The Treasury Department has argued that such inversions contravene the fundamental principles of fairness espoused in the tax code. Furthermore, there is a huge potential reduction in revenues to the Treasury. If American corporations are able to merge and reconstitute overseas, the consequence would be a severe erosion of the corporate tax base.

In March 2016, the Treasury Department introduced new regulations to govern corporate inversions. They have limited the number of times that a corporation can participate in a corporate inversion. The rules indicate that any M&A transactions performed by a partner in the inversion need to be deducted from the value of the corporation.

In the three years preceding the proposed inversion with Pfizer, Allergan was involved in two other significant inversions. In 2015, Allergan was involved in a \$25 billion takeover of Forest Laboratories, while later in the year, it was involved in a merger with Actavis in a \$66 billion deal. By stripping these valuations from the proposed inversion with Pfizer, Allergan retained a net value of approximately \$30 billion. This dramatically reduced its size relative to the \$200 billion valuation ascribed to Pfizer. The implication would be that Allergan would be a small shareholder in the combined entity. In fact, Allergan shareholders would hold only 10% to 15% of the equity in the new combined entity. The remaining value would accrue to Pfizer shareholders.

Because Pfizer shareholders would control more than 85% of the equity in the merger, the corporation could not be reincorporated in Ireland. As a consequence, the corporate inversion would not

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longer apply and the tax benefits would be eliminated. The deal no longer made sense. In the end, the deal was abandoned as a result of unfavourable regulations related to taxation.

Synergies

Many industry experts suggested that there were synergistic justifications for the merger. Both companies could take advantage of distribution channels, development infrastructure and regulatory efficiencies. Furthermore, many analysts argued that the deal offered Pfizer access to strongly growing products such as Botox, Restasis (a dry eye treatment) and drugs for irritable bowel syndrome. However, it is clear from the outcome and timing of the demise of this deal that these synergies were of only minor significance when compared with the justifications in terms of taxation.

There is no question that M&A deals will impact our professional supply chains as plastic surgeons. Changes in the corporate

structure of suppliers has important implications for sales as many plastic surgeons have discovered as Johnson & Johnson agglomerates supply in our industry. It will be important for plastic surgeons to realize the regulatory and financial environment in which these structures are being created. In this case, the marginal tax rate between two jurisdictions had the potential to alter our industry and change the relationship between plastic surgeons and one of our most ubiquitous suppliers. As we continue to evaluate these deals in the future, it will be important to assess the motivations for these mergers. These motivations will reveal the impacts that are likely to permeate the supply chain.

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