The Threat from Big Pharma

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In a move that is proving controversial, US pharmaceuticals giant Pfizer has advanced a $100 billion plus takeover bid for British drug major Astra Zeneca. Pfizer is clearly keen on the acquisition and has raised its initial bid of £46.61 per share to £50 a share, which reflects a 32 per cent premium above the pre-bid share price of the company. Pfizer has friends in high places. The first response of Britain's conservative government, which is more wedded to finance than to industry, was to welcome the takeover bid. Though Astra is yet to accept the deal, Prime Minister David Cameron has been in communication with Pfizer and has declared that he has "robust assurances" that if the deal goes through the merged company would continue research and manufacturing in Britain. Chancellor George Osborne went even further to declare the bid as being a "massive vote of confidence" for the UK.

Astra Zeneca is clearly not happy with the signal that its home government that favours a deal. The company, however, suffers because it is caught in a time of transition. The future profitability and, therefore, current valuation of a pharmaceutical company depends on its product portfolio. If that portfolio consists largely of drugs that are off-patent or scheduled to lose patent protection, profit potential is bound to be low. On the other hand, if recently patented drugs dominate or new drugs that would enjoy protection are expected to be included in that portfolio, profit potential would be higher, more so if the portfolio includes drugs that are or are likely to be blockbusters.

As of now Astra Zeneca is not among companies that has an established drug development pipeline, from which new products would be sure to emerge. Further, revenues have been declining and that trend is expected to worsen over the next two years when two drugs—Crestor used to treat Cholesterol and Nexium to relieve heartburn—fall out of patent. On the other hand, the company claims to have made significant progress on two drugs for treating cancer, that could hugely strengthen the development pipeline and allow it to perform well as an independent company. With a weak, as yet clearly-established product pipeline, Astra is seen as vulnerable. Shareholders may prefer to sell out at a 'good price' today, rather than wait for the still uncertain future gains from potential products.

However, Pfizer's keen interest in acquiring Astra suggests that it is willing to place a bet that products under development as part of Astra's research could prove to be money spinners. Such speculation is catalysed by the tax-saving benefits that would accrue from the 'inversion' the deal facilitates. Inversion is the practice through which a US company merges with or acquires an overseas firm and then relocates its headquarters and changes its tax residence to avoid US tax payments and save on taxes.

As of now Astra Zeneca's management is fighting back with the support of some shareholders. The firm has got its political support as well. Ed Miliband from the Labour party has accused the Prime Minister of acting like a cheerleader for Pfizer. Tory nationalist sentiment also seems disturbed by Downing Street's response, partly because past experience has been educative. When US food products giant Kraft

acquired Cadbury in 2010 it had given similar assurances or guarantees of saving jobs and promoting industry in Britain. It however reneged on those assurances.

All that notwithstanding, the expectation is that the deal, if sweetened with a high enough price, will finally go through. That expectation is based on evidence of an on going merger mania in the pharmaceuticals industry, that is expected to redefine the sector's competitive structure. In late April, GlaxoSmithKline (GSK) and Novartis announced a $16 billion deal involving an asset swap and a merger their consumer businesses. Under the agreement, Novartis acquired GSK's oncology products, while divesting vaccines (excluding flu) to the latter. The two companies also established a joint venture that combined their consumer divisions to create a mammoth consumer healthcare business.

Meanwhile, elsewhere in the industry, a host of offers have been made and rejected. Swedish pharmaceutical company Meda has rejected a $9 billion bid (at SKr135 and then SKr 140 a share) by Mylan from the US. In this case, the objective seems to have been size, since the drugs involved are largely generics. If Meda and Mylan had combined, the resulting generics drug producer would have notched up annual revenues of around $9 billion, or half that of Teva the world's largest generics producer. Thus, generic drug makers producing cheap, off patent medicines are also looking to mergers and acquisitions, often to stifle the competition or acquire higher-value products. India's own Sun Pharma had bid for Meda and has recently made a controversial $3.2 billion bid for Ranbaxy, a 64 per cent stake in which had earlier been acquired by Daiichi Sankyo of Japan. The Sun bid has been restrained by an Indian court, pending investigation of allegations of insider trading.

In another on-going bid, Pershing Square hedge fund manager William Ackman, who has a 9.7 per cent stake in Allergan, has teamed up with Valeant Pharmaceuticals in a bid to acquire Allergan, the maker of Botox. With Ackman's support Valeant has made a $46 billion hostile bid for Allergan. Meanwhile, Allergan had itself been engaged in a spurned bid to takeover Irish firm Shire Plc. Now, Allergan is reported to be scouting around for an alternative to and better offer than Valeant so as to win shareholder support against Ackman and his corporate ally.

With this M&A mania afflicting the industry, consultancy firm Dealogic estimates that, by early May, more than $160 billion worth of deals had been proposed this year. That is 50 per cent higher than in 2013 and three times the figure for 2012. This rising desire for acquisitions and mergers while motivated by the multiple factors discussed earlier could have one consequence: global consolidation in the industry. That is not just an issue for worry given the critical nature of the pharmaceuticals industry, but also because of the impact it can have on price.

As James Sorowiecki notes in the New Yorker: "Drugs designed to fight rare diseases routinely cost two or three hundred thousand dollars; cancer drugs often cost a hundred grand. And, whereas product prices in most industries drop over time, pharmaceuticals actually get more expensive. The price of the anti-leukaemia drug Gleevec, for instance, has tripled since 2001. And, across the board, drug prices rise much faster than inflation. The reason for this is that prices for brand-name, patented drugs aren't set in a free market." Consolidation would only aggravate such profiteering, that drug companies justify on the grounds that it is needed to recoup drug development costs—an argument that has been proved wrong many times over.

It is in this context that India's decision to allow the international drug majors a stranglehold over the drug industry has to be assessed. Despite differences of opinion even within the government, in 2000, the policy with regard to foreign direct investment (FDI) in the pharmaceutical industry was liberalised. Under the new policy, FDI in the sector was brought under the "automatic route", and the ceiling on foreign shareholding was removed allowing for foreign ownership of up to 100 per cent. The net result has been a spate of acquisitions of leading drug firms by foreign producers. Among the acquisitions by transnational firms have been the takeovers of Matrix Lab by Mylan of USA, DaburPharma by Fresenius Kabi of Germany, Ranbaxy Labs by Dailchi Sankyo of Japan, Shanta Biotech by Sanofi Aventis of France, Orchid Chemicals by Hospira of USA and Piramal Healthcare by Abbott of USA. An overwhelming proportion of FDI inflows into pharmaceuticals production has been in such acquisitions rather than in greenfield projects.

The pharmaceuticals industry is estimated to have attracted Rs.55,986 crore (around $9.5 billion at current exchange rates) in foreign direct investment in the 13 years ending 2013. More than half of that came in the last three years, according to data compiled by the department of industrial policy and promotion (DIPP). Much of it came into brownfield projects. There were different motivations. One was for transnational firms with a presence in India to exploit liberalized FDI policy to increase their share in equity and enhance their control over their exiting facilities. For example, GSK reportedly increased its stake in its Indian unit from 50.7 per cent to 75 per cent. The other is to acquire facilities engaged in the production of generic substitutes for off-patent, branded drugs so as to consolidate global capacities or just stifle competition that keep down prices.

At one point, the rapid pace of acquisitions forced the government to revisit the 100 per cent FDI policy in the pharmaceuticals sector, with the Ministry of Commerce and Industry and the Ministry of Health making a case for revision based on fears that this could affect the pricing of drugs in the more liberalised and less regulated pricing regime. But in January this year the government notified a Cabinet Committee on Economic Affairs decision to continue with the existing policy of 100 per cent foreign direct investment in both greenfield and brownfield projects. According to reports, in 2013 the government cleared as many as seven investment proposals in existing domestic drug manufacturing units. These included those of GlaxoSmithKline Singapore, Mylan USA, and Mauritius-based Castleton Investment. Over the nine-month period April to December 2013 FDI in the pharmaceutical sector doubled relative to the corresponding period of the previous year from $589 million to $1.26 billion. Clearly, India is being drawn into the vortex of global consolidation.

As noted, the acquisition drive possibly reflects an effort to stifle competition so as to prevent India's still significantly rational laws from curbing multinational power. In March 2012 India's patent office granted Hyderabad-based Natco Pharma a compulsory licence to manufacture and sell a generic version of Bayer AG's patented cancer treatment Nexavar. More recently, Natco Pharma has filed a "pre-grant opposition" with the Indian patent office, seeking denial of a patent in India for new hepatitis C drug Sovaldi launched by US drug maker Gilead Sciences. Sovaldi is seen as a much more effective cure for Hepatitis C than existing medicines, but costs $1000 for a day's treatment and $84,000 for a full 12-week course. With support from international organizations like Doctors Without Borders and New York-based Initiative for Medicines, Access & Knowledge (I-MAK), Natco is opposing the patent

(and demanding the right to provide a generic alternative) on the grounds that the drug is not novel or inventive enough.

As a result Gilead has been forced to consider a “tiered pricing” strategy, with a lower price in India than in the US for the drug, and is in talks with other Indian producers to licence a generic version. Owning Natco Pharma would have helped Gilead avoid such compromises and served to keep prices and profits high. Which is why from the point of view of health costs in India, keeping foreign firms at bay still makes sense. Even the British seem to think so.

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