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AstraZeneca

Background to our investment

Over many years, we had been very gloomy about AstraZeneca's attractions as an investment for two principal reasons: In truth market consensus forecasts for future profits looked far too high as analysts seemed to be underestimating the profit contribution from soon-to-expire blockbuster drugs and we had reservations about the R&D productivity of the business and its ability to deliver innovative treatments to unmet medical needs. Not a happy combination. Towards the end of 2013 profit forecasts for 2016 had come down from $9bn to nearer a much more achievable $5bn. Secondly, and much more importantly, there were growing signs of a transformation in the R&D pipeline.

Pfizer's approach to AstraZeneca (AZ)

AZ has rebuffed approaches from Pfizer, of varying degrees of formality, on three occasions; in each case arguing that Pfizer were undervaluing the business. As Pfizer's offers became public, the hand of the AZ management team has been forced to give more detail to investors about the pipeline potential to support the position that the Pfizer offer was too low.

An absolute valuation for a business such as AstraZeneca is challenging; a huge amount of the value lies in the potential of the pipeline of future products. AstraZeneca gave a compelling presentation on 6th May outlining the potential of several key products. On a reasonably sensible, risked and discounted basis, these probably justify a share price of £47. However, this is a value that will continue to grow over time as the discount factors are unwound and as new products enter the pipeline. In other words, if someone wants to buy it from you today, you should expect to be paid for some of this future value.

Part of Pfizer's proposition is that by paying partly in shares, AZ investors can still participate in this future potential. We struggle with this argument for several reasons; though this needs to be caveated with the disclaimer that we are UK investment managers and do not follow Pfizer closely. In itself, this is half the problem, a great deal of due diligence is required in order to value a business with a market capitalisation of almost $200bn to establish whether their shares are an attractive currency with which to be paid. We remain to be convinced. Pfizer looks a lot more like AstraZeneca of old; lots of highly profitable blockbusters that are expiring and a not wildly compelling pipeline. In a superb recent article in Forbes[1], John LaMattina[2] former head of Global R&D at Pfizer, describes Pfizer as a shark: its size, and the near impossible challenge of refreshing a product portfolio with sales of $50bn (before acquiring AZ) as patents expire every 12-15 years, force the business into major acquisitions every several years.

(1) http://www.forbes.com/sites/johnlamattina/2014/05/06/major-acquisitions-now-a-necessary-part-of-pfizers-future-strategy/

(2) We cannot recommend highly enough LaMattina's book "Drug Truths: Dispelling The Myths Of R&D" for anyone who wants to understand what thousands of some of the world's brightest scientists do when they go to work every day. The industry has a poor reputation, partially deserved, but nowhere near enough credit is given to the efforts of the research scientists in attempting to find cures for sick people.

How much would Pfizer need to offer to make us sell?

As mentioned, this is not a precise science. At a price above £55 AZ is becoming a less attractive investment: an awful lot of future potential would be in the valuation. At a price above £60, our hands are effectively tied: we would feel obliged to sell.

Is it just a tax wheeze? Not really. There is much to be said for having your cake and eating it. Pfizer faces two issues: first, they have something like $40bn in cash trapped outside the USA which cannot be repatriated to shareholders without incurring a considerable taxation penalty. In addition, US corporate tax rates are materially higher than UK corporate tax rates. Upon the acquisition of material operations outside the USA, it is permissible for Pfizer to move its tax domicile to the UK. This materially reduces the risk of the acquisition: the trapped offshore cash can be deployed more effectively than receiving near zero interest returns and the new enlarged group can lower its international taxation rate. There is then scope for “synergies” (more on this later), the cost savings from which offer a further relatively low risk return. In short, Pfizer can more or less acquire AZ’s pipeline for free.
So how much is Pfizer likely to offer?

We think Pfizer would offer £55 without hesitation. Pfizer has already made clear the degree of equity dilution they are happy to accept: the equivalent of ~$70bn. Pfizer has ~$50bn in cash (both inside and outside the US), currently earning nothing. This ~$120bn is equivalent to ~£55 per AZ share. Pfizer’s management incentives are heavily focused on EPS growth (with very little attention given to return on investment); in other words, they are paid to spend the money. Buying AZ will give a lot of EPS accretion at almost any price.

Would a price of £60 per share put them off? This would require Pfizer take on an additional $10bn of debt. With interest rates so low, this will make hardly any difference to Pfizer’s EPS accretion calculations.

Is the UK now just a tax haven?

The UK’s new and more competitive corporate tax structure, in combination with our multitude of bilateral tax treaties, is having exactly the desired effect: the UK is a more attractive location in which to base a business and resolves a large proportion of the problems US corporations face with cash accumulated from offshore operations trapped outside the US to avoid heavy taxation upon repatriation. The key judgement is the significance of R&D tax credits and the “Patent Box” and the extent to which this is influencing Pfizer’s calculations. Hopefully it is a significant factor as this is what will dictate the extent to which R&D activities remain in the UK.

Will the deal get political approval?

The 2002 Enterprise Act is reasonably explicit in defining the UK government’s ability to intervene. A lot of hot air is likely to be expelled but we suspect that, with some suitable assurances, (which hopefully the patent box, R&D tax credits and US tax rules would already ensure Pfizer would adhere to), the deal will be given the green light.

Conclusion

At a price above £60 we are going to feel obliged to vote in favour of the takeover. However, given the significance of AZ to the UK's life sciences research capability (AZ spends roughly £1bn/yr in the UK) we would understand if some clients would prefer to vote against the deal. Pfizer's previous cost cutting in UK R&D is not wildly supportive to their plans. Before major cut backs, Pfizer spent £325m/yr on UK R&D and were one of the top 10 spenders on R&D in the UK(3). Even though their intentions today may be honourable (and constrained by assurances to the UK government), circumstances may have changed in five years' time and Pfizer may decide on another major round of cost cutting. This would be highly damaging to the UK life sciences industry. The recent challenges facing the pharma industry have resulted in considerable pressure to cut costs. For reasons of history the UK pharma industry had large R&D facilities located in some rather far-flung locations (including Novartis in Horsham, GlaxoSmithKline in Harlow, Pfizer in Sandwich and AstraZeneca in Cheshire) all of which have been subject to major rounds of cost-cutting and job losses. Outstanding researchers have been left stranded with limited alternative employment options nearby; and worse still, with limited options anywhere else in the UK as consolidation and cost cutting has further shrunk the industry. The solution to this is not protectionism and not in preventing independent companies from pursuing their best interest.

In fostering a thriving pharmaceuticals and biotech industry maximising the support and incentives from both taxation but also the resources available to NICE, the NHS and the UK's outstanding academic and charitable research capabilities should give the UK huge scope to encourage innovation and employment.

(3) http://webarchive.nationalarchives.gov.uk/20101208170217/http://www.innovation.gov.uk/rd_scoreboard downloads/2010_RD_Scoreboard_data.pdf

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