

Sun Pharmaceuticals

Acquire Taro Pharmaceuticals

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Abstract

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The major pharma players in India want to invest in R & D but because their emphasis has so far been on the manufacturing of the generic drugs and hence there is reluctance on their part to deal with the R&D with vigor with which it should be introduced. The only answer lays in both mergers and acquisitions of the generic stalwarts with Indian pharma companies wherein they can collectively put a better use of the competitive advantage that India has in the form of cost effective chemical synthesis, strong economic growth and consolidations. This case study is an attempt to study the acquisitions of Taro Pharma industries of Israel, a multinational genetic manufacturer by Sun Pharma industries Ltd of India on May 21 2007. This case study will help understand the way mergers and acquisitions have become an indispensable way of existence for the pharma industry in India. It shall leave the question to the floor whether the regulatory environment is conducive for such developments in this country, and whether the international businesses could envisage such situations and had prepared itself for it. Should such practices be further encouraged in the better interest of the pharma industry? Is there a further need to amend the Company Law provisions to give better insight to the shareholders and stakeholders for such dealings by the MNCs.

Keywords: Mergers and Acquisitions, Generic Manufacturers, Pharma Industry, Research and Development.

1. History

Sun Pharmaceuticals Industries Ltd is an international, integrated specialist pharmaceutical company. It was established in 1982 and further got listed in the stock exchange in 1994. It started with mere five products and now boasts of brands in chronic therapy areas like cardiology, psychiatry, neurology, gastroenterology, diabetology and respiratory medicine. It manufactures and markets bulk drugs, also known as Active Pharmaceuticals Ingredients (APIs) and a large basket of pharmaceutical formulations as branded generics for both India and abroad. Under a recent corporate development, the areas related to new molecular entities and drug delivery systems are proposed to be demerged into a separate company.

The Company in the post 1996 era has used a combination of internal growth and acquisitions to drive growth; important mergers were those of the US, Detroit based Caraco Pharm

Labs and Pharma plant at Halol which is now UKMHRA and USFDA approved. In the second half of 2004, Sun Pharma acquired the trademarks, manufacturing know-how and other intellectual property of certain pharmaceutical products from Women's First Healthcare, Inc, which was under bankruptcy proceedings. On completion of the acquisition in December 2004, these products were assigned to the company at a cost totaling \$ 3.6 million, which included \$ 168,000 of inventory.

In January 2005, in extension to the company's distribution and sale agreement with Caraco, the business organization, management personnel, and distribution set up arrangements were further enhanced bringing credibility to such mergers. Sun Pharma is among the few top-rung pharma companies that has a presence across all therapeutic segments. In further rationalizing its portfolio, the company plans to sell off about

8-10 products that contribute about Rs 25 crore to the kitty. Sun Pharma's formulations-to-bulk drugs ratio now stands at 65:35. Bulk drugs contribute over 70 per cent of the turnover. The exports as a percentage of turnovers are around 20 per cent. The company churned out average growth rates of about 35 percent in the last three years. Total sales rose to 22.3 per cent over the last year and operating profits advanced 28 per cent. Net profits over the previous year rose 27.5 per cent. The company's shares were traded at an average of Rs 585 in the last one year. The stock price is approximately 17 times its earnings. At current process of Rs 662.05, valuations seem a little stretched. Given Sun Pharma's long-term outlook, investment in the stock can be considered at prices closer to the Rs 560-570 mark.

The company has strong skills in product development, process chemistry, and manufacturing of complex active pharmaceutical ingredients, as well as dosage forms. For the year ended March 7, 2007 Sun recorded net sales of Rs 20,792 million (representing a compounded annual growth rate of 30 per cent over the last 10 year). Based on the latest closing price on the Indian stock exchanges, Sun's market cap is US \$ 5 billion. International sales comprise 43 per cent of revenues. Of this, U.S generic sales are 23 per cent. Sun has filed 111 ANDAs in the U.S of which 34 are approved. Over 12 per cent of net sales have been invested in R&D every year for the last 5 years. Sun has a very able team of more than 550 scientists who work on complex products for all its geographies.

2. Taro

Taro is a multinational, science-based pharmaceutical company, dedicated to meeting the needs of its customers through discovery, development, manufacturing and marketing of the highest quality healthcare products. These products are both genetic and branded pharmaceuticals, used by prescription and over-the-counter, by patients in countries around the world. These medications are used primarily in dermatology, pediatrics, cardiology and neurology. In all, it produces more than 180 pharmaceutical products including topical preparations (creams, ointments, gels, solutions), oral medications (tablets, capsules, powders, liquid) and sterile products (injectables, ophthalmic drops). It completed the Initial Public Offering (IPO) of the ordinary shares in the United States. The company's ordinary shares are currently

quoted on Pink Sheets Electronic Quotation Services, or the Pink Sheets, under the symbol "TAROF".

During 2006, 2005 and 2004, the capital expenditures were approximately \$ 48.3 million, \$ 72.3 million and \$ 94.4 million, respectively. The focus of the capital expenditure program has been the expansion and upgrade of the manufacturing facilities and information technology systems in order to enable them to increase operational efficiencies, remain in compliance with cGMP, accommodate anticipated increased demand for our products, and maintain a competitive position in the marketplace. They develop, manufacture and market prescription and over-the-counter (OTC) pharmaceutical products, primarily in the United States, Canada and Israel.

The major projects undertaken during the past three years, as part of the capital expenditure program, include-the expansion of productions facilities in Canada which began during the fourth quarter of 2002 and ended during the third quarter of 2003; the construction of new research, development, manufacturing and administration facilities in Canada, which began during the fourth quarter of 2001 and ended during the fourth quarter of 2003.

Apart from the above, there are additional activities of production and packaging equipment undertaken by the company, the upgrade of information technology systems, the acquisition of a 124,000 square feet building in Hawthorne, N.Y for the research laboratory and administrative office of Taro U.S.A which was completed during the second quarter of 2005.

The company has been vigorously acquiring starting from the first quarter of 2003, the multi-purpose pharmaceutical manufacturing and research facility in Ireland and subsequent construction there which is still in progress; followed by the acquisition of a distribution center facility in New Jersey during the first quarter of 2004, the acquisition of a distribution facility in Ontario, Canada during the fourth quarter of 2004; and the acquisition of product rights to Topicort®, Ovide®, Lustra®, and U-Kera®, in the United States during 2003 and 2004.

Taro's success reflects a commitment it made in the early 1990s to grow through Research and Development. Since then, it has invested 12-16 per cent of gross sales in research

each year, for a total of more than \$ 190 million. Today, approximately one in five Taro employees work in R&D, led by more than 70 M.D and Ph.D scientists. Taro has more than 100 ANDA drug approvals in the US alone. The research has yielded another major benefit of Taro. It has enabled them to develop the active pharmaceutical ingredients (API's) for many of its key products. By manufacturing its own API's, Taro is able to control the quality and availability of these critical chemicals. But API production is only one part of Taro's quality story. Their manufacturing facilities in Israel and Canada have earned high marks from regulators in those countries and elsewhere. In the U.S, Canada and Israel, the largest drugstore and grocery chains, pharmaceutical wholesaler/ distributors and mass merchandisers stock dozens of Taro products, which find their way into millions of homes.

3. Mission / Vision /Corporate Objective

3.1 Sun Pharma

The main priority of the company is strengthening market share and keeping customers focused. Further, Sun Pharma has shown tremendous business acumen in trying to expand through acquisitions. It bought over a clutch of companies in the last few years and took over, through equity buy-outs, company or brand acquisitions, companies such as Tamil Nadu Dadha Pharma, Gujarat Lyka Organics, MJ Pharmaceuticals, Caraco, Natco Pharma (taken over the brands), Milmet Labs and Pradeep Drug Company. The principle advantage here is that Sun Pharma has gained access to the companies' brands or manufacturing facilities, much more cost-effective than setting up greenfield ventures.

On the export front, the company's new targets China and the CIS countries where close to 40 per cent of the total formulation exports are sold. Exports to Europe are to receive a fillip, post -2003, when the company is to step up presence in this region and register new products.

3.2 Taro

The company firmly believes that it has the potential to position itself very strongly in 2007, after having rectified the errors in assessing the estimates of inventory. The demand for the company's products has remained strong. During 2006, according to industry sources, prescriptions for the Company's products increased by 7 per cent compared to

2005. Taro has developed a business plan designed to enable the Company to operate profitability in 2007. The plan balances sales, marketing and production programs with customer needs. While it is still too early to gauge the success of this plan, the Company's sales performance to-date is ahead of plan, indicating that certain key customers have accelerated their reorders as their inventories continue to decline.

4. Focus Issues

Taro had till May 2006 considered qualitative information such as its judgment based on experience, chargeback data from wholesaler customers, actual returns and reputable third-party prescription data indicating the number of its products dispensed to patients from a more distant point in the drug distribution chain. However, the amount of wholesaler inventory on-hand directly affects the amount of the chargeback it receives, and thus is a critical part of estimating chargeback exposure and setting reserves.

Prior to May 2006, Taro did not have the information of official inventory from its key wholesaler customers, and while it did have certain unofficial information concerning wholesaler inventories, it did not utilize it in calculating its reserves.

In the spring of 2006, after negotiations with the key wholesaler customers for a number of years, Taro was able to obtain official products reports held in inventory by such wholesaler customers. These reports indicated that their reserve levels were inadequate. Using this 2006 inventory information, the Company undertook a "rollback" analysis to estimate the levels of inventory held by these customers as of December 31, 2005, 2004, 2003 and January 1, 2003. As a result of the rollback analysis, it concluded that there were understated reserves. Therefore, the company had to restate its prior period financial statements for 2004 and 2003. It is now believed that this methodology of using actual customer inventory data provides a more reliable basis for estimating chargeback exposure.

The company has restated its financial expenses to reflect the correction of an error in accounting for derivative instruments used to hedge certain long-term debt liabilities, correction of an error in accounting for the amortization of rights to a certain products and to account for additional

expenses related to stock-based compensation. Specifically, the value of a stock option grant is required to be calculated on the date the grant becomes effective under Israeli law, which is the date of the final corporate approval of the stock option grant, or the Grant Effective Date. However, under the previous administrative procedures, the exercise price of the option was set as the date of the option agreement, which in some cases preceded the Grant Effective Date. Since the market price of the shares as of the date of the option agreements was, in some cases, lower than the price on the Grant Effective Date, these administrative procedures resulted in the company failing to recognize certain stock-based compensation expenses in its previously issued financial statements. This was due to the difference between the price on the Grant Effective Date and the exercise price set forth in the option agreement. The amount of such unrecognized stock-based compensation expenses was an adjustment of \$ 320,000 to the opening balance of retained earnings in 2003, and a charge to earnings of \$ 192,000 and \$ 171,000 in 2003 and 2004, respectively, most of which relate to certain options that had previously been granted and approved by the board of directors as part of a shareholder-approved stock option plan, but were subject to shareholders' ratification that took place at a shareholders' meeting in 2002. The administrative procedures that led to this occurrence have since been modified.

With respect to the selected financial data included in Item 3 of this 2005 Form 20-F and other information that should cover the five most recent financial years, the company was not able to provide restated financial data for the earliest two years of the five-year period (2002 and 2001) without unreasonable effort and expenses.

This sequence of events severely hampered the reputation of the company. Its financial statements for 2003 and 2004 were required to be restated by the audit committee of its board of directors in view of errors in estimating the chargebacks from wholesalers and the actual inventory in the drug distribution chain.

4.1 *The Acquisition by Sun Pharma*

With the above background, on 10th May, 2007, Templeton, the beneficial owners of approximately 9 per cent of Taro's ordinary shares, filed an initiating motion in Tel Aviv District

Court seeking certain remedies intended to prevent alleged oppression of minority shareholders. They also filed a motion for the appointment of a special interim manager to review the Company's efforts to identify an appropriate transaction.

On 18th May, a meeting was held in Tel Aviv, Israel at the offices of Yigal Arnon & Co. at, 47th Floor, 1st Azreili Centre. At the Meeting, shareholders were given the news of a proposed agreement of merger between Taro Pharma and Aditya Acquisition Company Ltd, and Israeli Company and a wholly owned subsidiary of Alkaloida Chemical Company Exclusive Group Ltd. (Alkaloida), a subsidiary of Sun Pharmaceutical Industries Ltd.

On 19th May, 2007, Templeton filed an initiating motion in Tel Aviv District Court seeking certain remedies intended to prevent alleged operation of minority shareholders. They also filed a motion for the appointment of senior interim manager to review the Company's efforts to identify an appropriate transaction.

It was further submitted by Templeton under suit filed for prevention of operation of minority shareholders that transaction involving Taro with Sun Pharma for merger was imminent, and it sought a temporary injunction to prevent the company from entering into any such transaction.

On 20th May, 2007 on one hand the shareholders were asked to approve and adopt the previously announced agreement of merger, dated 18th May, 2007, which if approved by Taro's shareholders, would result Taro Pharma become a wholly owned subsidiary of Alkaloida, and the holders of Ordinary Share of Taro will receive US \$ 7.75 per share in cash, without interest and less any applicable withholding tax. No consideration shall be payable to the holders of the Company's Founders Shares in exchange for their Founders Shares or their interest in Taro Pharmaceuticals U.S.A Inc (a subsidiary of the company).

On the other hand on the same day Taro and Sun announced that they have entered into a definitive merger agreement providing for the acquisition of Taro by Sun for \$ 7.75 per share in cash, a premium of 27 per cent over the closing price of \$ 6.10 per share on 18th May, 2007, representing a transaction with total equity value of approximately \$ 230

million. Sun will also refinance approximately \$ 224 million in net debt of Taro. The total enterprise value of the transaction is approximately \$ 454 million.

On 21st May, 2007 Sun pharmaceuticals, clinched the deal in its favor and signed an agreement to acquire Israel's generic manufacturer Taro pharma for \$ 454 million (approximately Rs 1837 crore), making it the second largest overseas acquisition by an Indian drug company. This is spite of the litigation by minority shareholders looming over the transaction and Taro's projection on posting a "substantial loss" for 2006 which were brushed aside by the senior officials of Sun Pharma. It was stated by Sun Pharma that the acquired company has an upside and can be made profitable through improved sales, product filings and efficiencies.

On 21st May, 2007 the temporary injunction requested by Templeton was rejected by the Israel District Courts wherein all the impediments to the Sun Pharma Ltd, acquiring Taro were cleared hence confirming the deal. As part of the court proceedings, Taro agreed to decrease the interim equity financing to Taro by acquiring 6,787,500 million of the company's ordinary shares at \$ 6.00 per share and three-year warrants to purchase 6,787,500 shares with an exercise price of \$ 6.00 per share.

Pursuant to the definitive merger agreement between Taro and Sun, a newly formed Israeli subsidiary of Sun will merge with Taro, and each ordinary share of Taro will be converted into the right to receive \$ 7.75 cash. The merger is subject to a number of terms and conditions, including the approval of Taro's shareholders and regulatory review. Merrill Lynch, Pierce, Fenner and Smith incorporated provided a fairness opinion to the Board of Directors of Taro in connection with the proposed merger. Sun Pharma will pay all shareholders, including the Levitt and Moros families, who founded the Company, \$ 7.75 for each ordinary share. There will be no consideration paid to Dr. Levitt for the Founders' Shares, which have one-third of the voting power in the Company.

The price of the deal was indicated to be appropriate and it would help Sun Pharma to scale up its generics business in the US, as Taro has more than 100 ANDA (Abbreviated New Drug Application) drug approvals in the US. It will also

help Sun Pharma penetrate into North America which accounts for about 90 per cent of Taro's sales and in other parts of US, Israel and Canada where Taro had subsidiaries and manufacturing facilities. Sun Pharma will fund this acquisition through internal accruals and proceeds from its \$ 350-million FCCB. The deal values Taro's equity at \$ 230 million. Sun Pharma will also refinance \$ 224 million in net debt of Taro. In addition, to provide immediate liquidity for Taro, the company will provide interim financing to the extent of \$ 45 million.

The Taro acquisition would bring into Sun Pharma's fold products in dermatology or skin-care, pediatrics, cardiovascular or heart-related medicines, neuropsychiatry and anti-inflammatory products. Taro recently reported 2005 sales of \$ 298 million and profits of \$ 5.7 million. Taro has invested over \$ 190 million in research, which amounts to 12-16 per cent of sales. After the merger on 21st May, 2007 the Sun Pharma on BSE scrip closed at Rs 1,064.15 up 5.03 per cent.

It has been indicated that for the purpose of this transaction, Sun Pharma has/will set up a 100 per cent subsidiary in Israel, which will ultimately be merged with the operating company in Israel. Further, the acquisition has been financed by internal accruals and convertible bonds issue raised in 2004.

5. Issue for Debate and Analysis

1. Was the evaluation of the official inventory from the judgments drawn according to information given by chargeback data the main reason for not providing the financial data for the year 2001 and 2002? Give reasons in support of your answer.
2. What is "roll back" analysis? How would it help to reassess the reserve levels of a company?
3. Would the ruling of Israeli District Court be binding on the Indian Pharma Company? Explain the impediments it can create in cross-border mergers.
4. What is Oppression of minority shareholders? Defend the case in favor of Sun Pharma under the relevant provisions of the Companies Act, 1956.
5. Analyse the advantage and disadvantage of the mergers vis-avis Sun Pharma and Taro Pharmaceutical Ltd in terms of future prospects of the company, R&D initiatives and the financial standing of the companies.