Will The Third Acquisition Be The Charm? Pfizer's Integration of Wyeth

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After enduring criticism for five years about its inefficient hoarding of cash, Pfizer acted in early 2009 to dispose of the cash in an acquisition of Wyeth. The $68 billion price tag showed the continuing daring attitude of Pfizer management. In 2000 and 2003 Pfizer spent $170 billion in acquiring Warner Lambert and Pharmacia. While Pfizer obtained immediate benefits from the two huge acquisitions, the firm's labs spent more time consolidating than producing new drugs. It appeared that Pfizer's labs were losing their ability to develop new blockbuster drugs, and that Pfizer had to obtain new drugs through acquisitions.

The case requires the consideration of an alternative strategy of acquiring small bio tech firms rather than Wyeth. The firm's practices of using cash to pay dividends and to purchase Pfizer common stock are examined and compared to dissimilar practices at Exxon Mobil and IBM.

PFIZER BURNS THROUGH CASH IN ITS 2009 WYETH ACQUISITION

For the past five years Wall Street analysts and portfolio managers encouraged Pfizer to deploy its large cash balances into more productive alternatives than money market instruments. Then on January 26, 2009 Pfizer announced plans to purchase Wyeth, the twelfth largest pharmaceutical firm in the world, for $68 billion, two-thirds in cash and one-third in Pfizer stock. The acquisition will not come cheap as the offering price has a 30+% premium on Wyeth's stock price a day before the offer. Pfizer plans to cut its generous dividend in half and borrow $22.5 billion for additional financing. Furthermore, Pfizer has not stated where its cash for the purchase will come from; it is widely suspected that most of Pfizer's December 2008 cash balance of $23.7 billion is held outside the US. If the cash is outside the US and if Pfizer repatriates much of the foreign held cash for the US purchase, those transfers could be taxed at a rate in excess of 30%.

Wyeth brings to Pfizer a modest pipeline of new drugs near introduction and its existing product line complements Pfizer's product line with a strength in biologics, vaccines, and some consumer products. Pfizer believes that Wyeth's consumer lines will diversify Pfizer's heavy emphasis on pharmaceuticals. This is an unusual justification for the acquisition after Pfizer sold its consumer line in 2006 for $16 billion ($13.5 in after tax cash proceeds) to Johnson and Johnson. Analysts were quick to see the different strategic approach by the two drug giants in 2006. Pfizer appeared to increase emphasis on drugs by selling its consumer lines, while Johnson & Johnson spread the risk of its business by adding to its already large consumer line, thus diversifying across its three major lines of drugs, medical devices, and consumer products. Pfizer seems to have changed its mind relatively quickly in getting back some consumer product lines.

Pfizer needs Wyeth's drug pipeline to replace Lipitor when it starts to lose patent protection in 2010. But it will be difficult to replace the largest selling drug in the world with sales at $12 billion per year. Pfizer will get a lineup of current drugs and a pipeline of drugs close to commercial introduction. When the firms are combined, Pfizer plans to save $4 billion on cost reductions. In early 2009 Pfizer showed how serious it was in cost cutting by eliminating some of its sizable sales force and for the first time even resorted to firing some of its scientific staff.

CHANGES IN THE PHARMACEUTICAL INDUSTRY

In addition to acquiring physical resources in the Wyeth acquisition, Pfizer buys time until a major change in the pharmaceutical industry takes hold. That is when biologics replace the chemical based pharmaceuticals. The huge and successful pharmaceutical industry of today has its origins in the chemical industry more than a century ago. Scientists mixed and sorted various chemicals and then watched patients for their reactions. It was something of trial and error process. The old or small molecule industry is being replaced by the large molecule or biologic industry. The chemical solutions frequently treated the symptoms of illnesses rather than the cause of illnesses. The biologic solutions use long strings of proteins, the building blocks of human cells, plus the human genetic blueprint to treat the cause of the illness rather than just the symptoms. This shift in the industry will probably take ten to twenty years to complete, but in the mean time Pfizer can develop and market the chemical solutions and use those successes to fund the future of large, biologic solutions.

The biologics industry is characterized by small start up firms working on a single or narrowly focused group of biologics versus the traditional drug industry with large firms such as Pfizer, Merck, and Wyeth with broad product lines. In the current economic slowdown, characterized by a drop in venture capital and private equity financing, these small R & D firms have been hit particularly hard. These firms are burning through cash and do not have many options to find the continuing financing they would have found in more normal times. Industry analysts believe the industry can be salvaged by the cash rich drug firms swooping in to pick up the small firms at great bargains. The large drug firms can gain a foothold in the emerging biologic industry and fund the research necessary to push the biologics revolution further.

EARLIER ACQUISITIONS OF WARNER LAMBERT AND PHARMACIA

The Wyeth acquisition is expected to close before the end of 2009, and it will follow two huge acquisitions Pfizer made in 2000 and 2003. In 2000 Pfizer purchased Warner Lambert for $116 billion with the intent of gaining full access to Warner Lambert's drug, Lipitor. Prior to the 2000 acquisition, Pfizer had a marketing arrangement with Warner Lambert to use Pfizer's large marketing force to sell Lipitor. Under Pfizer's marketing control, Lipitor quickly reached $12 billion in yearly sales in the early 2000s with a gross margin over 90%, and becoming the largest single drug in the world. In addition to the successful product, Lipitor, Pfizer acquired other drugs in the development pipeline, plus added scientific personnel, more labs and equipment.

After achieving the success of Lipitor and the various other additions from Warner Lambert, Pfizer was challenged to integrate the scientific staffs of Pfizer and Warner Lambert and to decide which labs, offices, warehouses to keep from the two asset bases. It would not be an exaggeration to state that the integration efforts continued for most of the decade after the acquisition in 2000. This was shown by various cost cutting and streamlining efforts beginning in 2001 and continuing into 2008.

The second major acquisition Pfizer made was that of Pharmacia in 2003 for $56 billion. Pfizer sought Pharmacia's pain killer drug, Celebrex, a developing blockbuster drug with sales over $1 billion per year. Celebrex's benefit would be reduced in 2004 when Merck recalled its similar drug, Vioxx, due to bad reactions suffered by users of Vioxx. Over the next five years Merck would fight the legal cases brought against it for harmful effects of Vioxx, but in the end Merck offered a settlement of $5 billion. The $5 billion settlement was much smaller than the $10-20 billion expense that was estimated early in the litigation process. Celebrex was never recalled but did suffer some loss of sales and some litigation.

As with the Warner Lambert acquisition, Pfizer acquired from Pharmacia other drugs in development, talented and dedicated staff, and various physical assets of a drug manufacturer. But Pfizer was again challenged to determine which staff stayed and which staff was let go, as well as which assets were kept and which assets were sold off. This integration process continued into 2008.

We can see the results of combining these three pharmaceutical firms by looking at total assets over the period and comparing capital spending to depreciation. In the

2008 Financial Summary in annual report we see total assets peaked at $125.8 billion in 2004 right after the Pharmacia acquisition. In 2005 assets dropped to $117 billion and they continued to decline each year until 2008 reaching $111.1 billion for a four year drop of $14 billion or 11%.

For each year of the six year period, 2003-2008 depreciation was greater than property, plant and equipment additions. In 2003 plant and equipment additions were $2.6 billion versus depreciation of $4.0 billion or capital additions replaced 65% of assets consumed during the year. Pfizer was disposing of excess assets by selling them or letting them depreciate and not replacing the worn out assets.

STRUGGLING EFFORTS IN PFIZER'S LABS

According to some analysts the last drug to come out of Pfizer's own labs is Viagra, a blockbuster drug with sales over $2 billion in 2008. Viagra was introduced in 1998. Since that time Pfizer has gone out and purchased drug developments from firms with visible drug successes. Pfizer can then use its vast marketing machine to turn the drug into a blockbuster.

We have to assume that the effort to integrate over $172 billion in acquisitions would be a challenge to Pfizer's management and absorb the time of many of it managers. The integration effort included products in development, scientific staff, and physical assets.

In a meeting with security analysts in January, 2007, Jeffrey Kindler, president of Pfizer, made clear that he aimed to slash the bureaucracy inside the world's largest pharmaceutical firm; he stated he needed someone to shake up the insular mentality and intractable bureaucracy (Johnson, 2007, Pfizer). In a *Fortune* online article in October 2007 Martin Mackay admitted that Pfizer's labs "lacked focus for too long" and that executives "were fixated on restructuring and integrating far-flung labs." (Simons, 2007, p. 1) Just two days before Mackay had been named the new science chief to run Pfizer's labs.

In a November, 2003 article in the *Harvard Business Review*, Richard Passov, treasurer of Pfizer, defended the firm's accumulation of cash as necessary to fund its research and development efforts (Passov, 2003). Shortly after the article appeared, Pfizer's December 31, 2003 balance sheet reported $12.0 billion in cash and short term investments. Pfizer was earning a low, safe interest rate but possibly missing opportunities for more profitable investment of the cash. From 2003 to 2008 Pfizer's cash balance continued to grow along with Wall Street analysts' call for the firm to use the cash more productively and earn more than a money market rate of return on it.

TWO MAJOR FAILURES IN THE LABS

The first failure was the firm's termination of phase III trials (the last human trials) for torcetrapib (t-pib) in December 2006. The drug was a contender to replace Lipitor, the world's largest drug and 25% of Pfizer's sales, which would start to lose patent protection in 2010. Pfizer worked on the drug for years and had invested over $800 million in its development. The drug acted to increase the good cholesterol in the blood, while Lipitor reduced the bad cholesterol. A hoped for medication would combine both t-pib and Lipitor in one pill, thus increasing the good and decreasing the bad cholesterol.

The phase III tests resulted in an elevated number of deaths for those on the medication versus those just on Lipitor. The cancellation was a huge disappointment for Pfizer's management and investors. The stock dropped near 10% on the day of the announcement, a huge drop for the largest pharmaceutical firm in the world. This write-off shows the frightening risks of the pharmaceutical industry when a product in its last stage of trials can prove to be a bust.

Less than a year after the T-pip failure a second major disappointment for Pfizer's R&D efforts was the decision in the third quarter of 2007 to drop the marketing of Exubera, an inhalable form of insulin for the treatment of diabetes. Total pretax charges for the write off were $2.8 billion.

Pfizer had started work on inhalable insulin in 1996 and was confident Exubera would reach yearly sales of $2 billion by 2010. The drug has passed rigorous reviews by the Food and Drug Administration and was being marketed to the medical profession. Initial sales of $12 million in 2007 were way below expectations and management realized there were too many problems in trying to resuscitate the drug. Drug companies routinely stop efforts on a drug while it is being developed in the labs or subsequently tested on humans. But to drop a drug early in its marketing stage, after all the testing and government reviews, is unusual. One Wall Street analyst referred to canceling Exubera as "This is one of the most stunning failures in the history of the pharmaceutical industry." The Wall Street Journal referred to the flop as almost unprecedented (Johnson, 2007, Insulin).

Though the Pfizer labs did not produce any blockbuster drugs in the past six years, Pfizer cannot be faulted for reducing R&D spending. It normally spends over $7 billion a year on R & D, more than any other pharmaceutical firm in the world. For the period 2003-2008 Pfizer spent a total of $45.7 billion on R & D efforts or an average of $7.6 billion per year. Over the six year period from 2003 to 2008 Pfizer has not noticeably changed its commitment to R&D spending either in nominal amount or percent of sales.

OTHER WAYS PFIZER SPENDS ITS CASH

Cash Dividends

While we can say Pfizer kept a consistent course with spending on R&D either in dollar amounts or percentage of sales, the same cannot be said about its policy on dividends. Over the period 2003-2008 Pfizer paid dividends starting at $4.4 billion and increasing to $8.5 billion in 2008. The dividends per share started at $.60 and increased to $1.28 in 2008. Over that six year period both the total dividends and dividends per share doubled. In mid 2008 Pfizer's dividend yield was 6.67% versus the drug industry at 3.37% and versus the S&P 500 at 2.18%, indicating that Pfizer's dividend yield was the highest of the major pharmaceutical firms. As the years progressed stockholders were amply rewarded through cash dividends for holding the stock. (Exhibit A)

Common Stock Purchases

Over the period 2003-2008 Pfizer spent $41 billion in buying back its own common stock. While spending on R & D was constant during the period and moderately increasing for dividends over the period, the amount spent on common stock purchases varied widely year to year. The lowest amount spent was $500 million in 2008 versus the largest amount of $13 billion in 2003. With these purchases of its own common stock, Pfizer increased its holdings of treasury stock by 1.450 billion shares. If we take 2009's net income of $8.104 billion and diluted EPS of $1.20, then the reduction of 1.450 billion shares in the denominator of the EPS calculation, we get an increase of $.21 in EPS or 21% increase in EPS.

Pay Down Debt

In theory this is a choice for Pfizer to use its cash, but it is severely limited. Over the period 2003-2008 long term debt on the yearend balance sheet has averaged $6.7 billion, with a range of $5.5-$8.0 billion. For the same period the short term borrowings on the yearend balance sheet have averaged $8.2 billion, with a range of $2.4-$11.6 billion. There is no clear trend of reducing either the long term or short term debt, with both categories of debt increasing for two years after 2003, leveling off for two years, and then increasing again in 2008. The increase after 2003 may be due to the Pharmacia acquisition and the increase in 2008 may be in anticipation of the Wyeth acquisition.

HOW HAVE OTHER INDUSTRY LEADERS SPENT LARGE CASH

BALANCES

Let's look at choices taken by two other firms with large cash balances that were criticized by Wall Street for inefficient use of cash. These two firms are in very different industries from Pfizer, but like Pfizer are viewed as investment blue chips in the Dow 30 Industrial Average.

Exxon Mobil's Example

For at least the past three years Exxon has been in a similar position to Pfizer in that it had built up a huge cash balance from years of success in managing its business. Exxon did not choose to take on large acquisitions as did Pfizer in the past nine years. Exxon invested its excess cash in increasing dividends and purchases of its common stock. The last major acquisition for Exxon was that of Mobil in 1999, when Exxon leveraged its large cash balance during a period of low oil prices and lower stock prices to acquire Mobil. It was a fortuitous blend of events that allowed Exxon to take over a major oil firm like Mobil.

Over the period 2003-2008 Exxon Mobil spent $37.4 billion on dividends, starting at $6.9 billion in 2004 and gradually increasing each year until 2008 with dividends of $8.1 billion.

Over the period Exxon Mobil spent $125.3 billion on purchases of common stock. The amount starts at $10 billion in 2004 and increases dramatically over the later years until it is $35.7 billion in 2008. If we were to value Exxon Mobil's holding of its own common stock in early 2009, the market value of that stock was equal to the market value of either GE or Microsoft.

Through the past six years Exxon Mobil has acquired firms, but the acquisitions have been in the single digit billion dollar range. (Exhibit B)

IBM's Example

Over the period 2003-2008 IBM spent $9.4 billion on dividends, starting at $1.1 billion in 2003 and gradually increasing each year until larger increases in 2006-2008. The dividend in 2008 was $2.6 billion.

Over the same period IBM spent $56.8 billion on purchases of common stock, averaging $9.5 billion per year. The amount starts at $4.4 billion in 2003 and increases each year, except for 2007 to 2008. The common stock purchases in 2008 were $10.6 billion.

Through the past six years IBM has acquired firms, but the acquisitions have been in the single digit billion dollar cost range. (Exhibit C)

EXHIBIT A

Pfizer Financial Information for 2003-2008 (Dollar Amounts in Millions)

	2008	2007	2006	2005	2004	2003	Total
Sales	48,296	48,418	48,371	47,405	48,988	41,787	283,265
Net income	8,104	8,144	19,337	8,085	11,361	3,910	58,941
CFO	18,238	13,353	17,594	14,733	16,340	11,727	91,985
Dividends	8,541	7,975	6,919	5,555	5,082	4,353	38,425
Capital spending	1,701	1,880	2,050	2,106	2,601	2,629	12,967
Depreciation	5,090	5,200	5,293	5,576	5,093	4,025	30,277
Total assets	111,148	115,268	115,546	116,970	125,848	111,131	
Stock purchases	500	9,994	6,979	3,797	6,659	13,037	40,966
Div/share	$1.28	$1.16	$0.96	$0.76	$0.68	$0.60	
EPS diluted	$1.20	$1.17	$2.66	$1.09	$1.49	$0.54	
Acquisitions	1,184	464	2,320	2,104	2,263	55,871	64,206
R & D expense	7,945	8,089	7,599	7,256	7,513	7,279	45,681
Long term debt	7,963	7,314	5,546	6,347	7,279	5,755	
Short term debt	9,320	5,825	2,434	11,589	11,266	8,818	

EXHIBIT B
Exxon Mobil Financial Information for 2003-2008 (Dollar Amounts in Millions)

	2008	2007	2006	2005	2004	2003	Total
Sales	459,579	390,328	365,467	358,956	291,252	237,054	2,102,636
Net income	45,220	40,610	39,500	36,130	25,330	21,510	208,300
CFO	59,725	52,002	49,286	48,138	40,551	28,498	278,200
Dividends	8,058	7,621	7,628	7,185	6,896	6,515	43,903
Capital spend.	19,318	15,387	15,462	13,839	11,986	12,859	88,851
Depreciation	12,379	12,250	11,416	10,253	9,767	9,047	65,112
Total assets	228,052	242,082	219,015	208,335	195,256	174,278	
Stock purch.	35,734	31,822	29,558	18,221	9,951	5,881	131,167
Div/share	$1.55	$1.37	$1.28	$1.14	$1.06	$0.98	
EPS diluted	$8.69	$7.28	$6.62	$5.71	$3.89	$3.23	
Acquisitions	2,495	3,038	2,604	2,810	2,287	809	14,043
R & D expense	7,945	8,089	7,599	7,256	7,513	7,279	45,681

EXHIBIT C
IBM Financial Information for 2003-2008 (Dollar Amounts in Millions)

	2008	2007	2006	2005	2004	2003	Total
Sales	103,630	98,786	91,424	91,134	96,293	89,131	570,398
Net income	12,334	10,418	9,492	7,934	7,479	6,558	54,215
CFO	18,812	16,094	15,019	14,914	15,349	14,537	94,725
Dividends	2,585	2,147	1,683	1,250	1,174	1,085	9,924
Capital spending	4,171	4,630	4,362	3,842	4,368	4,398	25,771
Depreciation	4,140	4,038	3,907	4,147	3,959	3,961	24,152
Total assets	109,524	120,431	103,234	105,748	111,003	106,021	
Stock purchases	10,578	18,828	8,084	7,671	7,275	4,403	56,839
Div/share	$1.90	$1.50	$1.10	$0.78	$0.70	$0.63	
EPS diluted	$8.93	$7.18	$6.11	$4.87	$4.38	$3.74	
Acquisitions	6,313	1,009	3,799	1,482	1,738	1,836	16,177
R & D expense	7,945	8,089	7,599	7,256	7,513	7,279	45,681

Exhibits A, B, C source: Annual Reports of Pfizer, Exxon Mobil, and IBM.
CFO- Cash flows from operating activities
Depreciation- depreciation expense for the year from the cash flow statement

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