The Street

Greenberg: Will Valeant Overdose on Acquisitions?

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01/16/14 - 09:12 AM EST

This story first appeared on Real Money at 9:00 AM on Jan.15.

SAN DIEGO (TheStreet) -- If you've never heard of **Valeant Pharmaceuticals** (VRX), maybe you've heard of its predecessor Biovail, which for years was among the most controversial drug companies. Or perhaps you've heard of the more than 60 acquisitions Valeant has done in six years, including its most recent deal -- to buy Bausch & Lomb, the maker of eye-related products.

It's a classic and unabashed rollup of companies in the specialty pharma sector -- and, with the Bausch & Lomb deal, pharma in general, if not more.

Valeant has a top-notch roster of investors, including ValueAct, and its stock has been nothing short of a jaw-dropper. And for good reason: The company has executed on a strategy of creating growth in pharmaceuticals by emphasizing acquisitions rather than expensive research and development.

The role of serial acquirer started under CEO Michael Pearson, a former McKinsey consultant who joined the company in 2008. The transaction with Canada-based Biovail, which technically bought Valeant, was a pivotal one -- not because of Biovail's products, but because of its uber-low tax structure, thanks to its biggest subsidiary being based in Barbados. That tax structure has since been restructured to include Bermuda and other countries. Its tax rate of around 3% gives it an edge on the roughly 20% tax rate of its peers.

Since Pearson's arrival, Valeant's market value has zoomed to more than $40 billion from around $1 billion previously. With this, the company has reached what Pearson had called a "high-aspiration" goal of Valeant becoming among the top 15 pharma companies by the end of 2013.

Upping the 'Aspirational' Ante

With that target reached, the company has upped the "aspirational" ante, saying that it wants to be among the top five pharma companies by the end of 2016. This would mean Valeant more than tripling its market value (and, by suggestion, its stock), to a market cap of $150 billion.

Quizzed by an analyst on a recent earnings call on just how Valeant intends to get there, Pearson said: "We can't predict the path that will get us to the $150 billion, per se. But we find it's very helpful to set a structure of aspiration. It's something that we've done every year, and it gives our investors a sense of where we're trying to go. And unless you aim high, you don't achieve high."

What's clear, however, is that achieving this will involve acquisitions, including what the company calls a "significant deal" this year -- possibly a merger of equals.

So why dare hoist a yellow flag, especially when a company is talking about doing all it takes to, in effect, more than triple its stock price?

Foolhardy to Ignore Risk

The reason is: It's foolhardy to ignore the risk in any growth-by-acquisition company, especially one whose growth has been as speedy (and, some might say, increasingly cocky) as that of Valeant.

There are already signs of stretch, notably in organic growth -- the growth of companies and products once they've been acquired. This is an important metric for rollups, because it shows a parent company's true growth sans acquisitions. At Valeant, the stated goal is "positive" organic growth, but last quarter -- based on a reconciliation provided by the company in its earnings release -- organic growth tumbled 9% as a few generic drugs turned in sickly results. In all of last year it was down 2%.

The organic performance is worse if you turn to the "pro forma" results in the company's 10-Q reports, Valeant's formal accounting for companies as if they had been owned for a year. This shows three quarters of consecutive declines in growth, with a 5% slide last quarter.

Organic Growth Without the Bad Stuff

That's where it starts to get interesting -- and where it has gotten my attention. As organic growth has slowed, Valeant has decided to change the way it reports organic growth by leaving out the bad stuff.

Speaking on the last earnings call, Pearson said: "As we move forward we will continue to show organic growth without the impact of significant generics and also to disclose the quarterly revenue impact of products excluded from the calculation. We believe that this presentation will facilitate investors in modeling our revenues going forward."

Instead, the company directs investors to an organic-growth table in its earnings releases that lets them do their own math in order to get to a better read on genuine organic growth.

And, of course, there are always the pro forma tables in the 10-Qs, which the company doesn't spotlight. (Either way, not to worry, the company says: Organic growth next year will get better, as the poorly performing generics have easier comparisons.)

That gets to the bigger issue that faces every growth-by-acquisition company -- and the question I ask of every rollup: What happens when the acquisitions slow or stop?

'Don't Call Us a Rollup'

"Who says they have to stop?" A Valeant spokeswoman responded. She added that Valeant doesn't "believe we're a rollup strategy." She compared it to the funeral-home industry, where the consolidating companies have a finite number of funeral homes to buy. "Healthcare is a multi-trillion-dollar industry. We don't think anybody will be rolling it up anytime soon. We think there are an unlimited number of acquisitions out there."

Perhaps, but it has come at the price of a balance sheet. Thanks to low interest rates, Valeant's debt has ballooned to $17 billion last quarter from $4.9 billion two years ago, and from $2.6 billion in 2008, when the deals started.

Given the astronomical debt, the next big deal or deals, the company says, could also be done with stock. Good thing, because as ***Veritas Investment Research*** analyst ***Dimitry Khmelnitsky*** writes in a research report, "Net debt is rising faster than cash flows." More specifically, that's the company's preferred "adjusted" cash flow, which excludes restructuring, acquisition and other costs. (I would argue that for companies that are constantly acquiring as part of their strategy, those costs count. But I digress.)

Khmelnitsky, a forensic accountant, has been scrutinizing Valeant's accounting since 2011.

Low Taxes Sustainable?

Khmelnitsky's concerns include the company's tax structure, which allows for the low taxes.

"In our opinion," he writes, "the risk to the sustainability of the Company's tax rate remains high." He explains that Valeant's tax structure "relies heavily on transferring the acquired intellectual property offshore and using transfer pricing arrangements to reduce the taxable profits in high tax rate jurisdictions such as U.S. and Canada."

With such a structure, he continues, "there seems to be little business substance beyond tax planning in Valeant's offshore tax structure, which in our experience increases the risk of reassessment."

The company's accounting for its taxes caught the attention of the **SEC**, as has been laid out in a series of correspondences in recent months. The upshot: Valeant, whose headquarters are in New Jersey, will add a new, somewhat confusing and complicated disclosure to its disclosures.

Not that it matters.

Reality Check: Valeant's stock could continue its rock star status for five weeks, five months or five years.

I have no idea which one it will be, and neither do its investors. This is a classic game of investor chicken. For investors who don't own Valeant, the risk is in missing a stock that, based on the company's "aspirations," could shoot sharply higher. Investors who own it, on the other hand, risk getting lulled into complacency by an "aspirational" management that appears to have slipped into the trap of believing its own press clippings.

With rollups, you just never know. That's because all fundamental analysis and modeling, no matter how compellingly cautious, or complex, takes a backseat to a stock priced for the next deal.

That was evident when the stock spiraled even higher after the company offered up 2014 guidance that was at the low end of consensus.

Even then, Valeant is back-end-loaded to the last half the year as this R&D-shy company spends on R&D -- all of which is noise to investors who only seem to care about one thing: the next deal.

And make no mistake about it: In order for Valeant to make its stated internal rate of return of 20%, there must be more deals. "As the company grows, the acquisition treadmill keeps getting faster and faster," ***Khmelnitsky*** writes.

Trouble is, for those of us who have been around for more than a cycle, we've seen this before. Think of conglomerates and rollups like LTV, Allegheny International, **Tyco** (TYC), the old **Waste Management** (WM), funeral-home consolidator **Service Corp. International** (SCI) at the peak of its rollup heyday and, more recently, **Nuance Communications** (NUAN). No management yet has been able to outsmart every other manager that has gone the same rollup route. They almost all reset.

With Valeant, I believe, everything has to go just right.

If interest rates rise, its debt-bloated balance sheet becomes less attractive for deals. That leaves its stock as currency, as long as it remains elevated -- and as long as it doesn't involve issuing new stock, which would dilute existing holders. At the same time, as ***Khmelnitsky*** notes in a recent report, "M&A activity seems to be heating up across the pharmaceutical sector." That could make acquisitions more expensive. Among those taking a page out of Valeant's book, and possibly vying for similar deals: **Endo Health Solutions** (ENDP), dubbed by some as the son of Valeant. Last year, the company hired former Valeant President Rajiv De Silva as its new CEO.

Add to all of that: Valeant is now on the hook, for credibility's sake, to get its market value to $150 billion by the end of 2016. "Is the task of growing from $1 billion to $40 billion in six years more difficult than the task of growing from $40 billion to $150 billion in three? I don't know," Pearson said at a recent conversation with Goldman Sachs analyst Gary Nachman. "People have always been skeptical and . . . our investors are rooting us on and others are rooting against us. That's life."

Indeed it is, especially with companies pumped up on the stock-market equivalent of steroids.

-- Written by Herb Greenberg in San Diego

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