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VOX

Why Valeant needs a big dose of Allergan

DAVID MILSTEAD

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David Pyott is not, shall we say, an unbiased evaluator of Valeant Pharmaceuticals International Inc. As chairman and CEO of Allergan Inc., he and the company's board have decided that they very much do not want to accept Valeant's acquisition proposal, for a number of reasons.

One of them, Mr. Pyott said in a letter to Valeant chairman and CEO Michael Pearson, is that they do not believe Valeant's business model is sustainable. This is bold talk about a company that has delivered shareholder returns of more than 1,000 per cent over the past five years.

But while Mr. Pyott may be the most prominent Valeant skeptic, he is not the first. The company's philosophy of growth through relentless acquisition, coupled with its messy financial reports, have given conservative investors heartburn throughout Valeant's period of rapid growth. So far, they have been wrong – or, perhaps, they've just been right too early, which is often the same thing.

Count me among them. This column first expressed doubts about Laval-based Valeant in April, 2012, sharing the concerns of the analysts at **Veritas Investment Research** when Valeant traded at around \$50. I reiterated them in June, 2013, with the shares at \$85. And we will do it again today, with the shares at \$138.22.

The original **Veritas** critique was of a company that had made a series of choices in its accounting and its financial presentations that boosted sales-growth and earnings numbers. While **Veritas** observed that the company's formal financial statements are compliant with U.S. generally accepted accounting principles, its news releases have emphasized a number of non-GAAP metrics. Unsurprisingly, bad stuff, such as expenses, got excluded, and good stuff, such as one-time gains, got included. Strip away many of Valeant's adjustments, and the sheen on the growth story faded away. (Valeant has repeatedly declined to comment on analyst opinions.)

Veritas's criticisms are not as sharp these days, for a number of reasons. One is that as Valeant has continued to grow rapidly, the accounting choices of 2011 make far less of an impact on the Valeant of 2014. Another is that Valeant has dialled back some of its more aggressive choices in calculating the numbers it emphasizes. And, yet another is that, to Valeant's credit, its cash flow now more closely matches its preferred profit metrics, giving more legitimacy to Valeant's chosen numbers.

There remains, though, the matter of Valeant's "organic" growth, or the year-over-year sales of its existing pharmaceutical products, independent of all the deal making that's driving the top line. Valeant reported organic revenue growth of 1 per cent in 2014's first quarter, which was better than expected. But **Veritas' Dimitry Khmelnitsky** says a better measure of organic growth should also reflect the prior-year sales of products that have since been discontinued. (Look at it this way: If McDonald's stopped selling the McRib in September, we should still include all the sandwiches sold in last year's first quarter in assessing the change in restaurant revenue.)

When **Mr. Khmelnitsky** includes those sales, he figures Valeant's organic revenue declined at a 2.5-per-cent rate in the first quarter. This is remarkably uninspiring for what is supposed to be the pharmaceutical industry's big growth story.

Few investors have listened to these criticisms, and even fewer have cared, as evidenced by the performance of Valeant shares. The rising stock gives the company a powerful acquisition currency, in conjunction with historically low interest rates on its junk-rated debt.

It is a currency, however, that Mr. Pyott and the Allergan board are unwilling to accept. Mr. Pyott's letter says the Valeant offer's "large stock component ... is a risk for Allergan stockholders." They've been around long enough to know that companies who buy rather than build have to keep seeking bigger and bigger prey, until one day the acquisitions are just too big to properly integrate. The history of investing is littered with failed merger-driven enterprises.

It is Valeant's view that this time is, well, different. Mr. Pearson, in his response Tuesday, said: "Allergan offered a business-as-usual strategy while attempting to discredit our company. The silver lining of such an approach is that Allergan shareholders now have two very different options to consider and choose between."

Indeed. If Allergan shareholders wanted to invest in Valeant, they could have done so already. Actually, it can be said that Valeant's shareholders need Allergan much more badly than Allergan's need Valeant.