THE GLOBE AND MAIL

September 30, 2015

Is the great Valeant success story unravelling?

It is only Valeant Pharmaceuticals' amazing rise to a market value of almost $120-billion that makes its decline over the past month look like a mere stumble. After all, $50-billion in capitalization – what Valeant lost between its Aug. 6 high and Tuesday's low – is more than all but five other companies in the S&P/TSX composite index. It's like an entire BCE gone poof.

That track record of shareholder gains means that Valeant's boosters are out in force calling this drop a chance to snap up the shares. BMO Nesbitt Burns analyst Alex Arfei, who was among at least a half-dozen analysts to reiterate "buy" ratings on Valeant this week, headlined his note Fear and Uncertainty Create Another Buying Opportunity. For Valeant skeptics, however, the recent declines prompt a decidedly different reaction: Are investors finally coming around to the risks inherent in the company's much-praised business model?

Let's get something out of the way, right away: For years, Valeant has been making its critics look like chumps. I am one of those chumps, I admit freely. Even with the decline from $347.84 in August to $238.20 Wednesday, you would have made healthy gains if you ignored my warnings about the company's accounting in April, 2012 (when Valeant was at $50 a share), my June, 2013, reiteration of those concerns ($85), or my May, 2014, comments about the proposed acquisition of Allergan($138).

Valeant's success is a result, in no small part, to its rejection of one of the core philosophies of the pharmaceutical industry; namely, you need to spend money on research and development to create new drugs and succeed. Instead of spending much money on it, Valeant spots already-developed drugs it likes and buys the company, keeping the products and often laying off many of the employees staff.

At the same time, its Canadian incorporation and its corporate structure save it a ton of taxes: The company's effective tax rate is in the low single digits, versus roughly 20 per cent for peers. Meanwhile, the success of the shares has made CEO Michael Pearson a billionaire.

That particular combination has made Valeant a repeated target of U.S. politicians. Its shares' recent fall came amid a downdraft for all pharmaceutical companies as presumptive Democratic presidential nominee Hillary Clinton made negative comments about prescription drug price "gouging" and a public backlash developed against Martin Shkreli, the CEO of Turing Pharmaceuticals, who raised the price of a parasitic infection drug to $750 (U.S.) a pill from $13.50.

Monday's sharp fall in Valeant's shares came after 18 Democratic members of Congress compared Valeant's business model to that of Mr. Shkreli and said they want both executives to testify before the House Committee on Oversight and Government Reform.

BMO's Mr. Arfei notes that the chairman of the committee is a Republican, not a Democrat, and seems unlikely to co-operate with the calls for a hearing. Even if Valeant is raked over the coals on Capitol Hill, BMO's Mr. Arfei said, "it is very unlikely to lead to new pricing regulations for pharmaceuticals. Once we get past the political grandstanding and the negative headlines, we believe the focus will shift back to Valeant's fundamentals."

Mr. Pearson, in a letter to employees that was also filed with U.S. securities regulators, says the current "bear thesis" that Valeant is dependent on large drug-price increases and is exposed to potential cuts in U.S. government drug reimbursements "is incorrect … Valeant is well-positioned for strong organic growth, even assuming little to no price increases. … We have consistently pursued profitable growth through diversification, strong execution and financial discipline while minimizing exposure to governmental policy changes and volatility."

Let's look at fundamentals, growth, and execution. My past critiques centred on Valeant's presentation of its earnings and whether it gave the best possible picture of its financial performance. Since 2012, Valeant has dialled back some (but not all) of the aggressive choices it made in reporting its numbers, and its cash flow often better matches its reported earnings.

Organic growth remains a question, however. ***Veritas Investment Research's Dimitry Khmelnitsky*** previously observed that Valeant was not counting discontinued drugs in its organic calculations, helping boost the numbers. More broadly, he says, "the growing reliance on the acquired pipeline means that VRX's 'organic' growth critically depends on new acquisitions in the longer term."

I'd like to add my own bit of research: I went to Standard & Poor's Capital IQ and checked out Valeant's EBITDA, or earnings before interest, taxes, depreciation and amortization. This is Capital IQ's calculation, not Valeant's own heavily adjusted "cash earnings" metric.

From 2005 to 2014, Valeant reported cumulative EBITDA of $12.25-billion. Over the same period, in lieu of heavy R&D expenditures to develop its own drugs, it spent $12.1-billion on cash acquisitions. The net number of adjusted profit, in my view: $150-million, total, over the course of a decade. To be fair to Valeant, this analysis fails to recognize the future profits these acquired drugs will generate. My response to that, though, is that if Valeant is a perpetual acquisition machine, constantly plowing all the money it makes back into deals, there are never any real profits for the shareholders, or to truly support the valuation of $61.2-billion ($81.2-billion Canadian.)

To pay for its deals, Valeant has now pumped up its debt, to more than $30-billion at June 30, and now pays more than $1-billion a year in interest expense – which, you recall, is not reflected in EBITDA, because the "I" stands for "interest."

In this happy October of the Blue Jays' first postseason in more than two decades, some baseball analogies: A recent article on the website of U.S. business channel CNBC compared Valeant and Mr. Pearson to the*Moneyball* Oakland As and their general manager Billy Beane, who overachieved by acquiring players undervalued by other teams. Similarly, Mr. Pearson is quoted in the article, "We've always, from the very beginning, looked for assets we believe have been underappreciated."

I have another, different team in mind: The New York Yankees of the late 1970s and early 1980s. They outspent everyone in the early days of free agency, snapping up superstars and neglecting their own farm system. The team went to the World Series three times, winning twice, but afterward spent more than a decade in the wilderness when its players got old and they'd developed none of their own homegrown players to replace them.

The Yankees returned to winning championships by reversing their strategy. For now, Valeant is content on staying the same course. Time will tell whether it can return to Yankee-like dominance.