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The Lone Analyst Who Said Sell Valeant When Hedge Funds Piled In

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The Valeant Pharmaceuticals headquarters in Bridgewater Township, New Jersey.

In July 2014, ***Dimitry Khmelnitsky*** advised investors to sell Valeant Pharmaceuticals International Inc. and then watched the stock double in a year.

"It was very painful," ***Khmelnitsky***, an analyst at ***Veritas Investment Research Corp***., said in an telephone interview from his office in Toronto. "What I felt was pain."

Khmelnitsky was the lone analyst with a sell rating on Valeant for 20 months, sticking to his recommendation through the bull market as star hedge-fund managers including Bill Ackman piled in. Now that Valeant has plummeted almost 75 percent since its August 2015 peak of $262.52 -- as scrutiny intensified over its soaring drug prices, accounting and controversial distribution system -- the downturn has vindicated his research. Yet the analyst, an accountant by training and a former soldier in the Israeli army, doesn't see it that way.

"It was a mixed feeling of being justified in our prior analysis, but obviously I was feeling pain for all those investors who jumped into Valeant," ***Khmelnitsky*** said.

Veritas, a research firm, started covering Valeant more than four years ago, about a year after the drugmaker relocated to Laval, Quebec, through its acquisition of Biovail Corp.

Organic Revenue

In December 2011, ***Khmelnitsky*** issued his first report, “A Valiant Story.” He wrote that Valeant’s methodology to calculate organic revenue -- which excludes acquisitions -- didn’t result in apples-to-apples comparisons, and boosted the reported growth.

“Management guides investors to the Company’s non-GAAP metrics for assessing its business prospects and evaluating current performance,” he said. “However, our review highlights the unreliable nature of these avowed metrics.”

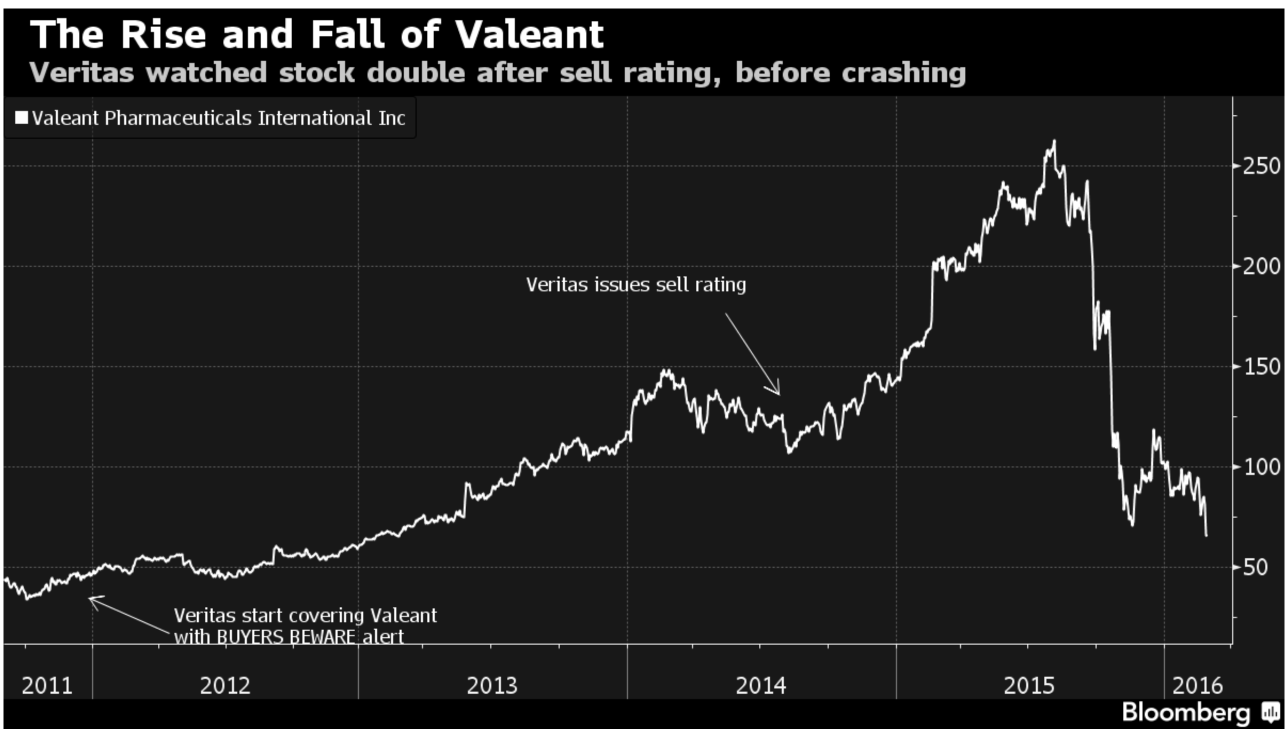
Although ***Khmelnitsky*** didn’t give a rating on the shares at the time, he ended the note with “BUYERS BEWARE.” The stock was trading in the $40s at the time.

A Valeant spokeswoman declined to comment.

Buying Spree

The analyst, who joined ***Veritas*** from Ernst & Young in 2006, continued to raise questions about the company over the next two years as Valeant went on an acquisition spree and the stock price soared above $100.

“Valeant’s underlying business is deteriorating,” he wrote in November 2013, without giving a rating. “Most importantly, in our view, the recent results offer a glimpse into the future, if and when the acquisition music stops.” The stock kept rising.



On July 23, 2014, ***Khmelnitsky*** issued his first sell call, with a target price of $112. The stock had closed the previous day at $122.54, with 17 analysts rating the shares buy and three hold, according to data compiled by Bloomberg. Valeant at the time was pursuingBotox-maker Allergan Plc -- a deal it lost out to Actavis Plc.

“Investors need to solely rely on management, as it is near impossible to independently confirm the results of most of the company’s acquisitions,” he wrote in a note titled “Desperately Seeking Allergan.” “An investment in Valeant was and remains a matter of faith.”

Activist Investors

Valeant -- which counts Ackman’s Pershing Square Capital Management, activistinvestment firm ValueAct Capital Management and hedge fund Paulson & Co. amid its biggest shareholders -- is currently the only company on which ***Khmelnitsky*** has a public recommendation. He says he doesn’t cover a set number of stocks and that his accounting analysis encompasses various industries. The analyst, who focuses primarily on Canadian companies, writes extensively about issues like pension deficits, tax structures and the quality of key non-GAAP metrics.

Changing Tone

Khmelnitsky reaffirmed his rating on Valeant 10 times before the stock’s peak in August of last year. Then, in October, Valeant was asked about its relationship with a mail-order pharmacy, Philidor Rx Services, that raised questions about the drugmaker’s business practices. The stock started to fall, dropping as the Philidor news dragged on, Congress started investigating its soaring drug prices, and Chief Executive Officer Mike Pearson went on sick leave in late December. Valeant eventually cut ties with Philidor, citing concerns raised about the pharmacy’s business practices. It plans to restate some earnings related to sales through the pharmacy.

Yet until about two weeks ago, when David Maris of Wells Fargo initiated his coverage of the stock at underperform, ***Khmelnitsky*** remained alone in his analysis of the stock.

Valeant has since plunged further, after it surprised investors Sunday night by withdrawing its financial forecast, delaying fourth-quarter results and announcing Pearson’s return from medical leave. The drugmaker also disclosed a new U.S. Securities and Exchange Commission probe on Monday afternoon. The stock is now tradingalmost 75 percent below its price in August, and closed Tuesday at $65.45.

Some sell-side analysts have started to change their stance. This week, RBC Capital Markets cut its rating on the stock to sector perform, Canaccord Genuity cut its rating to a hold, Jefferies lowered its target price, and Deutsche Bank suspended its rating.

“There was a lot of soul searching,” ***Khmelnitsky*** said of the time when he was the only one with a negative rating. “You start questioning yourself. I came to the conclusion that my analysis was right and I stayed with the call.”