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Valeant Write-Downs Next?

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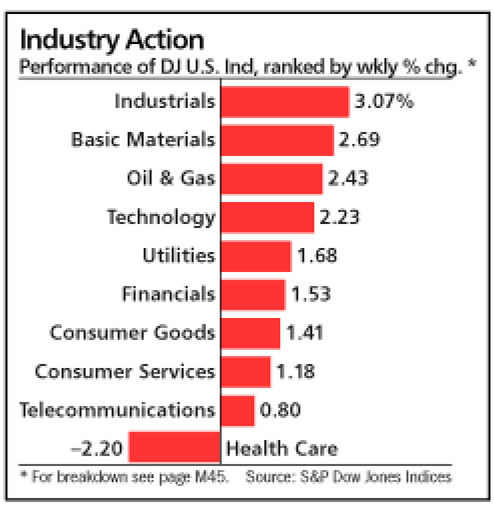
There's not enough room to outline the many serious woes—many self-inflicted and listed in previous columns—that have harmed Valeant (ticker: VRX), whose shares plunged 60% last week to $27 from $70—and were $264 last summer. But for those who read the regulatory filings closely, as *Barron's* recommended in June 2014, enough of the problems were foreseeable to have avoided most of the pain.

In the latest shock, Valeant last week reduced its 2016 revenue and earnings-per-share outlook to $11.1 billion from $12.6 billion and $10 from $13.50, respectively. More stunning was the warning of a possible debt default because Valeant might not be able to file certain regulatory documents on time. Creditors are unlikely to play hardball right away, but the prospect casts a long shadow.



The most important problem seems obvious: Valeant's vaunted business model was badly flawed. It's now been abandoned. But common sense suggests its problems are unlikely to be fixed quickly, particularly without a change in top management. That's reason No. 1 to avoid the shares.

Valeant's modus operandi was to pay top dollar for already-successful drugs, eviscerate research-and-development spending, and use permitted but aggressive accounting to push those costs onto the balance sheet instead of through the income statement. To make more acquisitions, it leveraged up—net debt is now about $30 billion, compared with a $9 billion market value. Valeant then sharply raised prices to get revenue growth, dismissing the need to invest in R&D to make more or better products.
What part of that seems like a reasonable model for a drugmaker?

Dimitry Khmelnitsky, an analyst at ***Veritas Investment Research***, says that whatever "trust remained in Valeant's numbers and in the sustainability of its business model has been shattered." Most of the key risks have yet to be addressed, says ***Khmelnitsky***, the rare analyst with a Sell rating on Valeant last summer, before the stock cratered.

Blame the drop in market value, to $9 billion from $90 billion at the high, and the business disarray of the past six months, on the unsustainable nature of Valeant's operating model, he adds.

Now that the stock is down nearly 90% from highs, Valeant has curtailed acquisitions, is selling assets, and is focusing on paying down that debt. Under such a scenario, its long-termgrowth rate is likely to be a mid-to-low single-digit figure, at best.
Some point to possible asset sales creating value. But with Valeant under investigation by the Securities and Exchange Commission and two U.S. Attorneys General, what company would risk buying into that? Valeant isn't in a position to get top dollar.

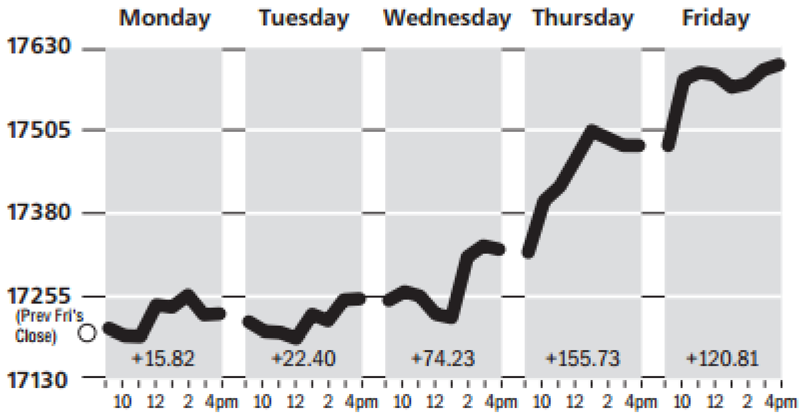
Our hunch is that the worst is still to come. For example, with revenues and earnings growth slowing at the assets for which Valeant overpaid, write-downs might be next, says Vicki Bryan, a Gimme Credit analyst. That would be blowback for effectively turning R&D costs into acquisition goodwill on the balance sheet. As of the third quarter, Valeant had $40 billion in goodwill and other intangibles on its balance sheet, "with a significant wave of downward revaluations" possible, she notes. Valeant's price/earnings ratio of three times seems cheap until potential large write-downs are factored in.
Some have compared Valeant to Enron in 2001. But at its peak, Enron had a $60 billion market value that fell to zero. Valeant has wiped out more, about $81 billion. And its CEO is still on the job.

Valeant declined to respond to *Barron's*.
Determining whether there's any value left in its assets will take time to sort out. Valeant remains an uninvestible trap with too many unknowns. There's never just one cockroach. Stay far away.

See Trader Extra "Overseas Cash Parking Lot"

FIVE-DAY DOW COMPOSITE

Dollar Down, Dow Up: The Dow jumped 2.3% last week, helped by a weak dollar, a dovish Fed, and rising oil prices. Boeing soared 8% but Pfizer fell 3%.



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