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Valeant may find it's still not out of the spotlight

by Sean Silcoff

Valeant Pharmaceuticals International Inc. doesn't walk away empty-handed from its trumped hostile bid for Allergan Inc. Thanks to its deal with hedge fund manager Bill Ackman's Pershing Square Capital Management in its pursuit of the Botox maker, it stands to make hundreds of millions of dollars in investment gains from losing out to a higher, friendly bid from Actavis PLC. But this bruising battle could also leave the insatiably acquisitive Canadian company holding a bagful of unwelcome booby prizes.

Valeant's agreement with Pershing has attracted a lawsuit from Allergan and an investigation by the U.S. Securities and Exchange Commission over concerns the two effectively engaged in insider trading before Valeant formally filed its tender offer. There has been no such finding to date but an SEC investigation is continuing and a U.S. district court judge in California concluded there were "serious questions" about whether the Valeant-Pershing arrangement broke the rules. I wouldn't bet on that one disappearing without a trace – or without millions of dollars in settlement costs.

Valeant's regulatory concerns don't end there. Since its combination with Biovail Corp. turned Valeant into a Canadian company, it has benefited from a clever international structure that enables it to pay rock bottom 3-per-cent tax rate. Until recently, much larger companies such as Apple attracted growing scrutiny from lawmakers for avoiding taxes. Now, thanks to the publicity around Valeant's hostile bid – including the emergence of former Biovail CEO Eugene Melnyk as its harshest critic – it is in the cross-hairs as well. A number of U.S. Senate and Congressional representatives have publicly criticized Valeant and the U.S. Internal Revenue Service is now digging into its books.

Perhaps the biggest price Valeant pays out of the failed Allergan pursuit is the unwanted attention brought to the company's opaque financial reports and questionable growth strategy. Valeant's play has been to buy up pharma companies and pump up its earnings by slashing staff, cutting R&D budgets and taking advantage of its much lower tax rates. But some analysts, notably **Dimitry Khmelnitsky** of **Veritas Investment Research**, have highlighted several concerns about its reported financials for years, and Allergan telegraphed those loudly in the heat of the takeover battle, drawing scrutiny to Valeant.

Valeant's disclosure has been spotty and ever-changing, making it "near impossible to independently confirm the results of most of the company's acquisitions," **Mr. Khmelnitsky** said in a note this year. At issue is how much organic growth Valeant yields from its purchases. **Mr. Khmelnitsky** has argued that growth is negligible; that its earnings are more heavily exposed to competition from generic products than the company has let on, and that its stock is overvalued.

Valeant has been prone to some abrupt and questionable reversals in its business. For example, Valeant was reporting rosy growth prospects for its "facial injectables" business right up until early this year, claiming revenues grew by 15 per cent in the first quarter. Then it sold the business and revealed revenues actually fell steeply in both the first and second quarter. The company was also caught out apparently overinflating revenue growth from its recently purchased Bausch and Lomb eye care business earlier this year, claiming revenues grew by more than 12 per cent when reported figures suggested they grew by less than 10 per cent. Valeant also admitted more than half of revenue growth from its top 20 products came from jacking up prices, an unsustainable long-term strategy.

The best thing Valeant can do now is to try to slink away quietly and buy up smaller companies that are willing to sell out. Given that Valeant seems to need to feed on increasingly larger acquisitions to keep its story going, it's probably only a matter of time before it has to go big and hostile again on another target again. Next time, the response will likely be even more hostile.