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Ignore Valeant stock at your own peril

By SEAN SILCOFF
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A bold acquisition strategy has fuelled a big jump in the drug maker's share price. But not everyone is cheering

Valeant Pharmaceuticals International Inc. is a complicated company – and a stock Canadian investors can no longer ignore. The Laval, Que.-based pharma company has had such a successful run under CEO Michael Pearson that it now has the 12th largest weighting on Canada's benchmark S&P/TSX composite index, with a market capitalization of $38-billion.

That means investors should get to know Valeant, particularly after a recent spell of troubling news. Last month, Valeant reported third-quarter results that fell short of projections, trimmed its estimates for the year and confirmed sales of its top-selling drugs are declining.

Valeant is not a conventional drug developer like Merck or a generic firm like Apotex. It follows a unique plan written by Mr. Pearson when he ran consulting giant McKinsey & Co.'s health-care practice. The Valeant board asked for his advice in 2007, and hired him as CEO a year later to put his strategy into play.

Mr. Pearson believes pharma firms get better returns buying established products than investing in research and development in pursuit of blockbuster drugs. On his watch, Valeant has done more than 60 deals, including this year's $8.7-billion (U.S.) purchase of eye care firm Bausch & Lomb, and slashed R&D spending.

He prefers products that have modest sales – they are less likely to attract rivals – and that aren't covered by cash-strapped public health plans. Mr. Pearson will buy drugs that are close to losing patent protection if he thinks he can squeeze out a good return – and even drugs that are off patent if they haven't yet been copied by low-cost generic competitors. "In a world that overpays for the sexiest growth assets, we get bargains on stuff nobody wants," said Valeant director Mason Morfit, whose California-based ValueAct Capital owns 6 per cent of the stock.

Another part of Mr. Pearson's strategy was to move Valeant's corporate home away from the U.S. and its punitive tax regime that forces companies to pay additional taxes on profits they earn overseas. In 2010, he merged Valeant with Canada's Biovail Corp.

Now Valeant can shift intellectual property and profit centres to low-tax jurisdictions and repatriate profits without paying more tax. It pays a 5 per cent cash tax rate, making it "largely a tax arbitrage story," ***Veritas Investment Research*** analyst ***Dimitry Khmelnitsky*** said. Despite the company's Canadian domicile, Mr. Pearson and CFO Howard Schiller are based in New Jersey.

Mr. Pearson wins praise for paying low prices, quickly integrating purchases and slashing spending. Like other consolidators, he funds deals largely with debt, which now stands at $17-billion, or 4.6 times operating earnings, which is high for a public company. The buying binge also means Valeant's strategic focus is ever shifting: from dermatology to oral care, then podiatry, vision care and "aesthetics" like wrinkle-reducing injections. Bausch & Lomb now accounts for 40 per cent of its $8-billion-plus annualized revenues.

The constant deal-making can make it difficult for investors to track Valeant's financial progress. In the third quarter, revenues surged by 74 per cent to $1.5-billion, but the company lost $972-million, dragged down by big charges for interest, amortization, asset impairments and restructuring.

So, like other acquisitive firms, Valeant urges investors to instead focus on its own custom non-GAAP measures, including "adjusted cash flow from operations" and "cash earnings per share." Those tell a rosy story.

But there are issues with these measures. ***Mr. Khmelnitsky*** says Valeant's custom measures include items that improve results like one-time acquisition gains, but don't count others that reduce them, like acquisition-related costs. By his measure, adjusted cash earnings per share fell by 10 per cent in the quarter; Valeant reported a 24 per cent rise.

Tracking revenues is also tricky. Valeant focuses on "organic growth," or how drugs sell compared to a year earlier. It has changed the way it measures organic growth several times, and in its most recent quarter, it reported a 7 per cent gain. But that measure excludes revenues for three drugs, including its top-selling drug Zovirax, a herpes treatment. Mr. Pearson argues that Valeant excludes these figures because those drugs are off patent, and investors are more focused on how its drugs with patent exclusivity are selling. ***Mr. Khmelnitsky*** disagreed: "In my opinion, acquisitions obscure the deterioration in the base business," he said.

Mr. Pearson said in an interview that Valeant has nothing to hide – it publishes all of its figures and lets investors decide. He added the company's expected revenue decline this year from "genericization" – about $300-million – is higher than normal and that the downside risk is lower for drugs that will lose protection through 2017. He says only three acquisitions have fallen short of his target return of 20 per cent per year.

Most importantly, he said, his large investors support his strategy, which The Globe and Mail independently confirmed with three large fund managers. "I don't see any reason why he can't grow this business a lot through acquisitions," said Glenn Greenberg, managing director with Brave Warrior Advisors, a New York-based fund manager with 6.6 million shares of Valeant.

As long as Valeant can keep its formula working, the stock should do well. Once the company gets too big to grow steadily by deal-making, it may need a new prescription.