



Veritas remains concerned about Valeant's underlying numbers, even if investors are not.  
THE CANADIAN PRESS

## Analysts see new hope at MTS ... and new questions at Valeant

DAVID MILSTEAD

Published Wednesday, Jun. 12, 2013

In this space, we periodically highlight the thoughts of the fine folks at **Veritas Investment Research**; their accounting-minded analysis often offers a fresh perspective on risks that others may not see.

Today, we update their views on a pair of companies we've written about in the past. In one case – Manitoba Telecom Services Inc. – things have turned out much better than **Veritas** expected. In another – Valeant Pharmaceuticals International Inc. – **Veritas** reiterates its concerns, but investors seem to disagree.

First, Manitoba Telecom, or MTS, for simplicity's sake. It was just two months ago that this column examined how MTS's underfunded pension plans were potential holes in MTS's cash-flow story.

Rather than pump cash into the plans, MTS took full advantage of recent federal regulations that allowed it to use letters of credit – notes from a bank that say a company's good for the money – to satisfy its obligations. MTS had \$235.9-million in letters of credit at Dec. 31, with plans to take out roughly \$35-million more.

The problem is that letters of credit, unlike cash infusions, don't actually generate investment returns. So while companies like BCE Inc. have benefited from healthy gains in the equity markets after funding their plans, MTS has not.

Of course, one way for a company to find some cash to pump up its pension plan is to sell off half the firm. That's what MTS plans to do with its business-services division, Allstream, in a \$520-million sale. About \$240-million of the ultimate proceeds will go into the pension plans or settle pension-related debt.

In a report titled *Against All Odds*, **Veritas** analysts **Neeraj Monga** and **Desmond Lau** praised MTS management for "finding a buyer at a reasonable price" and raised its rating to "buy," with an intrinsic value estimate of \$36, right about current levels. "MTS has removed the albatross from its neck and in so doing, has given itself financial flexibility – something the company lacked for several years," **Veritas** says.

There is no albatross at Valeant, investors figure: Driven by excitement over a deal to buy Bausch & Lomb Inc., Valeant's shares surged to nearly \$100 in late May, up two-thirds this year and roughly double their level in April, 2012, when we looked at the company's financial disclosures.

At the time, we noted "although the company dutifully reports the standard accounting numbers, it prefers to emphasize a few financial metrics that are far afield of normal earnings measures," including "cash EPS [earnings per share]" and "adjusted operating cash flow."

**Veritas** remains concerned about the company's underlying numbers, even if investors are not. Analyst **Dimitry Khmel'nitsky** notes the company's "organic growth" – gains in sales of existing products – has declined from 8 per cent in 2012 to 1.5 per cent in the first quarter. Valeant's calculations leave out discontinued products; put them back in, and the figure is zero, **Mr. Khmel'nitsky** estimates. He also points out that a generic competitor to Valeant's Zovirax ointment is expected in the second half; once its impact is factored in, organic revenue growth could actually be negative.

(Valeant spokeswoman Laurie Little says the company does not comment on third-party opinions, but notes, "We view organic growth as only one metric that should be used to evaluate the company and we have provided this information for the benefit of our shareholders.")

Meanwhile, **Mr. Khmel'nitsky** notes Valeant's ratio of net debt to cash flow is rising, "implying that debt grows much faster than Valeant's ability to generate cash."

Valeant grows mainly through acquisitions. In contrast, most of its pharmaceutical competitors spend large amounts on research and development, and the R&D expenses drag down their earnings. Compensate for this, **Mr. Khmel'nitsky** says, and Valeant trades at a 40-per-cent premium to its peers.

"The decline in volumes and negative organic growth for 2013, coupled with the fact that [Valeant]'s R&D is insignificant, implies that the company must keep buying," he says. "As the company grows, the acquisition treadmill keeps getting faster and faster."

So far, it's been Valeant shares that have sped ahead, making **Mr. Khmel'nitsky** sound as if he's crying wolf. One day, though, that treadmill may stop, and investors may take a tumble along with Valeant.