Look carefully at Valeant's chosen numbers

David Milstead, Globe and Mail
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A few weeks ago, my colleague Eric Reguly described Viterra Inc.'s VT-T plans to sell itself as a squandered opportunity for Canada to build a global corporate champion.

Spot-on: What Canada needs more of are companies like Valeant Pharmaceuticals International Inc. VRX-T, a voraciously acquisitive concern that's bulking up by buying smaller companies across the world.

What's good for Canadian economic nationalism, however, isn't necessarily good for investors.

Serial acquirers such as Valeant (which is soon to move from Mississauga to Montreal) can create long-term shareholder value by cannily snapping up companies at attractive prices and striking profitable licensing deals. However, an acquirer can also destroy value by overpaying for deals and failing to integrate them.

To figure out how Valeant is doing at the value-creation game, investors look to the drug maker's financial reports. And therein lies the problem.

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 as outlined by generally accepted accounting principles, or GAAP. For instance, Valeant chooses to highlight not the standard accounting measure of net income, but a figure it calls "cash" earnings, or "Adjusted Non-GAAP (Cash) earnings per share." And rather than point to operating cash flow, it uses an in-house measure called "Adjusted Operating Cash Flow."

To get a handle on what these numbers indicate, we'll fall back on the work by the folks at ***Veritas Investment Research***, who have had Valeant on their Accounting Alert watch list since December. (Valeant spokeswoman Laurie Little says the drug maker is aware of the ***Veritas*** reports and has talked to the investment research firm, but won't comment for this article. "We don't necessarily agree with everything they put in there, but it's their opinion, and everybody has their opinions.")

For its part, ***Veritas*** is not accusing Valeant of breaking the law: It notes that Valeant's formal financial statements are compliant with U.S. GAAP. "Management is free to define its scorecard as it wishes," says ***Veritas*** analyst ***Dimitry Khmelnitsky*** in a report. Ever polite, he adds: "If the rise in Valeant's stock price is an indication, investors are receptive to management's current strategy."

However, ***Mr. Khmelnitsky*** notes, "Valeant already commands a substantial premium over its peers, implying equally significant growth expectations. We believe that those expectations are supported by non-GAAP metrics that serve to boost the growth profile of the underlying business."

I can be less polite: Valeant's chosen measures of earnings seem to me to be consistently divorced from the reality of the company's economics.

Here's one example, as outlined by ***Veritas***: Valeant both licenses other companies' products and licenses its products to others. In a June 2011 deal, Valeant agreed to pay Swedish concern Meda Pharma SARL $438-million (U.S.) – $76-million upfront plus $362-million in royalties, primarily over the next four years – to license dermatology products.

Valeant accounted for the deal by creating a $438-million asset, offset by a $362-million liability that represented the future payments. As the liability is gradually decreased, it will flow through the financing section of the statement of cash flows. That means those royalties will never appear in either operating cash flow or in the income statement.

As Valeant sells the products it licensed, however, it will post profits, while “the cash costs of the underlying license will not be reflected in any of the company’s operating metrics,” ***Mr. Khmelnitsky*** notes.

What about when the shoe is on the other foot? When Valeant licenses its own products for others to sell, it recognizes revenue. In the first half of 2011, it recognized a $36-million upfront licensing payment in both “cash earnings” (in the first quarter) and in its “adjusted cash flow from operations” (in the second quarter).

This is not the only example of Valeant recognizing the good stuff while leaving out the bad. The company recognized an entire $40-million “milestone” payment from GlaxoSmithKline PLC in its favoured metrics in last year’s second quarter. When it made a $6-million milestone payment to Meda in the same quarter, it recorded the payment as an increase in intangible assets and marked it down in investing cash flows – absent from either “cash earnings” or “adjusted CFFO.”

It goes on. Tax benefits from the exercise of employee stock options are included in its “adjusted cash flow from operations” even though GAAP directs companies to place them in financing cash flows. Yet the cash paid for employee withholding taxes on the options is left out of this adjusted measure. Also not reflected: the cash costs of share buybacks used to offset the stock-option dilution.

And while the company includes one-time licensing payments and gains on investments in its “cash earnings,” it leaves out integration and restructuring costs from its many mergers.

Also, in the fourth quarter, Valeant excluded a loss of 9¢ per share on a sale of investments. “Given that in the past management did not hesitate to include the full benefit of investment gains in Cash EPS, we wonder why losses should be treated any differently?” ***Mr. Khmelnitsky*** mused.

The answer is simple. Losses are bad. And the bad stuff doesn’t get into the numbers Valeant management prefers to talk about.