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Valeant Pharmaceuticals International Inc naysayers say company can be saved, but it's going to take some major changes

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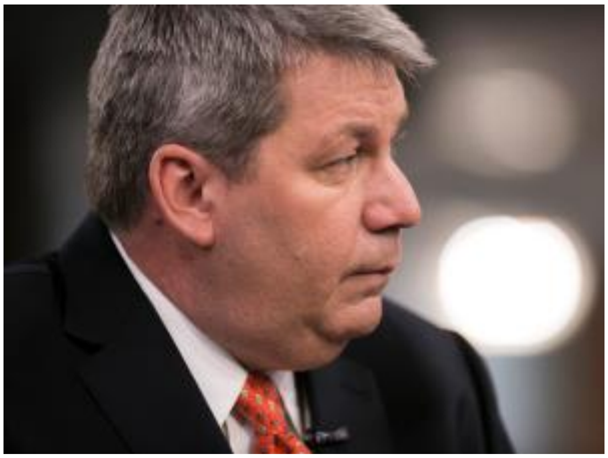


Valeant Pharmaceuticals CEO Mike Pearson. Even if Valeant is able to regain investor confidence, the drugmaker is unlikely to reach its former share price in the foreseeable future, experts say. Scott Eells/Bloomberg

MONTREAL — It's not easy to be a naysayer.

Only a handful of short-sellers and analysts were ringing alarm bells when Valeant Pharmaceuticals International Inc. was in the midst of its rise to the top of the TSX. They were largely ignored at first.

The stock's crash of almost 90 per cent from its August 2015 peak has certainly vindicated their bearish beliefs, as does the Laval, Que.-based drugmaker's admission on Tuesday that it would not meet a March 15 deadline for filing its annual financial statements with securities regulators, putting it in danger of defaulting on its US$30-billion debt load.

But now that Valeant has fallen so hard from its lofty heights, some of those same market watchers once again find themselves on the unpopular side of an argument. This time, though, they have some better news. They say the former investor darling can still recover, though it's is unlikely to return to its status as a stock-market giant.

“I believe there is hope,” said ***Dimitry Khmelnitsky*** at ***Veritas Investment Research Corp.*** “It’s a very different company now — a company that has a less questionable business strategy. We’re not there yet, but to a large degree, it’s the opposite of what I disliked in the past.”

Still, he said that even if Valeant is able to regain investor confidence, the drugmaker is unlikely to reach its former share price in the foreseeable future.

“In the short term, it is a different company. In the long term, it depends on where (company chief executive) Mike Pearson would want to take it and whether he would want to return to the old days,” ***Khmelnitsky*** said.

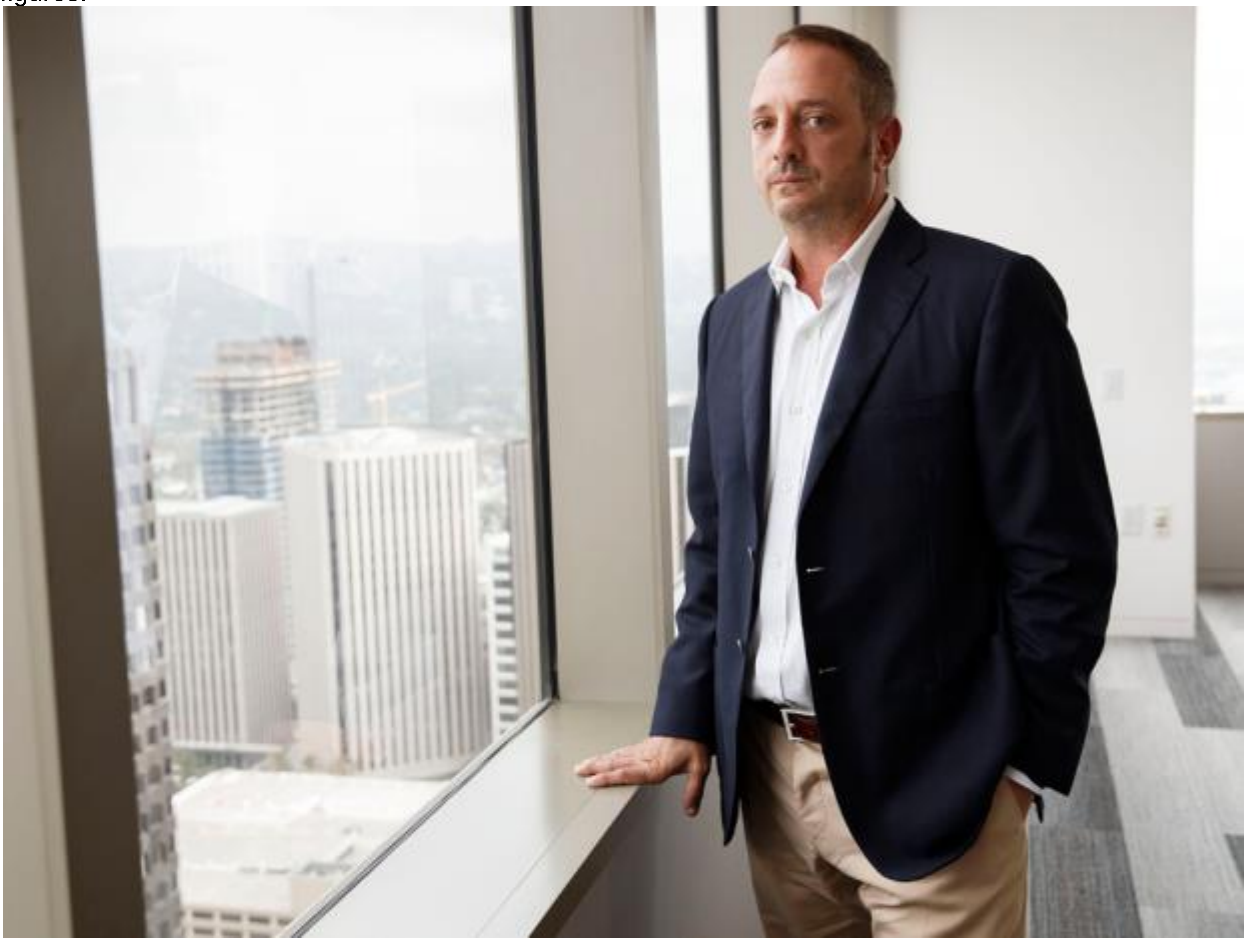
The old days are when Valeant got into this mess in the first place. In July 2014, ***Khmelnitsky*** was the sole analyst advising investors to sell Valeant, only to watch the stock double in a year. “It’s never easy to go against the commonly held opinion, especially if the stock price has been rising,” he said.
He said he initially didn’t like the risks associated with the company’s price increases, tax structure and aggressive growth strategy. He later saw risks associated with the lack of disclosure around the reimbursement tactics used by specialty pharmacy Philidor RX Services and Valeant being called out by U.S. lawmakers, notably Secretary of State Hillary Clinton.

“They took what seems to me to be short-term-oriented decisions where you try to squeeze payers by using this Philidor structure. That clearly backfired,” ***Khmelnitsky*** said.

However, he said his fundamental problem was that management’s disclosures were unreliable. “If you try to verify the numbers, you either can’t or you come up with numbers that are substantially lower than what management is saying,” he said.
Gimme Credit analyst Vicki Bryan also publicly questioned Valeant’s business model in 2014, and her concerns were solidified when, after seeing dismal same-store organic growth quarter after quarter, it suddenly picked up last year just as Valeant began its relationship with Philidor.

“Suddenly, same-store sales started moving and drugs that you’ve never heard of before started showing up as top sellers,” she said.
But the short seller who received the greatest ire from Valeant’s management was Andrew Left, who runs the stock commentary site CitronResearch, which beginning last October published a number of reports

accusing the drugmaker of being a "Pharmaceutical Enron" that was using Philidor to pad its sales figures.



Patrick T. Fallon/BloombergShort seller Andrew Left called out Valeant starting in October, and received the ire of management.

"(Left) intentionally designed the report to frighten our shareholders to drive down the price of our stock so he could [make money for](#) his short-selling," Pearson said of the short seller during a conference call in late October 2015 after a Citron report led to Valeant's stock tumbling 19 per cent in a single day to US$118.61 in New York.

One of Valeant's biggest fans, billionaire hedge-fund manager Bill Ackman, had his Pershing Square Capital Management sweep up 2.1 million additional shares of Valeant following Left's report, making it the company's second-largest shareholder.

He then spent four hours publicly defending his bet, likening the Citron reports to shouting fire in a crowded theatre.

Left said he has not received an apology from Ackman or Valeant's management for singling him out, even though the drug company has since cut ties with Philidor.

"Canadians have more of a right to be pissed than anybody else," Left told the Financial Post, as the Caisse de dépôt et placement du Québec and Canada Pension Plan are among the institutional investors that have held Valeant stock.

Toronto-based Lightwater Partners Ltd. also took a short position on Valeant when it was the third-largest company on the TSX in July 2015, saying it saw a number of red flags, including the company's serial acquisitions, massive debt levels and management issues.

Even though Valeant's stock then jumped from $290 up to $350 at one point, Lightwater held fast. "That's when you really test your resolve and your thesis," said portfolio manager Jerome Hass. "When things go up very fast, they can come down very fast and Valeant did both."

He said when Valeant surpassed RBC's market cap on the TSX last July, it evoked other companies that have risen to such a lofty place in recent years, including Potash Corp. of Saskatchewan Inc., BlackBerry Ltd. and Nortel Networks Corp.

"Their history shortly after surpassing RBC wasn't very good," Hass said. "We thought that at least we had karma working in our favour."

But now that the short sellers have won, at least one analyst believes Valeant can be salvaged. But for that to happen, ***Veritas' Khmelnitsky*** said the company must meet the guidance it puts out, achieve clear earnings that reflect real growth, manage transparently and, importantly, generate cash flow.

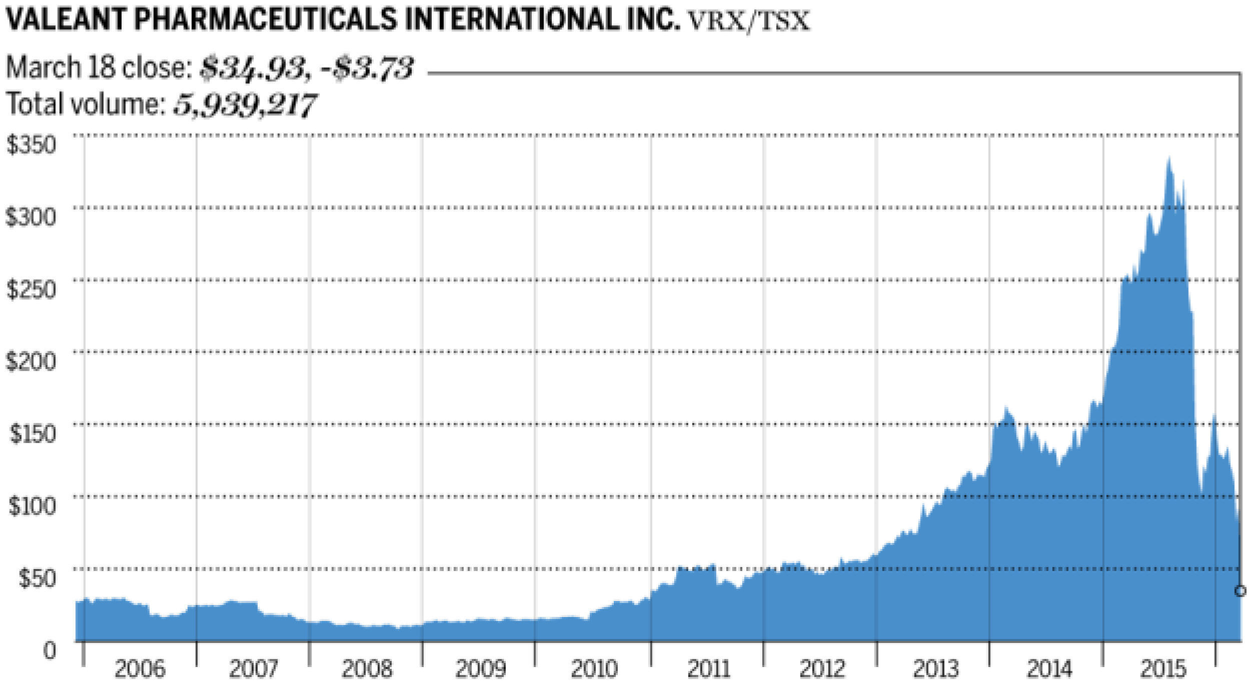
Valeant has already made some changes, such as realigning its strategy by selling its products at a discount through Walgreens Boots Alliance Inc., the largest drug retail chain in the U.S. Chief executive Michael Pearson has also raised the possibility of selling off assets, though the company has not indicated what those might be.

With the Philidor relationship severed, one of the biggest remaining concerns the former short sellers have is that Valeant's management, who have been accused of running the company more like a hedge fund than a pharmaceutical company, shows no indication of stepping down.

“Mike is clearly a very bright individual, there’s no question about this. He thinks outside the box, but he brings with him an aggressive culture that is in my opinion disproportionately focused on trying to make the numbers, as opposed to trying to take a longer-term perspective of the business,” ***Khmelnitsky*** said.
“What fundamentally is lacking is transparency and the ability to rely on management disclosures.”
Nevertheless, he and others have hope. Gimme Credit analyst Bryan said Valeant’s core assets have value — though not as much as their books say — and that it is capable of generating cash, albeit less than before.
“Just as I didn’t agree the company was going to the moon, the company’s not going bankrupt,” she said, adding it might have to sell off assets such as the dermatology business and parts of Bausch & Lomb at discount prices in the short term. “Everybody knows they need the cash.”

But Bryan still has some issues with the company. For one thing, she believes the board and even the ad-hoc committee put in place to investigate Philidor are not independent enough from the management.
“I don’t view management being capable of making the complete direction change that they need to do,” she said. “Since the company has started to unravel, the management missteps and blunders have only increased alarmingly.”
The latest misstep was on March 15 when Valeant cut its 2016 revenue forecast by about 12 per cent and said a delay in filing its annual report could pose a debt default risk.

THE LOWS, HIGHS, AND LOWS AGAIN OF VALEANT



SOURCE: BLOOMBERG NEWS NATIONAL POST

Its stock cratered more than 50 per cent that day, leaving many analysts scrambling to reassess the prospects for the company's shares going forward. Although not everyone is crying "sell," many of the former bulls have dramatically lowered their target price.

The stock continued to drop on Friday, falling 9.7 per cent to $34.93 in Toronto and 9.1 per cent to US$26.98 in New York.

"Now a lot of the risks we highlighted, they materialized, and in that respect I do feel some kind of vindication, but that doesn't necessarily make me feel good or bad, because we have people at the same time who lost a lot of money," ***Khmelnitsky*** said.

"The biggest lesson is that if you are not comfortable with companies' accounting, disclosure and reporting, don't invest in it even though you may miss on an upside."

Bryan said she believes the worst for Valeant's numbers could be still to come, since Philidor continued to operate until sometime in January.

“We’ll see the full force,” she said, projecting the company’s audited first-quarter report will be released sometime in early May.

Valeant has telegraphed a poor performance, with Pearson reducing its previous sales and adjusted earnings estimates for the first quarter.

“In a sense, we’ve botched a quarter,” Pearson said on a conference call before trading began March 15.

Citron’s Left said Valeant’s stock remains “uninvestable,” although the company might be able to make improvements.

“Turning the company around (and) getting the stock price higher are two different things,” Left said. “You might want to take a shot and buy some stocks if you’re a gambler, but it’s not an investment.”

Hass does not yet recommend buying Valeant either — he sees other drugmakers as better investments — though now that the money for M&As has dried up, he said the company’s true balance sheet is at least becoming more clear.

“What’s happened with Valeant is that they’ve had to stop making acquisitions and everyone’s suddenly realized these guys are swimming naked,” he said.