FINANCIAL POST

October 28, 2015

Valeant Pharmaceuticals: What the only analyst with a sell rating thinks

Jonathan Ratner

There is only one analyst with a sell rating on Valeant Pharmaceuticals International Inc., despite the stock being down roughly 55 per cent since September 18.

Of the 25 tracked by Bloomberg, 18 analysts rate the Canadian pharma giant's shares a buy, while six others have it as a hold.

Dimitry Khmelnitsky at independent ***Veritas Investment Research*** is the odd analyst out, so to speak, but, given the potentially explosive allegations being thrown at Valeant, his comments warrant a closer look.

In a note to clients on October 23, ***Khmelnitsky*** pointed out that after calling R&O Pharmacy to discuss a neurological prescription, ***Veritas*** was transferred to Philidor, suggesting an explicit connection between the two entities exists.

Recall that on Valeant's Q3 conference call, the company disclosed that R&O — one of the specialty pharmacies it deals with — is improperly holding significant funds it received from payers, such as insurers or pharmacy benefit managers.

Khmelnitsky noted that there are two related lawsuits unfolding at the same time, both of which revolve around the ownership and access to cash accumulated by R&O on the sale of drugs from Philidor, primarily Valeant's.

"We are not expressing a legal opinion or a view on the legitimacy of either parties' claims," ***Khmelnitsky*** said. "However, based on our reading of the court documents, along with the most recent revelations of Valeant's variable interest entity relationship with Philidor (and Isolani if owned by Philidor), if there is unlawful activity happening at either company, the ramifications for Valeant could be material."

He pointed out that Medicare is protected by whistleblower legislation, so any attempt to defraud the government can mean harsh penalties.

The analyst also noted that private insurers would probably pursue civil and criminal cases quite vigorously if fraud is involved. If there is any wrongdoing, it will difficult for the parties involved to prevent the details from surfacing.

Even if nothing untoward is discovered, ***Khmelnitsky*** believes there is still a possibility that Valeant will lose access to or is forced to recreate a key distribution channel in Philidor.

"Furthermore, Valeant could lose its 'secret sauce' — a premium multiple that enables accretive acquisitions — and the significant debt, coupled with a diminished likelihood of merger of equals leaves it with little room for error," he said in an October 21 report.

As for Valeant's re-assessment of its business model, which appears to stem from an increased U.S. scrutiny on price increases, ***Khmelnitsky*** noted that the company is considering the sale of a business that provides significant cash flow, while requiring little investment in marketing and R&D.

"The change in strategy seems to have eliminated the low hanging fruits that Valeant was tapping in the past," the analyst said.