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Valeant: Too Risky to Touch

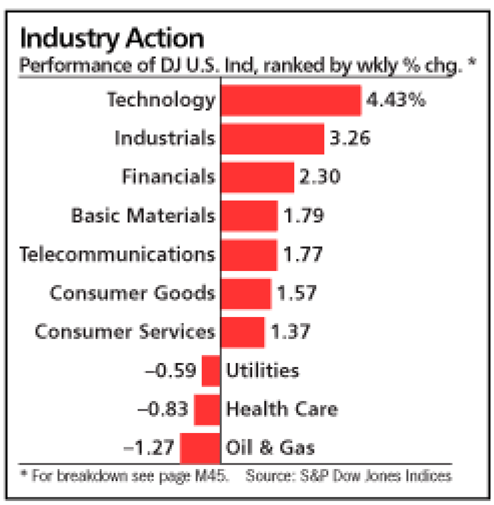
After a tumultuous week for Valeant Pharmaceuticals International, many Wall Street analysts still rate its stock a Buy. Don't take the bait.

By Vito J. Racanelli

After a tumultuous week for Valeant Pharmaceuticals International (VRX), many Wall Street analysts still rate its stock a Buy. Some hedge-fund managers have come out in support of the company, too. The bulls say Valeant will weather the storm of bad news that has sent the stock as low as $88.50 from a high of $263 just a few months ago. It closed at $116.16 Friday.

Don't take the bait.

Valeant shares are down plenty, but they aren't cheap, given the clouds threatening the medium-term outlook. Few of the biggest issues besetting the drug seller are likely to be resolved soon. The stock is uninvestible under common-sense valuation methods because some risks cannot be handicapped. For now, buying Valeant is like pulling a slot-machine arm.



There isn't enough space here to hash over all the news, but here are some highlights. Valeant revealed Oct. 14 that it received subpoenas from federal prosecutors seeking information on how it prices products, among other things. As this column noted Oct. 5, Valeant's price-raising prowess is a major investor attraction. That seems compromised for now, along with much of the rationale propelling the stock to its previously high valuation.

Last week two published reports—from the Southern Investigative Reporting Foundation and an analyst at Citron Research who is short the stock—called into question certain Valeant revenue practices with Philidor RX Services, a pharmacy network that mostly sells Valeant drugs. Valeant responded with a press release that referred to an "erroneous report" about "recent accusations," but it didn't name the report. The company did not respond to a request for clarification.

Until recently, Valeant happily sneered at drug research and development. It touted its “new” approach of incurring a high debt load to pay huge premiums for drug companies, slashing costs at its acquisitions, especially research and development, and hiking the prices of the drugs acquired. That rained fees on Wall Street investment banks and seemingly gave growth investors what they wanted: a stock that went from a $12 billion market capitalization in 2011 to $92 billion at the top last August—a rise that would make an Internet start-up blush.

Last Monday, a humbled Valeant said it would focus more on paying down debt and less on the aggressive deals for which it is known. It would raise R&D spending and consider disposing of its neurological-drug business—25% of total U.S. sales and the heart of the price-raising growth strategy. Overnight, the new strategy is the right one? That’s difficult to believe.

As this column pointed out in the summer of 2014, Valeant’s strategy was unsustainable, producing fast growth based on non-generally-accepted accounting principles that flattered earnings artificially because costs were shunted to the balance sheet from the income statement.

According to ***Dmitry Khmelnitsky***, an analyst at ***Veritas Investment Research*** and one of the few with a Sell rating since last summer, “significant and unquantifiable risks” overhang the stock. Although Valeant has some good assets, such as Bausch + Lomb, “…we don’t know what the authorities will find, if anything. We do know an adverse outcome in any of these challenges…could be materially negative.”

Valeant could lose its “secret sauce,” he says—that is, the premium multiple that enables accretive acquisitions using highly valued stock as currency. Its $30 billion of debt leaves little room for error, he adds.

Traditional valuation metrics aren’t useful here. The high volatility—the stock bounced between $88 and $171 last week—is a keep-out sign. The company plans a conference call to address the allegations Monday, so the shares might pop for a time. Some day Valeant shares might be cheap, but they aren’t inviting.

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