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# Valeant Doesn't Look Cheap

*Shares of the beleaguered pharmaceuticals company are up 15% from recent lows, but don't get too excited.*

By VITO J. RACANELLI
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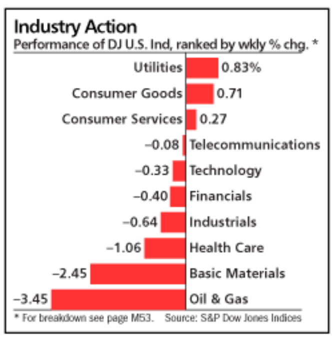
Shares of beleaguered Valeant Pharmaceuticals International (ticker: VRX) are up 15% from recent lows, to $30, although they fell 13% Friday after the company confessed to drug-pricing mistakes in the past and said it had formed a committee to deal with the issue now. On balance, the news hasn't been all that bad lately. But don't get too excited.

The rally began in late March as it became clear that former CEO J. Michael Pearson would exit. That signaled the end of his failed strategy of debt-fueled, high-priced acquisitions of middling assets and jacked-up prices of the acquired drugs.

Canadian-domiciled Valeant recently brought in new independent directors and hired Joseph Papa as chairman and CEO, effective on May 3. Papa held the same positions at over-the-counter drug company Perrigo (PRGO). Valeant filed its 2015 annual report on April 29—late, but in time to forestall the threat of technical default claims, and there were only minor restatements.




All good developments—but that doesn't make the stock a bargain. Valeant needs to wind down its use of "adjusted" earnings and make other changes. It regularly presents adjusted earnings, which exclude frequently incurred costs, alongside those based on generally accepted accounting principles, or GAAP.

"It's always a red flag when management relies on non-GAAP metrics" that artificially flatter results by removing expenses that should be considered a standard cost of operation, says David Trainer, president of New Constructs, an independent forensic- accounting research firm.

Valeant says its 2015 adjusted non-GAAP net income rose to $2.8 billion, or $8.14 per share, from $2.6 billion, or $7.72, in 2014. GAAP accounting tells a different story: Valeant swung to a loss of $292 million, or 85 cents a share, in 2015, from net income of $881 million, or $2.63, in 2014.

Why the discrepancy? Valeant's non-GAAP results exclude, among other items, inventory step-ups from acquisitions; stock-based compensation; research-and-development impairments; restructuring and integration costs; amortization and impairments of intangible assets; and foreign exchange. That totaled a whopping $3.13 billion last year. These expenses have been incurred and included in GAAP earnings for three straight years, so how unusual can they be? In GAAP's more realistic picture, Valeant has had only two profitable years out of the last five.

Despite the company's near-total loss of credibility over the past eight months, due to its questionable accounting and sales practices, bullish analysts and investors still value Valeant on non-GAAP figures. Hence, the stock trades at "just" 3½ times analyst consensus estimates of $8.66 this year, bulls note. The gap—sorry, we had to—between Valeant's GAAP earnings-per-share estimates and non-GAAP forecasts exists out to 2019. Ignore it at your peril. Valeant trades at 45 times GAAP EPS—not so cheap.

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Valeant's 2015 annual report revealed new investigations by authorities into pricing and patient-assistance programs. When and how these numerous state and federal probes will be resolved is unknowable.

Bulls say the company can sell assets to reduce its $31 billion mountain of debt. Bausch & Lomb, arguably Valeant's strongest asset, has been rendered less valuable after Valeant's reduction of R&D spending and cuts to the B&L sales force. Even if sold, the eye-care subsidiary might garner $9 billion, or what Valeant paid for it, says Dimitry Khmelnitsky, a Veritas Investment Research analyst with a Sell rating and $29 target price.

Taking a nice chunk out of the debt is good for bondholders, but "once you sell it, there is much less left over for shareholders," he says. The fundamentals haven't changed, and the underlying problems remain: lower revenue and profit growth, and an inability to raise prices as in the past.

Valeant declined to make Papa available for comment.

Even if everything goes right from here, Valeant is, at best, just another drug company. There has been a great deal of talk on Wall Street about Valeant's fresh start. We don't see it. Other companies are valued on GAAP. Valeant should be, too.

See Trader Extra "Questioning Perrigo's Growth"

**E-mail:** editors@barrons.com