Why Did Valeant's Shares Plunge Yesterday?

Description

Jim Grant is one of the most respected financial minds on Wall Street. His newsletter, *The Interest Rate Observer*, is one of the most read publications by investment professionals. So when the most recent edition took aim at one of Canada's highest-flying companies, **Valeant Pharmaceuticals** (TSX:VRX)(NYSE:VRX), it's no surprise that the company's shares plunged over 5% in response.

Mr. Grant referred to Valeant as a "financialized pharma company" that he is "confidently bearish on." He even cited legendary short seller Jim Chanos for the idea. Mr. Chanos is most famous for shorting the shares of Enron right before its collapse.

There were some interesting arguments made by Mr. Grant. First of all, as is well-known, Valeant is a serial acquirer. As a result, the company only spends about 2.7% of sales on research and development. Meanwhile, industry leaders **Johnson & Johnson** (NYSE:JNJ), **Pfizer** (NYSE:PFE), and **Merck** (NYSE:MRK) collectively spend 13.8% of revenue on R&D.

The acquisition strategy can lead to some issues with accounting. Mr. Grant cites one instance where Valeant changed the revenue recognition policy of Medicis after acquiring the company in 2012. Valeant also focuses on cash earnings per share, which excludes things like acquisition-related costs. When looking at Valeant's earnings according to generally accepted accounting principles (GAAP), the company actually is losing money.

In fact, Valeant uses many accounting metrics that do not conform to GAAP. The most recent quarterly call cited measures such as adjusted cash flow from operations and pro-forma same-store sales, among others. The problem is that management has complete discretion on how performance is measured. This can lead to abuse.

But this exact thesis could have been made years ago, and it would not have been good advice at all. The stock is up almost 10-fold over the past five years, and has more than doubled in the past year alone. Conversely, Jim Grant could argue that the skyrocketing shares are now much more overvalued than ever before.

Foolish bottom line

As mentioned previously, an investment in Valeant requires placing an enormous trust in management. The management team not only has discretion on which direction to take the company in, but also how to report progress. And if this discretion is abused, investors will pay a dear price.

Of course the exact same thing could have been said about Enron before it collapsed. In that case, Enron’s management did abuse its discretion, and manipulated manipulated earnings at will.

But betting against Valeant is a very risky move, one that would not have worked out well so far. And if Valeant’s leadership comes through for shareholders, Messrs. Grant and Chanos will be the ones paying a very steep price.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BHC (Bausch Health Companies Inc.)
2. NYSE:JNJ (Johnson & Johnson)
3. NYSE:MRK (Merck)
4. NYSE:PFE (Pfizer Inc.)
5. TSX:BHC (Bausch Health Companies Inc.)

Category

1. Investing

Date
2025/06/28
Date Created
2014/03/07
Author
bensinclair