



Don't Be Fooled by Valeant Pharmaceuticals Intl Inc.

Description

Last week, short-selling research firm Citron Research shocked investors by coming out with a scathing report on **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX).

The report centred on R&O Pharmacy, a tiny California-based drug dispensary nobody had heard of. R&O filed a suit against Valeant alleging the drug maker was charging R&O for some \$70 million worth of drugs R&O had never received and certainly didn't sell.

It gets worse. It turns out that R&O is owned by a company called Philidor, a company which is so closely associated with Valeant that the latter consolidates its results onto its financials. This close relationship was never disclosed to shareholders until Citron forced management's hand.

At least according to Citron, this is the smoking gun which shows the company's accounting standards aren't up to acceptable standards. Citron even went as far as comparing Valeant to Enron, pointing out that Enron committed many similar sins.

As a result of Citron's research and both Bernie Sanders and Hillary Clinton promising legislation that would crack down on pharma companies increasing the price of drugs shortly after acquiring them—which is a huge part of Valeant's and its competitors' business models—shares of the company have fallen by more than 55% in the last three months.

Normally, as a contrarian value investor, I'm all over a situation like this. But I'm staying far away from this one, and I think other investors should do the same. Here's why.

The cockroach theory

Accounting irregularities are sort of like cockroaches. There's never just one, especially when somebody who isn't management figures out what's going on.

As we move further away from Citron's original report, more damning news against the company is beginning to come out. A story released on Bloomberg on Thursday quoted former Philidor employees who said the company modified prescriptions to boost Valeant sales.

Additionally, Valeant's customers are starting to get upset. Also on Thursday, CVS cut off Philidor as a supplier to its pharmacies, citing concerns about what it calls "non-compliance with the terms of its provider agreement." CVS is one of the United States's largest pharmacies.

The *Wall Street Journal* is also reporting issues with some of Valeant's largest shareholders. Sequoia Fund owns some 33 million shares of the pharma giant, which is about 30% of its \$7.5 billion in assets. According to chairman of the board Roger Lowenstein, both Sharon Osberg and Vinod Ahooja left Sequoia's board over the weekend, presumably due to some issue with the large position in Valeant.

All of these pieces of news tell me one thing—the bad news surrounding Valeant is likely not over. It could very well get a whole lot worse before it gets better.

Not in value territory yet

Over the last 12 months, the company has only earned \$2.33 per share. At a closing price of \$148.23 on the TSX on Thursday, shares are still at an outrageously expensive 63.6 times earnings.

Analysts expect earnings to get much better over the next 12 months, coming in at more than \$21 per share in fiscal 2016. There are a couple of concerns with that though. Firstly, there's no way we can trust those estimates, since there are serious legitimate questions about the company's accounting. And secondly, these estimates assume there will be no unusual expenses, which have totaled nearly \$1 billion over the last year.

Or, to put it another way, Valeant is still worth twice as much as the price paid to acquire all of the drugs in the first place.

Good value investing means that you have to get a good company at a reasonable price. Valeant might qualify on the reasonable price part, but with all this controversy, it's hard to believe the good company part. For those reasons, I'd avoid the stock and suggest other investors do the same.

CATEGORY

1. Investing

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