Valuation Expert Misguided on Valeant

While we certainly respect Professor Damodaran and his work, he has unfortunately been led wildly astray by the media in his recent valuation of Valeant. Despite the politicians and reporters suggesting otherwise, Valeant’s strategy does NOT rely mostly on pricing increases as the only driver of its growth. It also does NOT buy companies with the sole purpose of raising prices to earn higher margins. This is clearly demonstrated in the company’s filings and press releases, though it can’t be seen in the income statement.

The business model

“At the risk of over simplifying Valeant's strategy, a central focus of its acquisition strategy was buying companies that owned the rights to "under priced" drugs and repricing to what the market would bear... If you accept my description of the Valeant business model (acquisitions focused on repricing drugs, funded with debt and quickly converted into earnings), there is reason to believe that a critical portion of the Valeant's business model is broken and cannot be fixed.”

The Professor has sadly completely missed out on the philosophy of Valeant’s business model. Clearly relying on the very critical New York Times piece, he argues that the only reason they’ve been able to grow so quickly without investing as much in R&D as the industry is because of pricing increases. This is absolutely not the case, and it’s easy to show. As a matter of fact, two thirds of their acquisition spending has been on companies where pricing wasn’t even a significant factor.

Salix

Salix is a company known for its expertise in GI products and its strong specialty sales force. 70% of the company’s revenue comes from a drug called Xifaxan, which is an antibiotic that’s used to treat travelers diarrhea, hepatic encephalopathy, and has recently been approved for IBS-D.

In 2014 the company was rocked with an accounting scandal. They had been severely stuffing the channel, and now had as much as 9 months worth of inventory sitting in distributor warehouses. The company committed to reducing this inventory back to normal levels, but the stock cratered.

This is when Valeant saw an opportunity. They recognized that in spite of the short term headwinds, the fundamental GI business was a very strong one. They decided to buy the company and work through the problems over the course of 2015. In April the deal closed for roughly $12 billion, which would represent 40% of Valeant’s debt.

If we are to believe the Professor, this deal was motivated by the potential for price increases. As we’ve seen though, there have been no significant price increases on Xifaxan since they bought the company. In fact, the company has seen significant growth in volumes due to their IBS-D approval in May.
Bausch and Lomb

Similarly, Valeant bought Bausch and Lomb in 2013 for almost $9 billion. Together, B&L and Salix represent $21 billion in acquisition spending, which would be nearly 70% of Valeant’s debt. Since then, they’ve seen significant growth in the business almost exclusively due to volume increases. Here is a chart from Q2 2014 where Valeant reviews the drivers of growth for B&L.

<table>
<thead>
<tr>
<th>County/Region</th>
<th>Q2 2014 Product Sales</th>
<th>Q/Q%</th>
<th>Growth Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ Consumer</td>
<td>$120M</td>
<td>12%</td>
<td>Continued growth in vitamins, and ~35% growth in BioTrue Multipurpose Solution</td>
</tr>
<tr>
<td>▪ Rx Pharma</td>
<td>$105M</td>
<td>16%</td>
<td>Continued growth in launch products: ~90% Proflensa, ~30% Lotemax</td>
</tr>
<tr>
<td>▪ Surgical</td>
<td>$56M</td>
<td>12%</td>
<td>Strong sales of premium IOLs; new management team</td>
</tr>
<tr>
<td>▪ Contact Lens</td>
<td>$42M</td>
<td>37%</td>
<td>Ultra selling to capacity, strong sales in Biotrue ONEday (99% growth); new management team</td>
</tr>
<tr>
<td>▪ Generics</td>
<td>$46M</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>Other Developed Markets</td>
<td>$284M</td>
<td>8%</td>
<td>Decentralized model: Japan / Western Europe</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>$228M</td>
<td>13%</td>
<td>Decentralized model: China and Middle East, Leveraging VRX large commercial infrastructure: Russia and Brazil</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$891M</strong></td>
<td>12%</td>
<td></td>
</tr>
</tbody>
</table>

Reliant on pricing? Valeant’s true business model

So the Professor claim that the company needs pricing increases to drive it forward, but 70% of their acquisitions had nothing to do with pricing? It certainly seems like the sensationalism in the media trumped the numbers on this issue.

No, in reality, Valeant’s true model is to buy opportunistically buy companies where they believe that they can achieve significant cost synergies by incorporating them into the Valeant platform. For Salix, they expect to achieve $500 million a year in cost savings. For Bausch and Lomb it’s even higher: $800 million in expected savings per year.

As far as R&D goes, the company’s model is to have a low cost, product focused R&D regime. This has proven highly successful, with the company taking Jublia from the IND stage all the way through clinical trials for only $40 million. It is now the second largest drug in their portfolio.
The model and its asinine assumptions

Professor Damodaran discusses the assumptions used in his model, and they’re wildly flawed. Correcting them gives us a far more accurate picture of the company’s value.

Flaw 1: Using TTM numbers for base year earnings

“Consequently, I added back acquisition-related expenses (impairment of goodwill, acquisition charges) to operating income to get to an adjusted operating income for the last twelve months.”

There are a number of issues with using TTM results to model base year earnings. First and foremost, as we pointed out and Professor Damodaran discussed on Bloomberg, the last 12 months only include 6 months of Salix financials. So the company is being docked for $12 billion in debt related to the acquisition, but only being credited for the first 6 months of performance?

The Professor acknowledged the error and attempted to fix the issue by adding back Salix’s numbers from Q4 ‘14 and Q1 ‘15. This too is incredibly flawed and misguided. As mentioned above, Salix has been dealing with a massive channel stuffing scandal. In the time frame the Professor has used to model 10 years worth of earnings on, the company has had to bring inventories down from 9 months to 6-8 weeks.

Furthermore, this period only included one quarter in which their largest drug had been approved for its new indication, IBS-D. Salix estimated in 2014 that this could lead to nearly $2 billion in peak-year revenue, yet it’s almost completely missing from the model! Valeant had not even begun its integrated advertising campaign at this point.

The final nail in the coffin is that these numbers quite obviously don’t include the massive cost savings that Valeant has stated they have achieved. How could it, if half the quarters financials are from before the acquisition?

Fix: Use 2016 guidance, it’s much more representative of long term earning power

The right way to do this would be to use management’s 2016 guidance, which has put out in mid-2014, and has been reiterated every quarter since, including multiple times in 30 days.

Management is currently projecting no less that $7.5 billion for 2016 EBITDA. This increase is attributable to a favorable change in mix as older and significantly less profitable drugs go generic, Xifaxan ramps into the IBS-D market, Jublia continues to grow into its own market, Bausch and Lomb products continue their strong growth, and cost synergies are able to full flow through to the financials.

This one change brings the valuation of the company from $72 to $166 a share.
Flaw 2: Assuming a 20% tax rate

Valeant very deliberately structured themselves to minimize taxes. According to 2016 guidance, they expect to pay only 6% in that year. Furthermore, when doing his due diligence on Valeant for the Allergan deal, he had the long term viability of the tax rate assessed by an outside firm who confirmed that something in the ballpark of 10% will in fact be sustainable.

Fix: Use a 10% tax rate

This is a very straightforward fix, just use the 10% rate confirmed by Ackman’s diligence. In fact the realized rate will likely be even lower, but 10% is a good conservative number.

This change brings the valuation of the company from $166 to $199 a share.

Flaw 3: Assuming a 10% earnings drop from pricing backlash

There are a number of reasons this isn't likely.

1. Congress is so divided that it could never do anything more than launch inquiries. The prospect of passing any federal price control with a Republican congress is absurd.
2. The two drugs that saw the steep hikes are actually a very small piece of Valeant’s business. The majority of its divisions took industry average increases, if any at all.
3. The Professor explains that this number came from assuming that Valeant’s operating margin would fall to the industry average. Valeant intentionally runs a very lean model, so there doesn’t seem to be any reason to assume this.

Fix: Assume no pricing growth instead

It’s fair to assume that Valeant won’t have room to raise prices going forward, so a reasonable step would be to reduce growth estimates but remove this earnings hit.

This change brings the valuation of the company from $199 to $232 a share.

Flaw 4: Assuming very low growth and no acquisitions

Due to the misunderstanding of Valeant’s growth and acquisition strategy, and a lack of information about their new drug pipeline, the Professor assumes just 3% for the next ten years, despite Valeant’s many year history of improving volumes. As they lay out in slide 21 of their most recent earnings call presentation for instance, their overall business saw 8% growth from volume increases in YTD ’15.
Fix: Adjust the growth rate upwards

Management has a great track record of growing drug volumes, and nothing that’s happened in the last six months will change that. Something higher is certainly justified, but to be conservative, let’s use 5% for the 10 year growth rate to account for zero price increases.

This change brings the valuation of the company from $232 to $273 a share.
Conclusion

If you read nothing about Valeant except what’s been reported on by the major papers in the last month or so, then you’d get a very skewed and unrealistic perception of Valeant and their business. Unfortunately, this appears to be what’s happened with Professor Damodaran. Again, while we greatly respect and appreciate his efforts to teach valuation, he has really missed the mark here.

After replacing his assumptions with reasonable but conservative numbers, Professor Damodaran’s model gives us a final valuation of $273 a share. We believe this is a much more accurate assessment of the company.