What happened to my Valeant shares?

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In a column whose chosen focus is on 'business' and 'health care in Canada', we would be remiss to overlook Valeant. The complex narrative of this precipitous fall is just so rich with fodder. While each step in the saga could serve as a springboard for discussion (mergers and acquisitions, short-seller attacks, senate investigations, price gouging, questionable accounting practices, hedge fund promotion, shocking market share losses, 'Cold-FX'), it really is more impressive when we run the gamut from start to present. We have been careful not to use the word 'finish'. The resolution may still be years in the making and this will certainly be out of date by the time of publication. This is a story still unfolding, and with that caveat we will do our best to sort through the themes.

INCEPTION AND BACKGROUND

Valeant is a Canadian company incorporated in British Columbia, headquartered in Laval, Quebec, principally run out of the United States (US), and traded on the Toronto Stock Exchange and New York Stock Exchange. The company arose from the merger of several small pharmaceutical players in the mid 1990s. Its interests are diverse: Valeant manufactures and markets a variety of over-the-counter and prescription medications across a spectrum of subspecialties and diseases. Unlike some of its pharma peers, Valeant eschews home runs for runs batted in. There are few-to-no heavy hitters in its lineup. Consistent niche players make up the team. It is not a research and development-based company; it does not devote years to developing a drug or class, bringing it to market and profiting from proprietary patented protection. Valeant is better thought of as a distributor with the catch that it is a distributor who also owns the patented rights to the medications it sells. How does it come by the product and the patent? Acquisition.

Growth strategy: mergers and acquisitions

Companies can grow organically through increasing sales and expanding the business, or by buying up a competitor through either a merger or acquisition. Mergers generally result in the creation of a hybrid and usually arise when companies of comparable size combine forces. Acquisitions are just that: a smaller player is gobbled up and becomes part of the parent. The principle is pretty simple: borrow money, buy a company, make more than the interest you owe, repeat. As we touched on years back, a publicly traded company doesn't go to the bank for a loan when it needs money; public companies finance their operations with equity or debt. Debt means bonds and equity means stock. It's a formula that has worked very well for Valeant; however, their unique approach to the model is not without controversy.

Pricing strategies

To ensure a steady flow of cash to service billions of dollars of debt, Valeant developed an aggressive pricing strategy. Classically, when a drug is developed by 'big pharma', they receive some form of proprietary protection on profit to cover the investment of research and development. In Canada, a manufacturer is forced to register the compound they intend to sell and is granted a process patent. After several years, that patent expires and generic manufactures can begin to produce and sell the drug, or can work around the process patent by synthesizing the same compound through an alternative series of steps. When a generic product becomes available, it is generally believed to be less profitable in that the per-unit price plunges. On the disease front, a generic or old drug doesn't necessarily lose its appeal. If there are no new developments on the pharma front, the generic remains the mainstay and the consumer and provider benefits from favourable pricing.

Generic evolution has met with disruption of late; several pharma players have been implicated. Companies either acquire a smaller manufacturer or purchase the rights to a drug and then drastically increase the price (1). As regulators and patients are left to struggle with the aftermath, many have been left to wonder where to find the unlocked value justifying the price hike. Take the drug Daraprim, acquired by Turing Pharmaceuticals in the summer of 2015. The price was increased from \$13.50 to \$750 overnight. The rise was so shocking that it seems unbelievable… for the record, its 5500%. The rises for which Valeant has drawn attention have been smaller but still in the hefty 200% to 500% range. There are many other players and examples, but all have drawn considerable ire. These are typically old, niche drugs. In some cases, patients' drug costs have climbed by hundreds of thousands of dollars per year, putting the unlucky group at significant risk.

Negative momentum builds

While one could argue there is no such thing as bad publicity, the position may be tenuous when you are talking stocks. Publicity and momentum appear to play a comparable – if not more significant – role than valuation these days. The CEO of Valeant was subpoenaed to a congressional hearing investigating aggressive drug pricing while the company was already being investigated by the Securities and Exchange Commission for potentially misleading accounting practices, while US prosecutors were simultaneously investigating Valeant for pricing and distribution discrepancies (2).

THE SHORT-SELLER ATTACK: CITRON AND PHILADOR

As a reminder, those who buy a stock and believe that it will go up over time are said to be 'going long'. If you believe the opposite to be true, you can 'short' a security. To short a stock, you borrow shares and sell them at their current value while promising to return the shares by a given date. If your prediction is correct and the stock falls in value, you can buy the shares for less and give them back while keeping the difference in price as profit. As we discussed a while back, hedge funds often use this strategy to protect themselves from major losses while simultaneously sacrificing gains for this protection.

Over the past few years, several Canadian companies have fallen victim to so-called 'short-seller attacks'. In addition to believing that a stock will fall, the short seller also releases a report in which they share some limited degree of information to justify their position. If the mainstream bites, the belief is promulgated among market movers. If the market believes the short seller has stumbled on some hidden gem of information, they will begin to move out of their position. As they do, the stock falls, fulfilling the short seller's prophecy. In essence, the short seller manipulates and moves the market. It's a fascinating topic that could consume an entire column; calls for short-seller regulation will likely rear their head again in the near future (3).

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Enter Philador

Philador is a specialty pharmacy that filled several Valeant product prescriptions. Unfortunately, there are a few allegations against Philador, including altering doctors' orders to increase profit on the prescriptions it filled, along with the suggestion of collusion with Valeant. Its alleged that Valeant had employees on the ground acting as Philador employees to help get things up and running, and it all went amok when Valeant failed to disclose to shareholders that they had purchased the option to buy Philador. That in itself was problematic, but it got worse when Valeant make the poor decision to report Philador's profits as their own in the financial statements they filed with regulators, despite not actually owning the company.

Enter Citron, the short seller

Citron research jumped on Valeant's Philador problem and widely publicized the information (4). Citron also alleged there was much more amok at Valeant. Short sellers are unregulated. Short sellers do not need to disclose the information they allege or their source, and some back-and-forth ensued with threats of legal action from Valeant. However, the damage was done and Valeant began its precipitous slide. There was only so much negative pressure the stock could bear and the downward slide gained momentum quickly.

Enter the hedge fund magnate

One of Valeant's greatest proponents over time has been Bill Ackman, a billionaire hedge-fund manager whose fund also happens to own 10% of the outstanding shares. He did well championing Valeant to investors, but has done worse in the turmoil of its downfall. Ackman has a history of buying large stakes in companies and then pushing the boards toward strategic change that sees a rise in share prices. As Valeant has plunged and his hedge fund has erased value >USD $1 billion over single days, Ackman has become more and more involved in the management of the company (5). Ackman added one of his firm members to the board of Valeant, and then recently joined the board himself to oversee the appointment of a new CEO and have some say in cutting his losses. While its easy to decry short sellers, its just as interesting to lend an inquisitive eye toward vocal stock promoters who find themselves on the board of directors when things go awry.

The aftermath

We don't know the aftermath. This is a saga still unfolding. At the time of publication, Valeant has yet to file its interim statements and the stock is hovering some 90% below last year's highs. The CEO is out but is said to be cooperating with the US Senate. Bill Ackman still owns a sizeable chunk of shares outstanding, and is a vocal board member and, although no one knows how much the short sellers made, we can assume their profits were sizeable. The future of the company is unclear. Will it wade through the storm or be broken up and sold off as scrap? Only time will tell, but its been a saga ripe with teaching points and fascinating turns.

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