Analyst Corner

A Perspective on Valeant

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Valeant Pharmaceuticals is a multinational specialty pharmaceutical company headquartered in Montreal, Canada. Valeant specializes in dermatology, neurology, branded generic drugs and over-the-counter (OTC) products. Over the past 4 ½ years, the company has transformed itself from an unfocused, inefficiently run, growth-constrained enterprise into a thoughtfully diversified, lean, value-focused operator with significant opportunities for growth. Valeant generates roughly half of its sales in the United States, with sizeable operations in Central & Eastern Europe, Latin America, Australia and Canada.

Pharmaceuticals?

Valeant is unlike any drug manufacturer we have encountered. Its management team is equal parts value investor and skilled operator in a marketplace ripe with opportunity for improved capital and cost discipline. Importantly, our investment in Valeant is not dependent on research and development (R&D) success or superior scientific knowledge. Rather, the company's strategy is to identify, purchase and subsequently improve niche pharmaceutical and OTC products already approved and sold in the marketplace. As the company often puts it, "we bet on management, not science." Given the fragmentation and inefficiency that exists globally in pharmaceuticals, the opportunity for someone with Valeant's skill set is substantial.

The company's product portfolio and culture have been thoughtfully constructed to avoid problem areas that have plagued many of its more well-recognized peers: product concentration, patent cliffs, uneconomic R&D, bloated sales organizations, high levels of government reimbursement exposure, and centralized decision making and bureaucracy, to name a few. Management has instead focused on smaller, "off-the-radar" and often neglected products in areas with more limited competition, where branding is important and/or would-be generic entrants lack incentive due to the cost of proving bioequivalence. These characteristics improve the long-term durability of cash flows and provide management a stable platform upon which they can continue to build the flywheel.

Valeant's exposure to patent loss is minimal and its portfolio diverse – the company's five largest products, combined, are expected to represent roughly 20% of 2012 sales. Organic growth is enhanced by a strong presence in attractive emerging pharmaceutical markets such as Brazil, Mexico, Russia, Southeast Asia and most of Central & Eastern Europe. Valeant's acquisition spending with a minimum 20% cash-on-cash return hurdle replaces the more typical R&D function with better risk-adjusted rates of return and a stable of products to improve and grow. Finally, Valeant's decentralized management structure and owner-oriented compensation program together foster an entrepreneurial and nimble approach to exploiting opportunity and limiting mistakes.

A Rare Combination

Quite a few businesses have strong competitive positions, reasonable growth and excess cash flow. The holy grail is finding one run by a talented and disciplined capital allocator at an attractive price. Valeant Pharmaceuticals under the leadership of CEO Mike Pearson fits this profile. He and his team consistently demonstrate an understanding of what creates and, perhaps more importantly, what destroys business value. The company has walked away from numerous well-publicized potential acquisitions on the basis of price, going so far as to call those experiences "successful" based upon what it did *not* do – win at any cost. This is the kind of capital stewardship we covet and why we often gravitate toward true owner operators (Valeant's board and management together own just shy of $240 million in stock).

At $45 and roughly 10 times 2012 cash earnings per share, we believe Valeant stock has considerable upside potential. Even assuming a slowing in the company's organic growth rate, fewer value-enhancing acquisitions, a higher future cash tax rate and no additional borrowing to enhance equity returns, our math suggests a business value in the upper $70 range. If management proves successful in reaching some of its intermediate-term goals, there is additional upside to our estimates.

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He graduated from Taylor University in Upland, IN and previously spent
2 1/2 years as an equity analyst with McCarthy Group Asset Management.
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