Citron RESEARCH

October 2, 2015

Citron Research Exposes the Information that Congress Will Find if it Subpoenas Valeant

Senator Sanders: You don't need a Hearing When you can read Citron.

Valeant's Business Model is Broken...
Stock is Too Dangerous to Own:
Short Term Price Target= $125

Over the past two weeks, shares of Valeant took a steep decline over concerns of price gouging that was recently expressed by Presidential hopeful Senator Bernie Sanders. In his plea for a subpoena of Valeant Sen. Sanders would like to see all communication regarding the price hikes and the reasons behind them. Look no further Senator -- Citron has done the work.

Before reading on, Citron would like to express one clear thought to the reader. The Valeant business model is broken and will fall under its own weight. Any kind of government intervention just expedites the inevitable.

Investors, Politicians, and Concerned Citizens must note that Valeant raised the prices on the two key heart drugs in question the very next day after they acquired them ... just to cover up for a bad quarter. Here's the proof -- all done without wasting taxpayer money on a hearing.

We can tell you all with impunity what the Valeant CEO to CFO email about Q1 2015 said...

On February 10, 2015, Valeant closed on its acquisition of Marathon's drug assets, including Isuprel & Nitropress.

That same day Valeant increased the price of **Isuprel by 525% and Nitropress by 212%.**
http://www.wsj.com/articles/pharmaceutical-companies-buy-rivals-drugs-then-jack-up-the-prices-1430096431

CEO Pearson even admitted on the Q1 conference call that the price hikes were implemented immediately. Pearson:

> Mike Pearson: "...in terms of the price increases, on the two products you mentioned [Isuprel & Nitropress], the company that sold to us [Marathon] had done some pricing work and had identified the opportunities. They had a consultant come in. **Those happened immediately...**"

http://seekingalpha.com/article/3117786-valeant-pharmaceuticals-internationals-vrx-ceo-mike-pearson-on-q1-2015-results-earnings-call-transcript?part=single

Then voila, in VRX's 1Q15 earnings slides (slide 9), despite the small size of the acquisition price, these drugs miraculously leapfrog all of VRX's thousands of products to take two of the top three slots - Isuprel is VRX's single largest drug in Q1 2015 and Nitropress is #3 (tied with Jublia)

Q1 2015 Top 20 Brands (1/2)
($M)

	Product	Q1 14	Q2	Q3	Q4	Q1 15
1)	Isuprel®	-	-	-	-	**$72**
2)	Wellbutrin®	$69	$72	$80	$82	**$68**
3)	Jublia®	-	$3	$12	$54	**$62**
4)	Nitropress®	-	-	-	-	**$62**
5)	Ocuvite®/PreserVision®	$60	$66	$62	$62	**$60**
6)	Xenazine®	$50	$54	$56	$52	**$57**
7)	Solodyn®	$51	$43	$54	$61	**$57**
8)	Targretin® Capsules	$15	$29	$44	$48	**$51**
9)	Lotemax® Franchise	$26	$45	$35	$47	**$43**
10)	ReNu Multiplus®	$55	$49	$41	$46	**$42**

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http://ir.valeant.com/files/doc_presentations/2015/Q12015-deck-Final_v001_r7o11m.pdf

Valeant discloses Isuprel and Nitropress sold $72M and $62M, respectively, in 1Q15 revenue. Citron broke out some algebra to calculate the impacts of these drug price hikes on Valeant's Q1 earnings, which beat consensus by 2c. We conservatively assume these are the revenues for the full quarter. (It was Marathon's revenue prior to the close of the product transfer ...)

(But if this supposition is wrong, and Valeant is reporting these revenues for only the 49 day stub period, the effect of these price hikes on their quarter is **even more extreme**.)

So how much revenue did Valeant gain from jacking prices on just these two drugs?
[Click Here for Calculation Details]

There were 89 days in 1Q15. Valeant owned Isuprel and Nitropress for 49 of the 89 days of the quarter and the prices of the drugs were 525% higher and 212% higher during this 49 day period than during the first 40 days of the quarter prior to VRX buying them.

The calcs show this February 10, 2015 price increase on just these two drugs netted Valeant an additional **$86.95** million revenue that flowed straight to its bottom line -- and that was only during the last 49 days of the quarter.

This $86.9M represented 8.5% of Q1 2015 adjusted EBIT and 10.5% of Valeant's cash EPS metric.

If Valeant had not taken these price increases, it would have missed the Q1 2015 Street consensus EPS estimate by 9.22%.

Here's the math:
Q1 2015 cash EPS reported by Valeant : $2.36
Q1 2015 sell side consensus cash EPS estimate): $2.32
Q1 2015 cash tax rate: 2.2% (= ($80.9M - $62.6M) of cash taxes/($155.4M + $673.0M) of adjusted pre-tax income, from Q1 2015 earnings release
http://www.sec.gov/Archives/edgar/data/885590/000119312515154227/d916861dex991.htm
Cash impact of 85.03 million / 343.4 million shares = $ .248
(Company reported 3c of debt and share impacts of transactions.)

So there's your answer, Senator Sanders, in black and white. The extreme price hikes on these two drugs were the only reason Valeant beat the Street on Q1 2015 estimates, avoiding a 9%+ earnings miss. This is what you will see if you ever get ahold of the emails between the CEO and CFO.

It should be noted that this is in complete contradiction to EVERYTHING CEO Pearson tells Wall Street: That his business model is **not dependent** on price increases.

The Valeant Chronology

The current controversy about Valeant's drug price hikes and its stock valuation did **not** begin when rogue hedge fund / biotech startup dude Martin Shkreli burst upon the scene last week. In 2014, noted shortseller Jim Chanos, most famous for his lone public call-out of Enron, called this stock "a rollup that isn't growing organically" and described its strategy as laced with "aggressive accounting games". It's pretty typical that when short-sellers notice accounting "issues", it's always a year and a half or two before Wall Street catches on.

"Valeant is a house of cards"

Note: These aren't our words.

When Valeant bid to take over Allergan, we really began to see what was under the sheets. Allergan published a presentation of why they were rebuffing Valeant's aggressive takeover maneuvers. To this day, it remains pivotally relevant reading for anyone trying to assess Valeant's business model.

http://www.allergan.com/miscellaneous-pages/allergan-pdf-files/investor-presentation-may-27-2014

Allergan went to great lengths to explain to its shareholders and all who would listen precisely why it was very skeptical of Valeant's business model. But it was none other than Morgan Stanley's analyst who penned the above phrase. For those of you who believe this is just words to poison the deal, it should be noted that Citron has **never** seen an acquisition target describe its presumptive suitor as a house of cards... You might say the price is too low, or you don't agree with the business strategy, but you never say that the suitor is "a House of Cards".

As a frame of reference just look at the current hostile takeover bid of Perrigo by Mylan. While trying to fight off this mammoth hostile takeover, Perrigo has used every possible reason but nothing even close to calling Mylan's business unsustainable or a "house of cards".

Post the Allegan takeover failure, Valeant moved on to take over Salix; Citron thinks it is highly relevant that Salix wouldn't take Valeant stock -- they would only be satisfied by a cash offer. Tipping its desperation, Valeant marched on undeterred, paying up big for Salix, then it took on the two above drugs from Marathon, a group of increasingly poor quality assets (Dendreon and Sprout), **doubled its debt load**, and executed an increasingly objectionable set of extreme drug price jacks. That's where we were as of Monday before the request for subpoena letter.

When the CEO sounds desperate and begins to lie, it is time to Exit the Stock

Monday was when Valeant CEO penned a remarkable "letter to employees", enshrined forever as an 8-K. We put this description in quotes, because not a single person who we have consulted on this letter thinks it was even remotely intended for employees, be it Valeant's or anyone else's.

This letter was supposed to address the concerns of employees about Valeant share price. Consider that as of the date he filed it, his stock was up 30% for the year, while the S&P and the IBB are flat for the year. So what exactly does CEO Pearson have to defend, other than his company's stock has pulled back after a massive run fueled by biotech?

Instead he goes on to the next lie, actually a pair of them, namely that:
1) His company is not dependent upon price increases, and that
2) His company has strong organic growth

It is Citron's strong opinion that Pearson's hyper-sensitivity to his company's stock price is typical of CEO's with something to hide. It was controversial for a while, but now the controversy is getting more ominous every day. **The last time we saw a CEO make a public comment of this magnitude about his company's stock to his employees was Kenneth Lay …. no comment.**

The Valeant Tactics are Getting Worse Every Day -- at the Expense of Patients and Taxpayers

Valeant has moved on to its next target, the newly acquired diabetes drug Glumetza (from Salix).

Wall Street has to understand the difference between Valeant's narrative: "We manage around our ability to raise prices. We find a drug that's inefficient, we raise prices." ... and reality.

At face value, this sounds like a strong business case. Citron understands raising prices on drugs. Raising prices on pharmaceuticals is necessary and it standard at 6-8% across the industry. **But what Valeant does is not simply raise the price but rather it pushes the limits of every vulnerability it can find across the entire US healthcare system**.

Raising a drug price 10-fold overnight is worse than Congress holding a secret meeting one night to raise their own salaries. If one night in a secret meeting Congress decided to raise salaries from $170k a year to $1.7 mil a year- we would have a revolution…..But that is just what Valeant just did with Glumetza -- **a damned diabetes drug**.

$60,000 a year? **For a diabetes drug? Have you guys no decency at all?**

Look at what hit ordinary Americans when they went to the pharmacies to refill their prescriptions **last week**. We hope every member Rep. Chaffetz's House Oversight & Government Reform Committee reads these posts.

> I too have had to fight with my insurance company to cover my Glumetza script. It was being denied because the price had jumped astronomically, over $6K a month! I found out that even some of the generic forms of this medication have had their prices driven up. I cannot take metformin due to the really bad side effects.
>
> -- September 26, 2015

> My Glumetza was $685 for a month supply in June. July it went up to $4750. August went to $6270….still for 1 month…..Totally ridiculous if you asked me but what can you do…..NOTHING! My doctor put me something else that seems to be working OK ... so far..
>
> -- September 28, 2015

I was shocked by the cost increase of Glumetza. My insurance will no longer cover it because of the cost. I'm now on Metformin XR which is causing me massive gastric side effects. I did extremely well on Glumetza for several years. Metformin doesn't control my diabetes as well.

-- September 28, 2015

Hello. I'm a New York Times reporter looking into drug price increases. I'd be interested in speaking with any of you who posted here.

Sabrina Tavernise – sabrinat@nytimes.com.

http://pharmacychick.com/2015/07/07/dump-glumetza-and-hang-their-reps/

These posts are from diabetes patients. They don't know anything about stock, or anything else except they can't get their medicine.

Citron suggests that Valeant explain to each of these and thousands more patients just trying to cope with their diabetes that it's going to have another great quarter!

The Myth of "Organic Growth" at Valeant

This is CEO Pearson's "phrase that pays" -- he invokes this mantra whenever he needs to project the mental image of Valeant's revenues effortlessly growing toward the sky forever, as though his pipeline of drugs is possessed of powers like a bag of magical beans from a fairy tale, justifying an ever more optimistic multiple.

Nothing could be further from the truth. In fact, his mantra, usually expressed in the incantation "double digit organic revenue growth" **is a complete lie**. Here's how it really works.

Drug revenues have always been a withering asset class; even more so for Valeant's strategy of buying mature drugs already in the market. Attrition of drug revenues is normal in the pharma business, as newer products, better treatments, expiring patents and competition from generics all eat away earlier-achieved revenue runs.

But in the case of Valeant's drugs, there are also induced erosions, such as seen with its drugs Isuprel and Nitropress. As we saw, Valeant posted these drugs as the #1 and #3 top revenue earners in Q1 2015, but Q2 results demonstrates their run rates **had already peaked** -- Nitropress was flat, and Isuprel fell significantly from $72 million to $49.

In reality, Valeant's portfolio of high-revenue drugs is a tumultuous jumble of boom-bust cycles, created by the earlier-described extreme price jacks, and the weight of inevitable attrition.
We were struck to notice that as quickly as the 2nd quarter 2015, Isuprel and Nitropress had already been eclipsed by many other drugs on Valeant's "top 20" drugs disclosure, falling to 7th and 11th respectively.

Q2 2015 Top 20 Brands (1/2)

($M)

	Product	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
1)	Xifaxan®	-	-	-	-	**$148**
2)	Jublia®	$3	$13	$53	$62	**$102**
3)	Provenge®	-	-	-	$30	**$74**
4)	Wellbutrin®	$72	$80	$82	$68	**$67**
5)	Xenazine®	$54	$56	$52	$57	**$66**
6)	Solodyn®	$43	$54	$61	$57	**$65**
7)	Nitropress®	-	-	-	$62	**$64**
8)	Ocuvite®/PreserVision®	$66	$62	$62	$60	**$59**
9)	Lotemax® Franchise	$45	$35	$47	$43	**$53**
10)	Arestin®	$30	$30	$38	$32	**$52**

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Q2 2015 Top 20 Brands (2/2)

($M)

	Product	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
11)	Isuprel®	-	-	-	$72	**$49**
12)	ReNu Multiplus®	$49	$41	$46	$42	**$46**
13)	Apriso	-	-	-	-	**$31**
14)	Elidel®	$25	$22	$31	$26	**$31**
15)	CeraVe®	$26	$21	$27	$30	**$30**
16)	BioTrue® Solution	$27	$26	$25	$28	**$29**
17)	Syprine®	$18	$20	$30	$18	**$28**
18)	Glumetza®	-	-	-	-	**$26**
19)	Targretin® Capsules	$29	$44	$48	$51	**$25**
20)	Artelac®	$27	$25	$23	$19	**$24**

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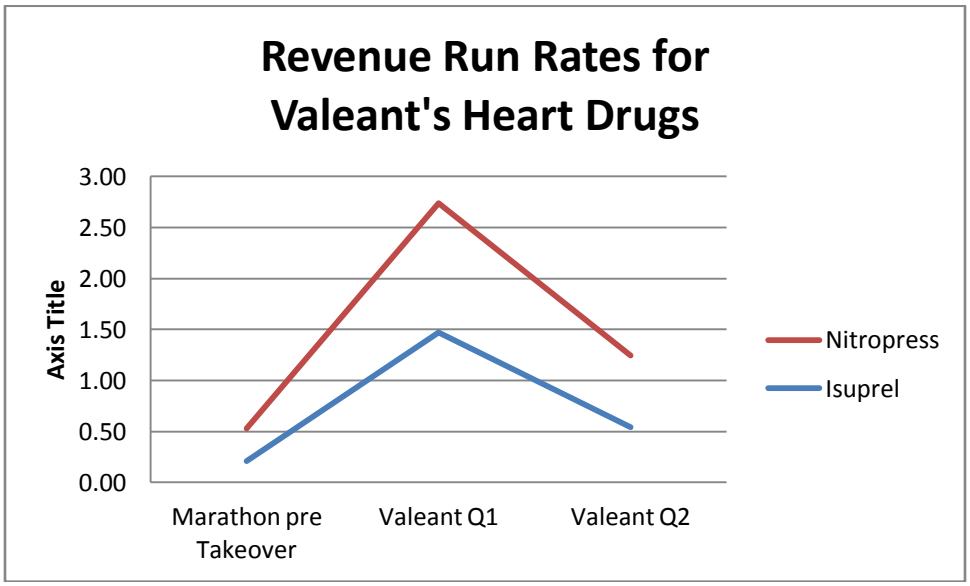
So we returned to the spreadsheet where we calculated the per-day revenue run rates on these drugs, extending the revenue analysis into Q2, and even we were shocked:

Morgan Stanley's downgrade this morning stated blandly:

"the investment community may scrutinize (and discount) select product revenue driven by outsized price increases , given concerns about sustainability of such action."

-- Morgan Stanley Research Note
October 2, 2015

Here's what they really meant**. This quarter over quarter result for Isuprel and Nitropress is graphed here:**



The Very Portrait of "Unsustainable: Yeah, but they made the quarter.

	Q1 Run Rate per Day ($M) Valeant	Q1 Run Rate per Day ($M) Valeant (*)	Q2 Run Rate per Day ($M) Valeant	Run Rate Net Change Q1 to Q2	Run Rate Net Change Q1 to Q2 (*)
Isuprel	1.30	1.47	0.54	**-58.60%**	**-63.38%**
Nitropress	1.00	1.27	0.70	**-29.93%**	**-44.46%**

(*) If all the revenue on Q1 "Top 10" slide above is Valeant's

Despite being the "saviors" of Valeant's Q1, both of these drugs took massive run rate hits in Q2, falling 30% or 40% to over 60% depending on which assumption is made about Q1 revenues.

We can only guess that as the market absorbed 200% and 500% overnight price hikes, insurance company pushback, adjustment to other drugs and treatment regimes, etc., was inevitable. **These price hikes appear to be seriously impairing the market for these drugs.**

But the real lie is the way Valeant has redefined Organic Growth -- in its treatment of the drugs they discontinue during a quarter. Withering is not a problem for the genius accounting of Pearson. With the stroke of a pen, they sunset a drug, and it becomes a positive, not a negative. How?

Simple. "Divestitures and discontinuations" is an adjustment to prior period revenue for the purpose of "Organic Growth" calculation. "Prior period same store revenues" is not a "real" accounting entry, it's just a benchmark from which to measure "organic growth". So if you're constantly culling the wasting assets in the drug portfolio, you will always be overstating organic growth. This is where the "bodies are buried". When it discontinues a drug, Valeant "adjusts" that revenue **out of the prior period** for the purposes of computing "organic growth". This magical stroke of the pen turns a negative -- the failure of a previously paid-for revenue stream -- into a positive, as it **lowers the bar** against which new "organic growth" is measured.

Thus arithmetically, the larger the “divestitures & discontinuations,” the higher Valeant’s organic growth rate. If sales of a given product are doing poorly in the current period and dragging down organic growth, say because of a patent expiration or manufacturing trouble or lack of marketing investment, Valeant can discontinue the product and thereby exclude it from the organic base, label the write-off a one-time impairment. Poof, problem solved! A negative is neatly turned into a positive -- a very persuasive positive on The Street.

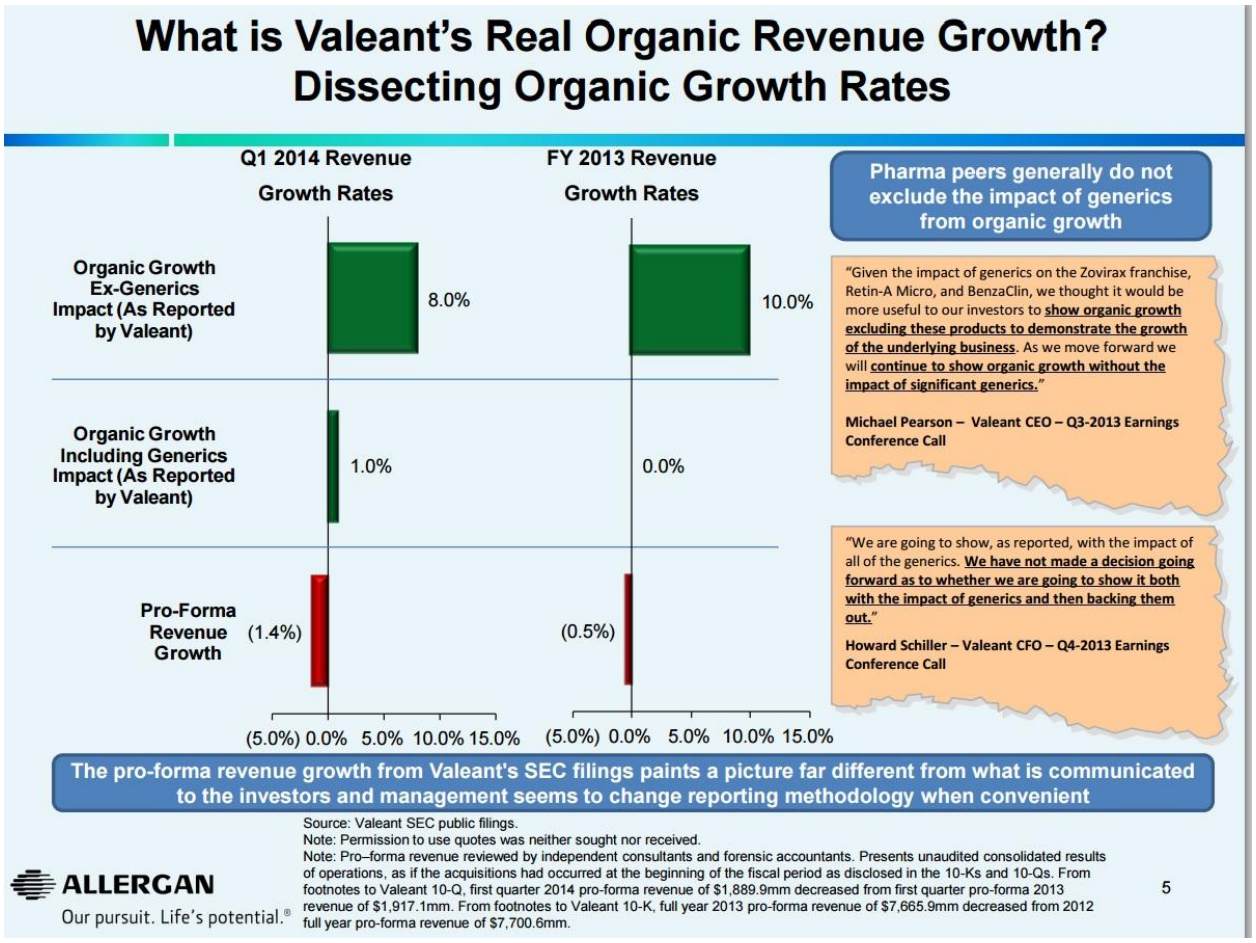
And when the "discontinued" product has really just been replaced by a rebranded, slightly reformulated version of the same drug, well, you can see where that leads ... But wait, Valeant wouldn't do that ... or do they ?

Suspicions about Valeant's organic growth rates stretch back to Allergan's spurning Valeant's bid in 2014. Now you know why Allergan deemed Valeant's organic growth "low" and "driven mostly by price increases".

"Allergan claimed Valeant had overstated its organic growth rates and pro forma revenue growth."

http://dealbook.nytimes.com/2014/05/27/allergan-seeks-to-discredit-would-be-buyer-valeant/

Below, Allergan savages Valeant's Organic Revenue growth for yet another reason: Excluding the impact of generics, another area where reality and fiction part ways. Allergan lectures that "Pharma peers do not exclude the impact of generics from organic growth"...



http://www.allergan.com/miscellaneous-pages/allergan-pdf-files/investor-presentation-may-27-2014

Taken together, discontinuing drugs to remove them from prior period baselines, and excluding the impacts of generics on organic growth, completely warp the true organic growth of Valeant. Considering the rate at which it is digesting companies and burning consolidation expenses, it is truly impossible to determine how much, but for certain, it is far lower than the "double digit" number they are fond of touting, and may in fact be non-existent. We suggest investors focus on GAAP cash generation going forward.

Our conclusion is that Valeant's organic growth numbers are dangerously misleading and cannot be relied upon. The pattern of Isuprel and Nitropress demonstrates Valeant destroying their goodwill with classes of customers and providers, and as the market adjusts away, as shown by the Isuprel and Nitropress Q2 run rate declines, they are undermining their own sustainability -- trashing the long-term earning power of their drug portfolio in an ever-more-desperate strategy of "making the quarter". It's a desperate strategy doomed to failure.

The Morgan Defense Spectacle

This morning's downgrade on Valeant comes 18 months too late and is tepid compared to their earlier "house of cards" comments. Just when you think the Valeant story is really a debate about accounting issues, Morgan came out with a response relying on political gridlock -- why the Republican committee chairman will assure that no congressional action will amount to anything. Whether the company is engaging in price gouging, accounting fraud, or a rollup bubble, don't worry, Congress is too dysfunctional to solve it. That's Morgan's investment advice.

You know the system is broken when Wall Street constructs an investment thesis resting on the fact that the system is gridlocked and can't take action.

When Wall Street calls Congress broken, now you **know** there's a problem.

Time for some Senators to show up and demonstrate that they know that its Wall Street that's broken.

Bill Ackman

While Citron has great respect for Mr. Ackman, and no doubt he has the best head of hair on Wall Street, he does make many BIG mistakes. We believe many investors own Valeant because of Mr. Ackman's pouding of the table on Valeant comparing it to Berkshire Hathaway.

Nothing could be further from the truth. Berkshire Hathaway, while mainly an investment vehicle, is still the nations 14th largest employer, who operates steady cash-flow businesses that are part of the fabric of this world -- Nitropress is not Dairy Queen. For every General Growth Properties, let us not forget JC Penny, Target, Fannie and Freddie *. Mr. Ackman made a bold and savvy move with his Allergan trade but in the case of Valeant, he is plain out wrong.

* Citron has no comment on Herbalife -- that would require a book, not a paragraph.

Conclusion

The Valeant story has so many interesting angles to comment on that Citron has not even started with how and when this falls apart -- but we think we are closer to the end than the beginning. The political firestorm over price hikes is one that is deeply necessary. As noted by Morgan Stanley this morning, Valeant's ability to execute more acquisitions is now deeply impaired. If this company cannot move forward, it moves backwards.

Valeant Stock was $125 when their Allergan takeover was rebuffed- since then the debt load has doubled, while the quality of acquisitions has waned – look for a round-trip right back.

Morgan Stanley had their moment of truth this morning, when they acknowledged the real danger that Valeant's business model of acquiring companies for the sake of raising drug prices with no consequence to anyone is now over.

YES -- There will be a Part 3 which shows the that Valeant's cash flow is not what it is claimed. More importantly, management is currently playing shell game accounting worthy of a magician. It's an exhausting story, but worth it … the American people deserve to know how the greed of Wall Street affects their daily lives.

Cautious Investing to All.