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Dear Shareholder,

We are witnessing a series of attacks against the management credibility and business practices of our largest holding, Valeant Pharmaceuticals International, Inc. Over the past few months, the market capitalization of its shares has fallen by more than 50%. This has caused an extraordinary level of pain, made worse because the most serious allegation leveled against Valeant – that it set up specialty pharmacies as a way to create fraudulent sales and inflate its reported growth rate – is false. As an academic case study, Valeant would be fascinating. As a real life experience, it hurts.

As most of you know, Valeant is a pharmaceutical business built largely by acquisition rather than by research and development. Its chief executive, J. Michael Pearson, has in our opinion done a masterful job of acquiring a broad portfolio of prescription drugs across dermatology, ophthalmology, neurology and gastrointestinal categories, as well as over-the-counter products and branded generics. In a letter to clients, we once described Pearson as a value investor in pharmaceuticals. He understood that developing drugs from scratch via in-house R&D had become a low-return proposition for many companies and that higher returns could be earned by acquiring products in attractive categories, using historically low interest rates to fund purchases with debt, and then taking out costs and utilizing lower tax domiciles to house intellectual property. He has been aggressive every step of the way and has attracted equally aggressive critics.

In February 2015, Valeant purchased a portfolio of older branded drugs that it believed had been underpriced by the former owner. Once acquired, it dramatically increased prices on the entire portfolio. In this case, two of the drugs were important cardiac medicines used by hospitals during heart surgery, prompting a harsh reaction from politicians, health care payers, hospitals and the general public. While these were small products for Valeant in terms of revenue, the episode created an impression that the business is driven primarily by egregious price increases.

The short seller Andrew Left, writing as Citron Research, exploited the negative sentiment surrounding Valeant. Last week, he published a report in which he compared Valeant to Enron and claimed he'd found a "smoking gun" that proved that Valeant was engaged in fraud. Valeant, he wrote, had created a network of captive pharmacies into which it sold product as a way of inflating its revenue and reported profits. Valeant's stock price fell dramatically in the hours after the report was published. Left's claim was quickly addressed by Valeant in considerable detail, including in a 75-minute conference call on the morning of October 26. The sensationalist claims already seem to have been abandoned. But perception matters. Past behavior made Valeant vulnerable to claims that it might cross a legal line.

Valeant has disclosed that it is closely involved with a pharmacy called Philidor Rx, and that Philidor has relationships with several other small pharmacies. These pharmacies dispense Valeant prescriptions to dermatology patients. Valeant says the inventory held by these pharmacies remains on Valeant's books until the product is shipped to a patient. If Valeant were recording phantom sales, as alleged in the Citron Research report, we would expect its accounts receivable would be growing out of proportion to overall sales growth and its cash flow would be poor. Instead, Valeant's accounts receivable growth has been in line with overall sales growth for the first nine months of the year, both up about 30%. Cash flow conversion has been in line with expectations.

The short sellers have moved on to other claims. They now seem focused on the structure of Valeant's relationship with Philidor. Valeant helped create Philidor and has an option to buy it, yet Valeant says it does not control the pharmacy. It seems Valeant initially made some effort to conceal its involvement with Philidor, which Pearson concedes was "stupid." And clearly, Philidor exists to dispense Valeant-branded prescriptions to patients who might be asked to accept a generic substitute at a drug store. This bothers some observers, though every prescription that Philidor fills is written by a doctor who intended that the patient receive a Valeant drug. Our research suggests many dermatologists like Philidor and resent having their prescribing decisions questioned by managed care.

Our consultations with lawyers who specialize in the pharmaceutical industry lead us to believe there is no legal reason Valeant can't advise, control or own Philidor. At least one other large drug company owns its own pharmacy. There is no point in trying to conceal the relationship.

There are allegations that Philidor turned to smaller pharmacies to fill prescriptions when health care payers began to reject invoices from it. We don't know whether this is true, though Valeant says only one large health care payer declined to do business with Philidor.

The company has named four members of its board of directors to a special committee to examine the relationship between Valeant and Philidor and report its findings to shareholders. Whatever the committee finds, Philidor does not drive Valeant's results. Roughly $180 million of volume, or about 7% of Valeant's third quarter sales of $2.7 billion, was dispensed by Philidor. These prescriptions carry average profitability for Valeant. If Philidor did not exist, Valeant probably would lose a portion of its prescription volume as these prescriptions moved into other dispensing channels. Its growth rate might slow. But the company is not dependent on Philidor.

We work hard to understand Valeant and its business model. Our belief has always been that Pearson is honest and extremely driven. He does everything legally permissible to maximize Valeant's earnings. One lesson of recent events is that sometimes doing everything legally permissible to maximize earnings does not create shareholder value. All enduring businesses must strive to earn and maintain a good reputation. Because of its large indebtedness and need to tap the capital markets to make acquisitions Valeant in particular needs the confidence of the credit market to execute its business model. The company has no large debt maturities over the next two years, and we believe it intends to pay down scheduled maturities through 2018 out of cash flows. We'd like Valeant to consider paying down more of its debt early and adopting a conservative capital structure that insulates it from the possibility of long-term tightness in the credit markets.

We have been asked by clients and friends why we own such a company. In our view, Valeant is an aggressively-managed business that may push boundaries, but operates within the law. When ethical concerns arise, management tends to address them forthrightly, but in the moment. We would stress the importance of taking a more systemic approach to managing business practices with an eye on the company's long-term corporate reputation. We believe the company will learn from the current crisis the importance of reputation and transparency to all stakeholders, especially the shareholders.

We note a few things in closing. The company has a robust pipeline of new products and has said that it will not need significant price increases over the next three years to achieve double-digit earnings growth. In 2016, we believe Valeant should grow earnings by at least 30%, generate free cash flow in excess of $4 billion and have the liquidity to pay down some of its bonds before their scheduled maturities. At a recent price of $110, Valeant trades for about seven times the consensus estimate of 2016 cash earnings, which does not strike us as a rational price for a company with a diverse collection of product lines and strong earnings growth.

Sincerely,

Robert D. Goldfarb

Robert D. Goldfarb David M. Poppe

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