



## Today's 40% Drop Is Not Enough For VRX

Valeant Pharmaceuticals (VRX: \$36/share) had been in a bit of a limbo lately, as investors awaited the long delayed 4Q15 results. The company finally released its earnings today and the results were to be expected [if you heeded our previous warnings](#).

### Bad News Not A Surprise

In the release, the company recognized the significant issues it faces after the termination of its relationship with Philidor, the cancellation of almost all price increases, and underperformance in several of its business lines. Not only did Valeant report weak results for 4Q15, but looking forward, the company guided for revenue (\$2.3-\$2.4 billion vs. \$2.8-\$3.1 billion expected) and earnings (\$1.30-\$1.55/share vs. \$2.35-\$2.55/share expected) to come in significantly below expectations.

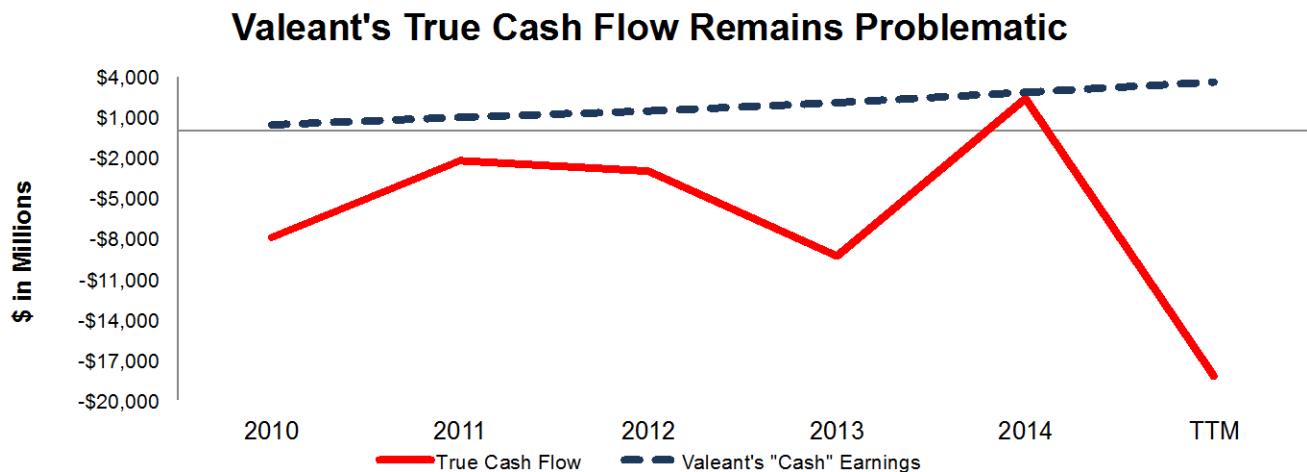
Adding even more uncertainty, Valeant also revealed that it faces a risk of default if it is unable to file its 10-K with the SEC by April 29, which would break its reporting covenant in its bond indentures. The initial filing was due February 29 but has been delayed while Valeant investigates its business relationship with Philidor. Valeant is already in the process to extend deadlines for filing its 10-Q for the first quarter of 2016.

### Has The House Of Cards Finally Collapsed?

As early as [June 2014](#), we pointed out Valeant was presenting itself in a misleading way. Ultimately, the company was relying on non-GAAP metrics to present its cash flow as highly positive, when in fact, the true cash flows of the business have been highly negative. This contrast between cash flow calculations is a [topic of much debate between bears and bulls of Valeant](#) and really gets at the heart of why non-GAAP metrics continually fail investors when analyzing a company. Analysis using Valeant's reported "Cash Earnings" weren't getting a true picture of the company, as can be seen in Figure 1.

The company's non-GAAP "cash earnings" have grown from \$421 million in 2010 to \$3.55 billion over the latest trailing-twelve months (TTM). In reality, [free cash flow](#) has been highly negative with a cumulative -\$38.4 billion in losses over the same time frame. Cumulative non-GAAP earnings during the same time are \$11.2 billion.

Figure 1: True Cash Flow Provides True Picture of Valeant



Sources: New Constructs, LLC and company filings

Valeant uses [non-GAAP metrics](#) to make its business look better than it is according to corporate accounting rules (i.e. GAAP) while burning through cash at an unsustainable and alarming rate.

### Non-GAAP Doesn't Pay Down Debt

As seen above Valeant's true cash flow is not only much lower than Valeant would have investors believe, it is also largely negative. While management can prop up shares by touting non-GAAP results, those results don't help pay debt covenants because the true cash flow is not available. Debt covenants may soon become just another issue in the already long list if Valeant defaults on its bond indentures. We already know Valeant has raised significant capital, as its debt has increased from \$372 million in 2009 to \$30 billion over the last twelve months. Without a sale of assets, one has to wonder how well Valeant can service such debt because it won't be happening with non-GAAP "cash earnings."

### Warning Signs Were All Around

The warning signs at Valeant have long been in clear view, if you looked past the positive analyst sentiment, excellent non-GAAP results, and management rhetoric.

1. In [June 2014](#), we noted that Valeant was presenting its business in a misleading way to bolster its takeover attempt of Allergan.
  - a. Valeant claimed it was undervalued based on P/E ratios when in fact the company was comparing its adjusted P/E to the unadjusted P/E of industry and market peers.
  - b. Additionally, Valeant claimed its previous acquisitions were value creating when in fact the company's return on invested capital (ROIC) has been in decline for quite some time. From 2009 to the last twelve months, Valeant's ROIC has fallen from 15% to 5%.
2. In [July 2014](#), Valeant made our list of companies with the most misleading [non-GAAP earnings](#). According to GAAP, Valeant lost \$866 million in 2013, but by their non-GAAP metrics the company earned \$2 billion. This disconnect stems primarily from excluding the costs related to its acquisitions. Does it make sense to exclude the costs related to how you grow your business from how you measure profits? We find that fishy.
3. We revisited the non-GAAP red flag again in [November 2015](#), and the story had only gotten worse.
4. In February 2016, we placed [Valeant in the Danger Zone](#). After today's share price decline, VRX is down 57% since our report.

### Stock Remains Overvalued, Even After 40% Decline

After such a drastic price decline, one might think VRX is a bargain. Not even close. Those purchasing Valeant now would be buying a highly overvalued stock with a long history of misleading accounting. These are not exactly the characteristics of a quality investment.

In order to justify its current price of \$36/share, the company would need to [grow NOPAT by 15% compounded annually for the next 8 years](#). In this scenario, Valeant would be generating \$29 billion in revenue, greater than AstraZeneca's (AZN) 2015 revenue.

Even in an ideal scenario, in which Valeant focuses on internal growth and not destructive acquisitions, VRX still has significant downside. If Valeant can [grow NOPAT by 9% compounded annually for the next decade](#), the stock is worth \$23/share today – a 36% downside.

*Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.*



## ***New Constructs® – Profile***

---

### ***How New Constructs Creates Value for Clients***

We find it. You benefit. Cutting-edge technology enables us to scale our [forensic accounting expertise](#) across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our [stock rating methodology](#) instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our [forward-looking fund ratings](#) are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating ([details here](#)) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

### ***Our Philosophy About Research***

Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

### ***Additional Information***

Incorporated in July 2002, [New Constructs](#) is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. [NOPAT](#), [Invested Capital](#), and [WACC](#), to create [economic earnings models](#), which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).

## DISCLOSURES

---

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

## DISCLAIMERS

---

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.