

Sept 28, 2015

Why a Congressional Subpoena to Valeant About Price Gouging on Drugs Should be Granted

Short term price target \$130 -- Longer Term ... worse.

Note: This is part 1 in a multi-part story. While this note 1 discusses moral outrage over Valeant's (**NYSE:VRX**) twisted strategic assault on the healthcare system, Part 2 will discuss the imminent danger of an over-levered balance sheet and why it will implode sooner than later.

Note: This is not a biotech problem. It is a Valeant problem.

The Real Risk to the US Healthcare System is when Health Care Costs are controlled by Hedge Fund Billionaires

How Pharmaceutical Pricing Runs Amok While U.S. Taxpayers Are Looted

For the last 14 years Citron Research has specialized in stories fighting against the abuse of ordinary investors in the stock market. Of course, we have never been shy to expose the greed of the Wall Street establishment. The story we share today has the farthest-reaching social implications of any that we have ever exposed.

While the whole country is in an uproar about Turing Pharmaceuticals, a one-drug startup pharma company attempting to raise prices on a single AIDS drug, the **real** issue is a 100-billion monster only Wall Street could love -- an extremely leveraged company that set the standard for this type of abuse, while being cheered on by a cadre of Wall Street high-rollers too wealthy to fret over their own personal health care costs, and its posse of hedge fund operators.

The real problem with drug pricing in America is forged in a single word:

Valeant

Don't Hate The Player – Hate the Game

In the Twitter-storm furor over Turing's recent one-drug price gouge attempt, the media has overlooked the reality that **Martin Shkreli was created by the system**. Shkreli is merely a rogue trying to play the gambit that Valeant has perfected.

This article is not for you hedge fund managers who believe that this quarter's performance is more important than human decency or long-term viability; this article is for the millions of Americans who together can be strong enough to mandate change. Wall Street will understand in time.

While Citron Research analyzes the future viability of Valeant based on their highly levered portfolio of drugs, the main takeaway of this article is the danger that Valeant's corporate strategy jeopardizes the entire US pharmaceutical industry, and its status as a leader in the development of drugs for the entire medical system.

Systemic Drug Price Hikes ... Because they Can

Lets us start with drug price hikes. [Senator Sanders called attention to just two instances](#): heart drugs Isuprel and Nitropress.

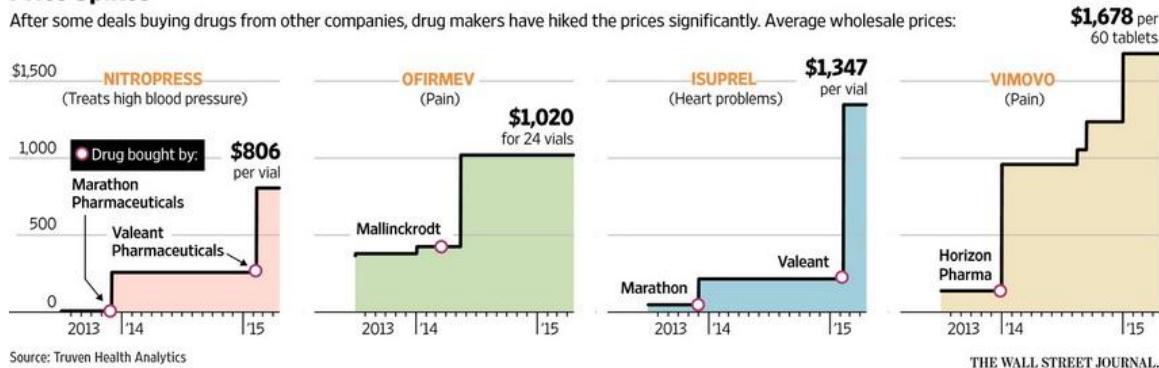
Cleveland Clinic states price hikes for the two Valeant drugs unexpectedly adds \$8.6 million, or 7%, to this year's budget of roughly \$122 million for medicines administered at its hospitals ...

[Pharmaceutical Companies Buy Rivals' Drugs, Then Jack Up the Prices](#) [\(WSJ 4/26/2015\)](#)

Sadly, these are but two examples of the whole truth. Citron Research is in the process of compiling a comprehensive dataset detailing drug price increases by Valeant. We will publish our findings on <http://www.valeantpricing.com> as soon as our research is conclusive. In the meantime here is an example of some of the more egregious increases:

Price Spikes

After some deals buying drugs from other companies, drug makers have hiked the prices significantly. Average wholesale prices:



<http://www.wsj.com/articles/pharmaceutical-companies-buy-rivals-drugs-then-jack-up-the-prices-1430096431>

This Chart Cannot Be Ignored

Valeant Drug Price Increases	From	Thru	Years	% Increase
OFLOXACIN 0.3% EAR DROPS	Q1-13	Q3-15	2.50	2288%
CUPRIMINE 250 MG CAPSULE	Q1-14	Q3-15	1.50	786%
LODOSYN 25 MG TAB	Q1-13	Q3-15	2.50	596%
TASMAR 100 MG TABLET	Q2-13	Q3-15	2.50	575%
CARAC CRM	Q1-13	Q3-15	2.50	557%
ERYTHROMYCIN-BENZOYL GEL	Q1-13	Q3-15	2.50	515%
ZELAPAR 1.25 MG ODT TAB	Q1-13	Q3-15	2.50	507%
MESTINON 60 MG TAB	Q1-13	Q3-15	2.50	428%
ISORDIL 40 MG TABLET	Q3-14	Q3-15	1.00	424%
VASOTEC 20 MG TABLET	Q1-13	Q3-15	2.50	421%
EDECIN 25 MG TAB	Q1-13	Q3-15	2.50	420%
WELLBUTRIN XL 300 MG TABLET	Q1-13	Q3-15	2.50	381%
MEPHYTON 5 MG TABLET	Q3-13	Q3-15	2.00	350%
CARDIZEM CD 360 MG CAP	Q1-13	Q3-15	2.50	335%
TRETINOIN 0.1% CRM	Q2-14	Q3-15	1.25	328%
VANOS 0.1% CREAM	Q1-13	Q3-15	2.50	279%
ATIVAN 2 MG TABLET	Q1-14	Q3-15	1.50	275%
mysoline 250 MG TABLET	Q1-14	Q3-15	1.50	233%
ALDARA 5% CRM	Q1-13	Q3-15	2.50	223%
HYDROCORTISONE BUTYR 0.1% OINT	Q1-13	Q3-15	2.50	221%
XERESE 5%-1% CREAM	Q1-13	Q3-15	2.50	216%
NORITATE 1% CREAM	Q1-14	Q3-15	1.50	212%
IPRATROPIUM 0.06% SPRAY	Q1-13	Q3-15	2.50	200%
NEOMYCI/POLY/GRAM OPHTH SOL	Q1-13	Q3-15	2.50	199%
PROPARACAIN 0.5% EYE DROPS	Q1-13	Q3-15	2.50	184%
TIMOLOL 0.25% GEL /SOLN	Q1-13	Q3-15	2.50	172%
MIGRAL NASAL SPRY	Q1-13	Q3-15	2.50	159%
ERTACZO 2% CREAM	Q1-14	Q3-15	1.50	147%
LOPROX 1 % SHAMPOO	Q1-13	Q3-15	2.50	145%
ATRALIN 0.05% GEL	Q1-13	Q3-15	2.50	135%
DIHYDROERGOTAMINE MESYLATE 4 MG/ML NASAL SPRAY	Q1-14	Q3-15	1.50	90%

Consistently, the justification for high prices of drugs in the U.S. has been the argument that we need continued R&D to drive innovation -- and high drug prices are the only way to pay for such innovation. The argument has substantial merits. However, it should be noted this argument is also highly subject to abuse; Valeant has become the ultimate abuser.

Valeant's Slash and Burn Strategy for R&D

Valeant CEO Michael Pearson is a former pharmaceutical consultant with McKinsey & Co. (23 years) Correspondingly, Valeant's strategic plan reads like a consultant's playbook: cut costs and raise prices. Simple, right?

From a consultant's perspective, Valeant's fiscal strategy is logical.

Unfortunately, from a systemic perspective, just about every American is worse off as a result of Valeant's strategy. Increased drug prices also drives higher health insurance premiums for every policyholder in the entire country, and higher deficits for the Federal Government, which bears Medicare costs. Meanwhile, no one is getting any incremental benefit; Valeant has made little to no effort to improve these products.

Comparative R&D Expense for Major Pharmaceutical Companies

Comparative Company Analysis										
Ticker	Name	EV (US\$)	R&D	R&D/Sales	2014A	EV / Sales		EV / EBITDA		2014 EBITDA Margin
			2014A	2014A	R&D / EV	2016E	2017E	2016E	2017E	Margin
US Large Pharma										
JNJ	Johnson & Johnson	\$242,437	\$8,400	11.2%	3.5%	3.3x	3.2x	9.6x	9.0x	33%
MRK	Merck & Co. Inc.	\$158,344	\$7,180	17.0%	4.5%	3.9x	3.9x	9.9x	10.1x	29%
ABBV	Abbot Inc	\$116,822	\$3,297	16.8%	2.8%	4.4x	4.1x	9.7x	8.6x	21%
LLY	Eli Lilly & Co	\$98,883	\$4,734	24.0%	4.8%	4.6x	4.4x	16.6x	15.1x	21%
BMY	Bristol-Myers Squibb Co	\$100,665	\$4,534	28.9%	4.5%	6.0x	5.3x	21.6x	16.6x	19%
PFE	Pfizer Inc	\$207,442	\$8,400	17.1%	4.0%	4.0x	3.8x	9.3x	8.6x	38%
Non-US Large Pharma										
BAYN	Bayer Ag-Reg	\$128,430	\$4,324	8.9%	3.4%	2.3x	2.2x	10.1x	9.4x	20%
NOVN	Noventis Ag-Reg	\$254,113	\$9,900	17.0%	3.9%	4.8x	4.6x	15.8x	14.3x	30%
ROG	Roche Holding Ag-Genusschein	\$237,715	\$9,839	20.8%	4.1%	4.7x	4.5x	11.1x	10.4x	35%
SAN	Sanofi	\$135,745	\$5,050	15.1%	3.7%	3.2x	3.1x	10.1x	9.6x	30%
NOVOE	Novo Nordisk A/S-B	\$139,793	\$2,236	15.8%	1.6%	8.0x	7.3x	17.3x	15.8x	43%
AZN	AstraZeneca Plc	\$87,522	\$5,579	21.4%	6.4%	3.7x	3.7x	12.3x	12.0x	32%
GSK	Glaxosmithkline Plc	\$113,341	\$4,849	13.5%	4.3%	2.9x	2.9x	9.4x	8.9x	33%
SHP	Shire Plc	\$44,024	\$1,068	17.7%	2.4%	6.1x	5.5x	12.7x	11.1x	35%
Average			17.5%	3.9%	4.4x	4.2x	12.5x	11.4x	29.9%	
VRX	Valeant Pharmaceuticals Inte	\$101,239	\$246	3.0%	0.2%	7.5x	7.0x	13.3x	11.9x	46%

*Forecast period information is based on Bloomberg consensus estimates

The chart above shows how pitiful the research and development spend is at Valeant. The average pharma spends **17%** of revenue on R&D, but Valeant spends **only 3%**.

An easy defense to this from bulls is the ineffectiveness of R&D. Well that is what separates a “good” pharmaceutical company from one not so good -- the ability to innovate. Any asshole can jack up prices and cut spending.

To give an example to this point, look at the story of Allergan, the same company that rebuffed Valeant’s takeover proposal because of their business practices.

"From the \$7 billion that Allergan invested in R&D between 1992 and 2013, the company gained \$50 billion in sales between 2007 and 2013"

-- WSJ, June 10, 2014

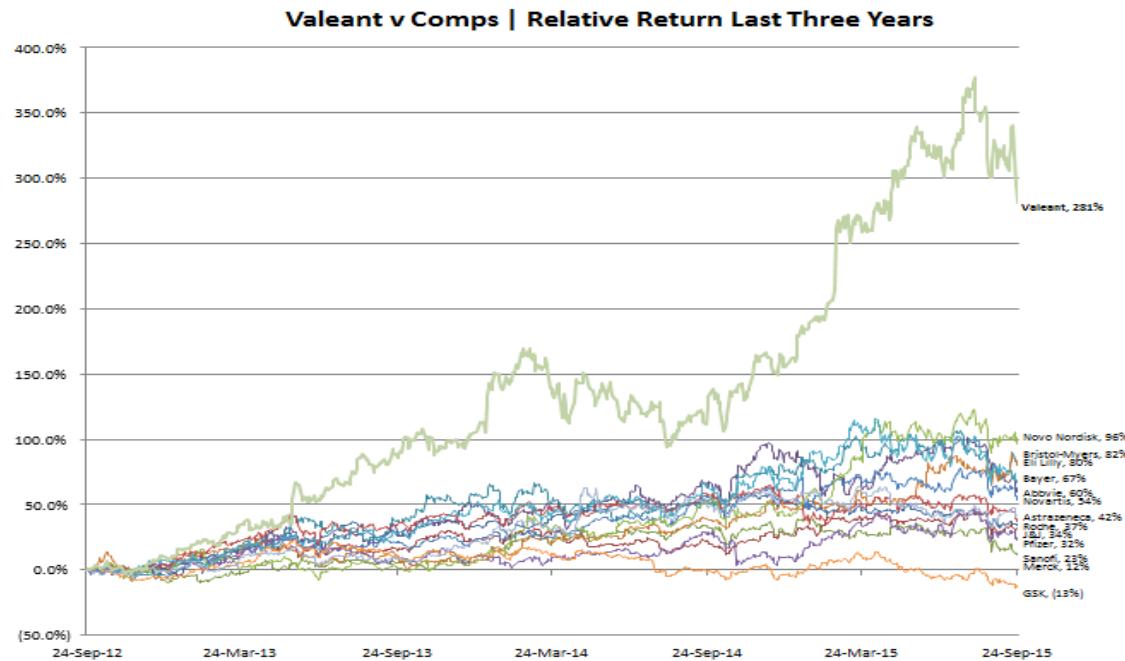
<http://www.wsj.com/articles/bid-for-allergan-puts-valeants-research-and-development-cuts-under-scrutiny-1402443053>

Valeant has recently started to defend its scant R&D by stating they are more focused on “output” rather than “input”, meaning the results they achieve vs the money they invest. This is an insult to every other pharmaceutical company and to the system that supports Valeant. Do you really think that if you are efficient you can provide the same outputs and spend 90% less on research and development than companies like Johnson and Johnson, Pfizer, Merck or Eli Lilly?

Escalating drug prices with no additional innovation simply drains resources from the system, and providing zero additional benefits. It should be stopped and needs to be stopped; otherwise, such practices simply encourage a crescendo of bad behavior from participants. Eventually, it reduces incentives for companies to invest needed R&D that can actually improve the quality of care through the development of new drugs.

This is where it Gets Scary!

Valeant's strategy to simply slash and burn R&D has rewarded it with an escalating stock price compared to peers. Does this look like a bio-tech bubble or a Valeant bubble?



As shareholders notice the rising price of Valeant stock, other companies are starting to follow in lockstep. [Recently, Endo International, now run by a former Pearson lieutenant, is emulating aspects of the Valeant approach by taking out costs and raising prices](#), then turning into an aggressive bidder for pharma companies like Salix. Similarly, Mylan has started to “play hardball” as we observe with the Epi-Pen controversy.

<http://www.fiercepharma.com/story/mylan-leverages-marketing-savvy-price-hikes-make-epipen-go-med/2015-09-24>

Note how extreme Epi-Pen price hikes impact public school district budgets for schools only trying to do the right thing by protecting students from life-threatening anaphylactic shock incidents.

The risk that Citron is discussing now was articulated in 2013 article in Forbes comparing Valeant to Genentech. Genentech CEO Art Levinson is a scientist dedicated to research and development versus the consultant in Pearson. This Forbes piece was a chilling foreshadowing of the future.

“There’s also the non-trivial concern that if Valeant’s acquisition strategy were widely adopted, who would build the companies everyone intends to acquire?”

<http://www.forbes.com/sites/davidshaywitz/2013/05/25/what-the-ascent-of-valeants-ceo-the-anti-art-levinson-means-for-pharmas-future/>

It is just two years since this article was published. Valeant stock price is up 100% since this article and other pharmaceutical companies being forced to mimic its strategy.

This has become such a plague in the pharmaceutical industry that the Allergan CEO was forced to admit that, “Dealing with shareholder activists-like Pershing Square’s Ackman should become a CEO/Chairman’s first priority”

http://www.in-pharmatechnologist.com/Regulatory-Safety/Dealing-with-activist-shareholders-Allergan-CEO-shares-advice-at-BIO?utm_source=copyright&utm_medium=OnSite&utm_campaign=copyright

Does this mean you must answer to activist shareholders and work through government loopholes to increase share price regardless of the long term effects of an aggressively leveraged balance sheet?

Valeant has forgotten that by the time this company staggers under the weight of their balance sheet debt, the “shareholders” they are appeasing today will have moved on to whatever the next opportunity is.



Valeant's True Core Competency:

Lets Loot The US Taxpayer

Follow the Money and See Exactly How They Do It.

Take just one step back from connecting the dots on a system that rewards slashing R&D and forcing unlimited drug price rises, you get to an insight even uglier. Follow the money to see why this company is a frontal assault on every American.

Step 0: The obvious point that a vast amount of all drug research begins with National Institute of Health (NIH) Grants -- funded by all US taxpayers. Drug companies are all beneficiaries of this fundamental expansion of science, the intent of which is to make life better, for all of us.

Step 1 is the unregulated, ungoverned and unrestrained drug price jack-up, mastered by Valeant, as analyzed above. The US is the only developed country without some form of control over drug pricing; we have the highest pharma prices in the world. Most of the reason devolves from a backroom deal cut when the Bush administration set in motion the Medicare Drug benefit and inexplicably (if you're not a lobbyist) gave away the rights of the US Government -- the nation's largest buyer of pharmaceuticals -- to negotiate drug prices with suppliers.

Step 2 is the Tax Inversion Game. [Valeant was the first pharma company to play this gambit](#), rolling its tax burdens to friendlier venues offshore in 2010 when it took over Biovail, a Canadian pharma company in order to lower its tax rate to 5%. So as Valeant gouges the US healthcare system, you taxpayers will be happy to know lots of that revenue is (legally) evading US taxation.

"**I**There is no question that we would not be in the same place we are in today if we had a higher tax rate,"

-- " Valeant's former finance chief, Howard Schiller, testifying at a July 2015 congressional hearing

Step 3 Now it gets really perverse. Valeant becomes irresistible to hedge funds -- it has become a virtual **hedge fund hotel**. [Bill Ackman crows it is "a very early-stage Berkshire Hathaway"](#) ... "a platform company that systematically makes acquisitions in order to increase its own value""

In fact, CNBC recently listed it as the #1 "[Most Profitable Hedge Fund Bet of Q2 2015](#)" owned by 7 of the 20 top performing hedge funds.

Most of these hedge funds own the stock in their offshore component and than the principles will take their fat profits using -- [the carried interest loophole](#).

Of course this tax break is true for every stock, but it is most important in Valeant because the company has given up a future in order to have a better "right now" just to assuage its many hedge fund shareholders without planning for the future. As consistently stated by Valeant:

" Our duty is to our shareholders and to maximize the value of the products that Valeant sells"

-- " Valeant company spokeswoman Laurie Little

Why is this Moment of Truth for Valeant ?

Short Sellers and critics have discussed Valeant for years. But now it has hit a perfect storm of bad news over the past two months will have a direct effect on their share price.

1. The presidential elections have made prescription drugs a major topic of discussion. Bernie Sanders has already singled out Valeant for the increase in their heart medication pricing:

<http://www.wsj.com/articles/bernie-sanders-elijah-cummings-question-valeant-on-heart-drug-price-increases-1439574723>

Just wait until Senator Sanders get the full list of price increases employed by Valeant. Senator Sanders most likely didn't know that Valeant also raised the [price of Metformin](#) by a staggering 600%.

<http://www.pharmacybenefitnews.com/#!PRICE-FLASH-Glumetza-therapy-could-now-cost-you-50000-per-year/c193z/558f31730cf2711ebbceb5>

Hillary Clinton has laid out an in-depth drug industry regulatory scheme to reward R&D and penalize companies that are gaming the system ... exactly like Valeant.

2. The recent selloff in the market has forced investors to reevaluate risks in their portfolio and the highly levered balance sheet of Valeant does not seem as desirable as it was just 3 months ago.
3. Martin Skreli has put a face to the gouging of America by pharmaceutical companies. The media seems roused to demand answers. Now Senate Democrats are demanding action, and this is the stimulus.



The future for Valeant

It is too late to put this genie back in the bottle. America is starting to care about the rising cost of prescription medicine and it is a topic that will stay in the forefront of next year's presidential elections.

US Citizens are not divided on this issue

"One poll, released last week by the Kaiser Family Foundation, found that 93 percent of Democrats, 83 percent of independents, and 74 percent of Republicans want the federal government to negotiate drug prices for Medicare."

<https://www.bostonglobe.com/news/nation/2015/08/24/prescription-drug-prices-becoming-presidential-campaign-issue/tOlUbF6UBIAxj4ppnTgeSP/story.html>

Valeant is a malignant tumor on the US Healthcare system that needs to be removed before it infects all the other healthy companies ... or you end up with no money invested in drug innovation and forever skyrocketing drug prices.

Part II will dissect the unsustainability of Valeant, even without the firestorm of public disgust with its drug price gouging.

Analyst's responses ... duh!

Citron expects the analysts to respond to this before we can even press the send button. Valeant has a lot of friends on Wall Street and the banks will be quick to dismiss the validity of any critique, especially if the basis is the well-being of ordinary American citizens ... Occupy Wall Street was not an accident.

Conclusion

In this piece, Citron gives the full context of why Congress should move to subpoena Valeant about price rises to its portfolio of drugs. Citron believes the moral outrage at Valeant's abuse of the health care system is a story that will not go away.

Those risks go right to the heart of Valeant's strategy. The stakes have just risen by orders of magnitude on its ability to raise prices, while overpaying for debt-funded acquisitions. And its ability to service existing debt becomes an ongoing risk that the market has yet to factor in.

In our soon-to-be-released part 2, we will provide further detail about Valeant's debt-burdened balance sheet, analyzing the company's ability to manage its ballooning debt. Specifically, Citron will discuss the consequences if Valeant it cannot resort to unending cycles of unrestrained drug price hikes, or it cannot make ever-more overpriced acquisitions.