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Meet Valeant Jr.

With its zippy share price and fashion-forward business model, Valeant Pharmaceuticals International Inc., world-famous stalker of Allergan Inc., has become a kind of drug industry idol. Endo International Plc (ENDP on the Nasdaq), one of Valeant's many votaries, is the subject at hand. In preview, we're bearish on it.

Constant readers will recall the ABCs of the Valeant stratagem (*Grant's*, March 7). Low corporate taxes achieved by renouncing American corporate citizenship is the first rudiment. Ruthless chopping of R&D expense is a second. Growth through acquisitions—with attendant complex acquisition accounting—is a third. So enamored was Endo of the Valeant M.O. that last year it installed as CEO the former Valeant president, Rajiv De Silva.

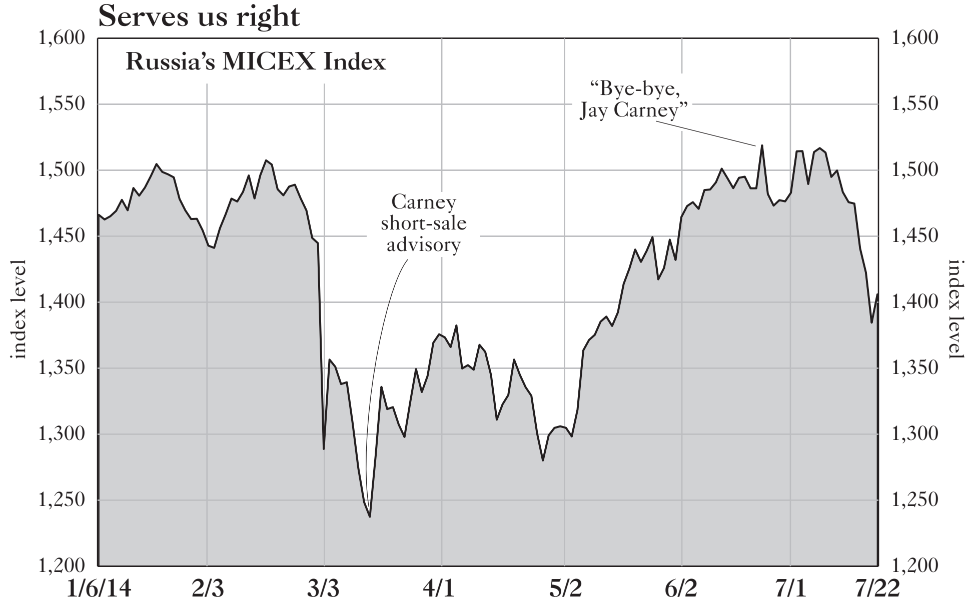
The bear case on Endo echoes the arguments we've advanced already against Valeant, except that the protégé (with a market cap of $10.6 billion) is more highly valued than the mentor (with a market cap of $40.9 billion): 16.6 times 2015 earnings vs. 11.6 times 2015 earnings. Then, too, the businesses that Endo manages are dwindling at an even faster rate than the ones in the Valeant stable. Nevertheless, only one of the 24 analysts who purport to scrutinize Endo dissents from the prevailing consensus of sell-side opinion. The astute Irina Rivkind Koffler of Cantor Fitzgerald is that contrarian; she's bearish.

Confronted in 2009 with the imminent expiration of key patents of its legacy pain medications, Endo went on an acquisition spree. The outlay of $3.8 billion bought a revenue stream that, although diversified—into urology, oncology and generics—was not visibly improved. In the case of the $2.7 billion purchase of urology device maker American Medical Systems (AMS) Holdings Inc., in June 2011, the acquisition came complete with significant product liabilities. In December 2012, the incumbent CEO, David P. Holveck, prepared to pack up his office.

De Silva, the new hire, laid out his Valeant-like strategy on a June 5, 2013, conference call. Endo would divest non-core businesses, cut costs and acquire strategic assets, he said. Non-core assets included Endo's early-stage R&D development pipeline (sold for an undisclosed sum to Asana BioSciences, LLC last month) and parts of Endo's urology services and device businesses. For cost cutting, De Silva set a goal to reduce operating expenses by $325 million. "Overall," said the CEO, "this represents the 32% reduction in operating cost base, and individual actions include a 15% reduction in overall global head count." Just how well and how deep the new knife has cut is unclear. In part, the answer depends on your approach to accounting. To the first quarter of 2014 from the first quarter of 2013, non-GAAP operating income increased to $219.4 million from $209.9 million, whereas GAAP operating income plunged to a loss of $597.2 million from $68.2 million.

So far, De Silva, whose approach to new businesses is eclectic in the extreme—"therapeutic agnostic," as he put it last year—has made five major acquisitions: specialty gener-

Serves us right



source: The Bloomberg

ics' maker Boca Pharmacal for $225 million, branded drug maker Paladin Labs Inc. for $2.7 billion, generic drug maker Grupo Farmaceutico Somar for $269 million and generic drug maker DAVA Pharmaceuticals for $575 million, plus up to $25 million in contingency payments. The fifth transaction involved not a whole company but a single medication, the purchase of migraine drug Sumavel DosePro from specialty drug maker Zogenix Inc. for $85 million.

"The Paladin acquisition was the key to the transformation to Endo in the Valeant mold," colleague Evan Lorenz relates. "It wasn't Paladin's size that made it so, but rather its location. The Montreal-headquartered target allowed Endo to relocate its corporate legal persona to the tax-friendly precincts of Ireland. On Nov. 5, 2013, the day the deal was announced, Endo's stock price soared by 29% to $56.22."

In the Valeant mold

source: The Bloomberg

Still, there's a business to consider as well as a stock price. In the first quarter—second-quarter results are due July 31, after we go to press—Endo's sales, adjusting for divestitures, fell by 10% year-over-year to $594.6 million. Branded painkillers were the main culprit; the Endo division that houses those products, the U.S. branded drug unit, suffered a 35% year-over-year decline. Even so, American-branded drugs still accounted for 39% of total revenues and 52% of non-GAAP profits. Excluding the impact of Boca and Paladin, Endo would have reported a 16.8% year-over-year decline in sales.

"The steep fall in U.S. branded drugs is actually understated," Lorenz points out. "Last September, Actavis Inc., which began manufacturing a generic version of Endo's Lidoderm, an adhesive patch containing 5% lidocaine, agreed to pay Endo a royalty so long as there were no other generic competitors to Lidoderm. In the first quarter of 2014, royalties totaled to $39.8 million vs. $0.1 million in the first quarter of 2013. Without these royalties, U.S. branded pharma sales would have declined by 46% year-over-year in the first quarter. There are few costs associated with royalty revenue, so it appears that this income stream from Actavis accounted for 22% of the $178 million of non-GAAP pretax profit. (On a GAAP basis, Endo showed a pretax loss of $654.1 million, driven by a $626.2 million charge for the AMS product settlement as well—another homage to Valeant—a host of restructuring and acquisition-related charges.)"

On the May 1 earnings call, De Silva announced that Endo would relinquish the royalty stream by choosing to produce its own authorized generic of Lidoderm to compete with Actavis. "[I]t's a very calculated decision," the CEO said. Calculated, to be sure, we think, though not necessarily in the way the market has assumed. If, as the aforementioned Irina Rivkind Koffler posits, Mylan unveils its own generic later this year, the new entrant would do further damage to Endo's Lidoderm generic. Koffler says she expects two more competitors in 2015. In other words, Endo was likely to lose the royalty stream from Actavis later this year anyway. In short, the company's "very calculated decision" to create its own generic looks more like a rearguard action to protect a declining earnings stream rather than an expression of corporate self-confidence.

If anyone from Endo had chosen to speak to Lorenz, that individual might well have talked up first-quarter results of the U.S. branded generics division: Sales surged by 19% to $211.9 million and non-GAAP operating profit by 57%, to $73.8 million. "However," Lorenz notes, "this level of improvement is likely unsustainable. The 10-Q report disclosed that 'gross margins associated with this segment improved, primarily as a result of pricing increases.' Raising prices of acquired products is another classic Valeant stratagem; it comes at the expense of market share.

"It's not only Endo's existing businesses that face declines," Lorenz continues. "Consider the aforementioned DAVA, a generic drug maker that entered the Endo fold only last month. You look at DAVA's EBITDA margin, and you rub your eyes. In 2013, it came in at 76%, more than triple that of generic-maker Mylan and not quite double that of Pfizer, the branded drug aristocrat. The source of this astounding profitability is a single chemotherapy drug, methotrexate sodium."

"Here's what is going on with methotrexate," a biotech investor (he asks to go unnamed) tells Lorenz. "Medicare was not reimbursing at a price that made sense for the industry to manufacture it. So, the generic companies said, 'Fine, we're not going to make it.' They all wound up dropping out. There was one more generic company [Ben Venue Laboratories] that made it and they had a '493,' which is a manufacturing inspection violation. They were shut down for a little while. It got to the point to where people couldn't get chemotherapy because there was no methotrexate around. There was tremendous pricing power."

Now that the crisis has passed—the FDA no longer designates methotrexate as a drug in short supply—one would suppose that DAVA's margins would revert to levels a little less rarefied. If they were to fall to Pfizer's level, DAVA's sales and EBITDA would drop by 57% and 75%, respectively. If DAVA's profitability were to fall to Mylan's level, DAVA's sales and EBITDA would fall by 69% and 90%, respectively.

Why would De Silva buy a company with a declining earnings stream? In the wake of Endo's purchase of DAVA, Goldman analysts Gary Nachman and Roger Kumar proposed an answer. They pointed out that, after the deal, Endo could borrow an additional $800 million and still remain in compliance with its bankers' debt covenants. The reason? The acquisition boosts the acquirer's reported cash flow. "If we assume that ENDP could also leverage off of a target's EBITDA," the Goldmanians wrote, "then we estimate it would have financial capacity to do a deal (without using equity) in the $2-3 billion range." In other words, the art of the deal trumps the near certainty of lower methotrexate prices.

The Sumavel acquisition, too, bears scrutiny, the dissenting lady from Cantor Fitzgerald observes. When Endo purchased Sumavel from Zogenix, Sumavel had already lost patent protection. According to Koffler, Sumavel only commands 12% of the injectable sumatriptan market compared to 84% for generics. Nor, relates Koffler, was Sumavel a growing brand. By total prescriptions, Sumavel declined by 13% year-over-year in the 12 months ended March 31. There is some question as to whether Sumavel was even profitable—Koffler speculates it wasn't. Note that the drug generated sales of $31.7 million in 2013 and that Sumavel was Zogenix's only marketed product. We must assume, says Koffler, that the majority of Zogenix's $50 million operating expenses were incurred in selling Sumavel. "Recall that Endo previously attempted to acquire another commercially nonviable migraine asset from Nupathe earlier in the year," she concludes. "We don't understand the company's interest in this arena outside of its existing sales force," which is to say, Endo might find it hard to sell Sumavel after firing all the Sumavel sales reps.

As of March 31, Endo had a cash balance of $1.1 billion and debt of $3.9 billion, or net debt of $2.8 billion. On April 30, the company agreed to settle 20,000 of the 23,500 AMS product liabilities' cases for $830 million ($41,500 per case, although there will be some lag between when Endo agreed to settle and when Endo has to make payments). Settling the remaining cases at the same price per case would boost indebtedness by $975 million, raising net debt to $3.8 billion. After the close of the quarter, Endo completed three acquisitions for a total consideration of $929 million and spent $450 million to pay down $240 million of convertible notes. The post-quarter activity elevates net debt to around $4.9 billion.

In the 12 months to March 31, the company generated an operating loss of $1.1 billion (on a non-GAAP basis, Endo showed operating profits of $963.8 million) and expensed $263.4 million in depreciation and amortization expenses. So you may take your pick. Endo generated (*a*) an EBITDA loss of $828 million or (*b*) positive EBITDA of $1.2 billion using non-GAAP operating figures.

"As with Valeant," Lorenz notes, "you watch the bouncing ball—or try to. There are GAAP earnings and non-GAAP earnings. Management excludes the cost of acquisition and integration ($45.3 million in the first quarter—the costs will likely be higher in the second quarter), though De Silva's very strategy is to expand Endo's product range by buying companies and products rather than investing in R&D. Some one-time expenses on the P&L would be better classified elsewhere. For instance, the company incurred a $626.2 million expense for AMS-related litigation. As payments for the settlement will occur over time, the settlement expense should (one supposes) be lifted from the first quarter's results and added to the company's debt balance. Thus, over the 12 months to March 31, Endo generated a GAAP net loss of $1.2 billion—and a non-GAAP net profit of $134.5 million. Perhaps a better way to gauge Endo's health is cash from operations less capital expenditures, a.k.a. free cash flow. On that basis, Endo generated $17 million.

Insofar as any clarity is in the cards, second-quarter results—expected, as we say, on July 31—may furnish a bit of it. The Street expects revenue of $646 million and non-GAAP earnings per share of $0.88 (few pay any attention to old-fashioned GAAP earnings). In the second quarter of 2013, Endo reported revenue of $766.5 million ($712.1 million excluding business since divested) and non-GAAP EPS of $1.42. In other words, don't expect the recent run of acquisitions to completely replace Endo's existing business. It continues to decline.

Neither Endo nor Valeant is what the bear community knows as a crowded trade; about 5½% of the outstanding shares of each company are sold short. Endo insiders, in any case, seem not unsympathetic to the bear case. Year-to-date, they've sold a net 275,912 shares for $19.8 million, at an average price of $71.75.

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