Valeant's default risk surges amid aggressive business strategy

by Justin Hsiao

The default risk of Valeant Pharmaceuticals International Inc. (Valeant), a Canadian drug maker, rose to an all-time high on Mar 18 according to RMI-CRI data, casting doubt on the firm's ability to stick to its aggressive acquire-to-grow business model.

With mounting pressures on drug manufacturing, extremely high investment in research and development (R&D) and higher regulatory requirements, mergers and acquisitions (M&A) have become a proactive approach for global pharmaceutical companies to consolidate redundant businesses, to get rid of unprofitable business segment, and to grow in size. On top of that, after the global financial crisis in 2008, central banks worldwide adopted a quantitative easing policy to stimulate the growth of economies, resulting in a low interest rate environment thereby bringing down the cost to raise funds in the debt market. As a result, borrowing money and buying other companies in order to grow seemed to be a logical strategy to implement.

From 2010 to date, Pharmaceuticals industry completes a volume of USD 570bn in M&A events, which ranked fourth in all industries, after Oil&Gas, Real Estate and Telecommunication. Valeant is one of the most acquisitive firms among its peers using such a strategy. Michael Pearson, Valeant's current CEO, once stated that he wanted Valeant to be the top-five pharmaceutical company by the end of 2016. To achieve that goal, Valeant had completed 53 M&A events from 2010 to 2015 (see the left panel of Figure 1), making the firm the top-15 pharmaceutical company by market cap. In the same time frame, the market cap of Valeant grew from USD 2.32bn to its peak at USD 89.57bn in August 2015, and the firm's total debt rose around 10 times from USD 3.60bn to USD 30.88bn.

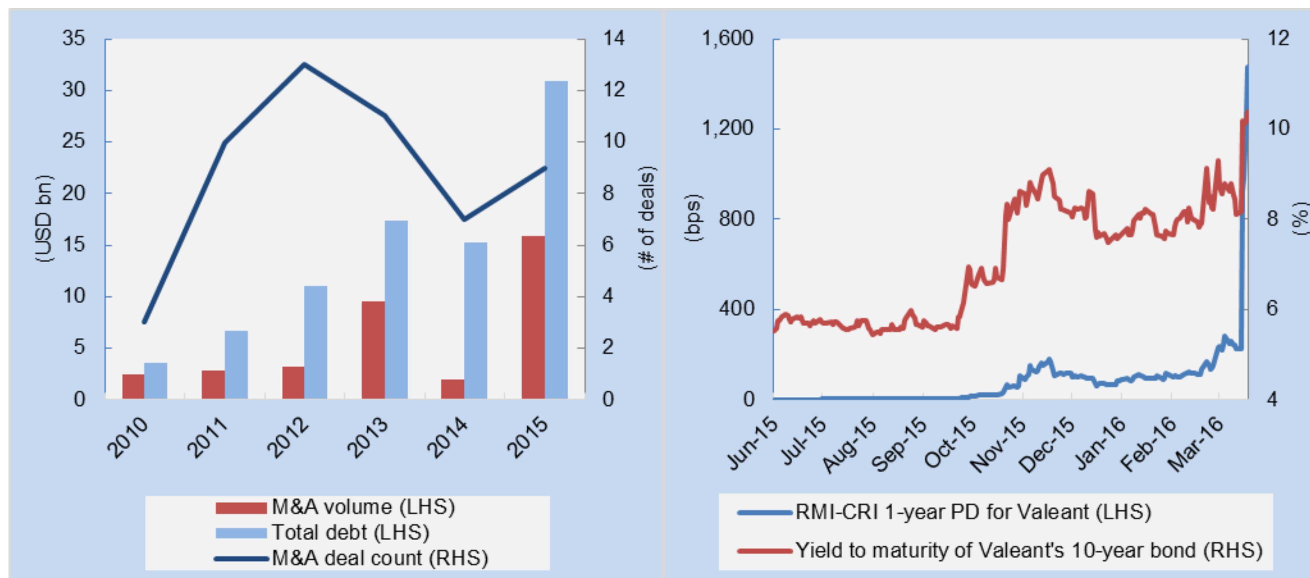

Figure 1. M&A deal count, M&A volume, and total debt* of Valeant (left panel in Figure 1); RMI-CRI 1-year PD (LHS) and yield to maturity of 10-year corporate bond (RHS) for Valeant (right panel in Figure 1) *Source: RMI-CRI, Bloomberg*
*total debt in 2015 updated until Q3

However, the firm's shares plummeted in the second half of 2015 due to the scrutiny over its drastic medicine price increases and accounting practices. On Mar 15, 2016, Valeant saw its share price plunge more than 51% after it stated that it will not meet its earnings goals and may default on its USD 30bn debt because of the breach of the loan covenant from delaying the filing of its 10-K. In the right panel of Figure 1, the RMI-CRI 1-year probability of default (PD) for Valeant reached at its record high of 1,475bps on Mar 18, 2016, compared to its low level one year ago, indicating the firm's credit health has weakened severely. On Mar 21, CEO

Michael Pearson resigned after Valeant admitted that the improper financial conduct by senior management caused the company to misstate its financial results.

Based on the current developments, Valeant would face difficulties to continue using its private-equity-like approach to scale up in the long run. First, Valeant, with a worsening credit profile or a potential default record, will face hurdles to get the funds from lenders. Secondly, its funding costs increase, making it more costly for it to do more M&As. The yield to maturity of Valeant's 5-year corporate bond increases from below 6% to over 10% in tandem with the deteriorating credit profile (see the right panel of Figure 1). Meanwhile, the Fed is also under pressure to raise the interest rate, which may moderate the benign funding environment. Finally, compared to its bigger peers, Valeant barely invests in R&D. Its R&D expenditures only accounts for 3% of its total revenue in 2015 – the ratio was around 17% for its peers. A pharma company without R&D could be viable in the short- and mid- term, but it would be challenging for the firm in the long term.

	Q4 2014	Q1 2015	Q2 2015	Q3 2015
Net Income Margin (%)	23.46	3.36	-1.94	1.78
EBIT / Interest Expense	2.86	1.82	0.83	1.07
Total Debt / Equity (%)	280.68	395.74	470.86	477.72

Table 1. Credit metrics of Valeant. *Source: Bloomberg*

Table 1 shows that Valeant's credit profile has deteriorated in terms of profitability, liquidity and leverage. The net income margin dropped drastically from 23.46% in Q4 2014 to 1.78% in Q3 2015. In the same time period, the interest coverage ratio also decreased from 2.86x to 1.07x, and the total debt to equity jumped 1.7 times from 280.68% to 477.72%. If Valeant could manage to deliver its 10-K within 30 days after March 30, the firm would not face any credit event. The drug maker also does not have any major maturity wall before 2020. However, Valeant should adjust its business model to adapt to the ongoing developments. Otherwise, Valeant's credit outlook would be negative in the long term.

*All Q4 2015 financial figures are based on Valeant's preliminary financial report.

Credit News

China has a USD 590bn problem with unpaid bills

Mar 21. As payment delays spread from the industrial sector to technology and consumer companies, accounts receivable at the nation's public firms have swelled by 23% over the past two years to about USD 590bn, exceeding the annual economic output of Taiwan. These difficult times have been caused by the fact that businesses and consumers have been squeezed by the deepest economic slowdown since 1990, while overcapacity has fueled an unprecedented stretch of declines in producer prices. (Bloomberg)

South Africa's largest clothing retailer skips coupon payment

Mar 18. Edcon Holdings Pty Ltd, South Africa's largest clothing retailer, is struggling to meet coupon payments as falling sales and a heavy debt burden weakened the company's ability to repay creditors. The firm did not pay bondholders interest due on March 15, but has 30 days to make payments without triggering a default. Edcon Holdings was a profitable retailer with few debt commitments before Bain Capital took control of the company in 2007. (Bloomberg)

China coal miner faces bond date after flagging bailout in 2015

Mar 17. Chinese premier Li Keqiang is trying to cut industrial overcapacity without mass layoffs or derailing economic growth. However, Heilongjiang Longmay Mining Holding Group, the state-owned firm that said in November it would get a 3.8bn yuan (USD 584.7mn) bailout from the local government to use toward bond payments in December, must pay RMB 800mn of 7% one-year securities due March 20. Heilongjiang's governor Lu Hao said at a briefing on March 6 in Beijing that if Longmay completely stops production due to a cash crunch, the provincial government wouldn't have enough financial power to rescue it. (Bloomberg)

Energy companies drain loans before banks clamp down

Mar 17. Troubled US energy companies are racing to tap cash still available under existing reserve-based loan commitments before banks cut their credit access next month. In April, lenders will conduct the semi-annual valuations of oil and gas reserves backing these loans, and are expected to cut available credit to many energy companies based on deeply depressed collateral prices. Earlier in March, Stone Energy joined a growing pack of companies, including SandRidge Energy and Linn Energy, drawing down the full amount remaining under its credit facility. Every company in the industry is nervous that if they do not draw in the next couple of weeks with determinations coming up, banks will finally start saying no during the spring redeterminations. (Reuters)

Largest US mining firm Peabody Energy close to bankruptcy

Mar 16. The coal mining industry in the US has been hit hard by mounting regulation and competition from natural gas and cleaner energy suppliers. Peabody Energy, The largest coal mining firm in the US, announced that it was considering filing for bankruptcy protection followed by the bankruptcy event of Arch Coal, the second biggest US coal miner. Peabody missed a USD 71mn debt payment and has invoked its 30-day grace period to avoid defaulting. According to the company, it might need to voluntarily seek protection under Chapter 11 of the US Bankruptcy Code despite sufficient liquidity. (BBC)

Catalonia said to court default in Spanish game of chicken (Bloomberg)

Brexit could blow GBP 100bn in UK economy (Independent)

At MYR630bn, Malaysia's debt nearly hitting ceiling (Malay Online)

Regulatory Updates

ESMA ordered to fine tune securities reform

Mar 17. The European Commission (EC) has ordered the European Securities and Markets Authority (ESMA) to revise technical standards relating to the transparency of bond markets and two other technical standards governing the trading of commodities. ESMA was tasked to make annual assessments of bond liquidity but the EC said that the draft standards might identify too many bonds as liquid instruments and need revisions to ensure that regulations accurately reflect market liquidity. (Reuters)

China needs caution as it mulls debt-equity swaps, CBRC says

Mar 16. China needs to move cautiously before allowing the country's banks to convert their soured loans into equity, according to the China Banking Regulatory Commission. China is drafting rules to make it easier for lenders to convert bad loans into equity stakes in debtor companies in a move that would help authorities clean up banks' soured credit which has climbed to the highest level in a decade. Plans to reform state-owned companies could lead to an additional 1.2 trillion yuan of loans turning sour, on the assumption that industrial companies cut 20% of their output in order to address glutted markets for their products, China International Capital Corp. estimated on Tuesday. (Bloomberg)

EBA's report highlights wide asset quality gaps across European banks

Mar 16. The European Banking Authority's (EBA) annual transparency exercise shows large gaps in asset quality across European banks according to Moody's Investors Service. In particular, asset quality in Austria is considerably weaker than in Germany, and Spanish banks have sizable legacy assets versus their European peers. When combining non-performing loans and forborne loans classified as performing, Irish and Italian names lead the ranking of banks most exposed to problematic loans within Europe's large economies, followed closely by Spanish institutions. All Spanish banks analyzed (except for Bankinter) show a problematic loan ratio above the European average of 8.1%, and nine of them (out of 14 included in the EBA sample) show a problematic loan ratio above 15%. (Moody's)

Basel III implementation assessments of Russia and Turkey

Mar 15. The Basel Committee on Banking Supervision published progress reports on Basel III implementations in Russia and Turkey. The assessment outcomes for both countries are positive and the

domestic implementations of the risk based capital framework were found to be compliant with the Basel standards. Both countries' regulatory frameworks were also found to be compliant with the Basel Liquidity Coverage Ratio (LCR) standards and LCR disclosure standards. (Basel)

Insolvency code to make start, exit easy for startups (The Hindu)

EU executive studies tweaks to bank capital rules (Reuters)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Victor Liu