Case Study: Valeant

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Lessons from the Trenches: Value Investing, Hedge Fund Entrepreneurship and Life

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A Brilliant Case Study in So Many Areas

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- Circle of competence
- Arrogance vs. humility
- Will anyone tell you when your shit stinks (and setting up norms and processes to ensure this)
- Portfolio management
  - Position sizing
  - What do you do when a big position runs up a lot, fast?
  - What do you do when a big position goes down a lot, fast?
- How to process disconfirming information
- The challenges of companies in heavily regulated and/or politicized industries
- The accounting gamesmanship possible with highly acquisitive companies
- Who to trust – and what would cause you to stop trusting someone?
- When to listen to short sellers (or not)

Valeant Incinerated Three of the Smartest Investors in the World

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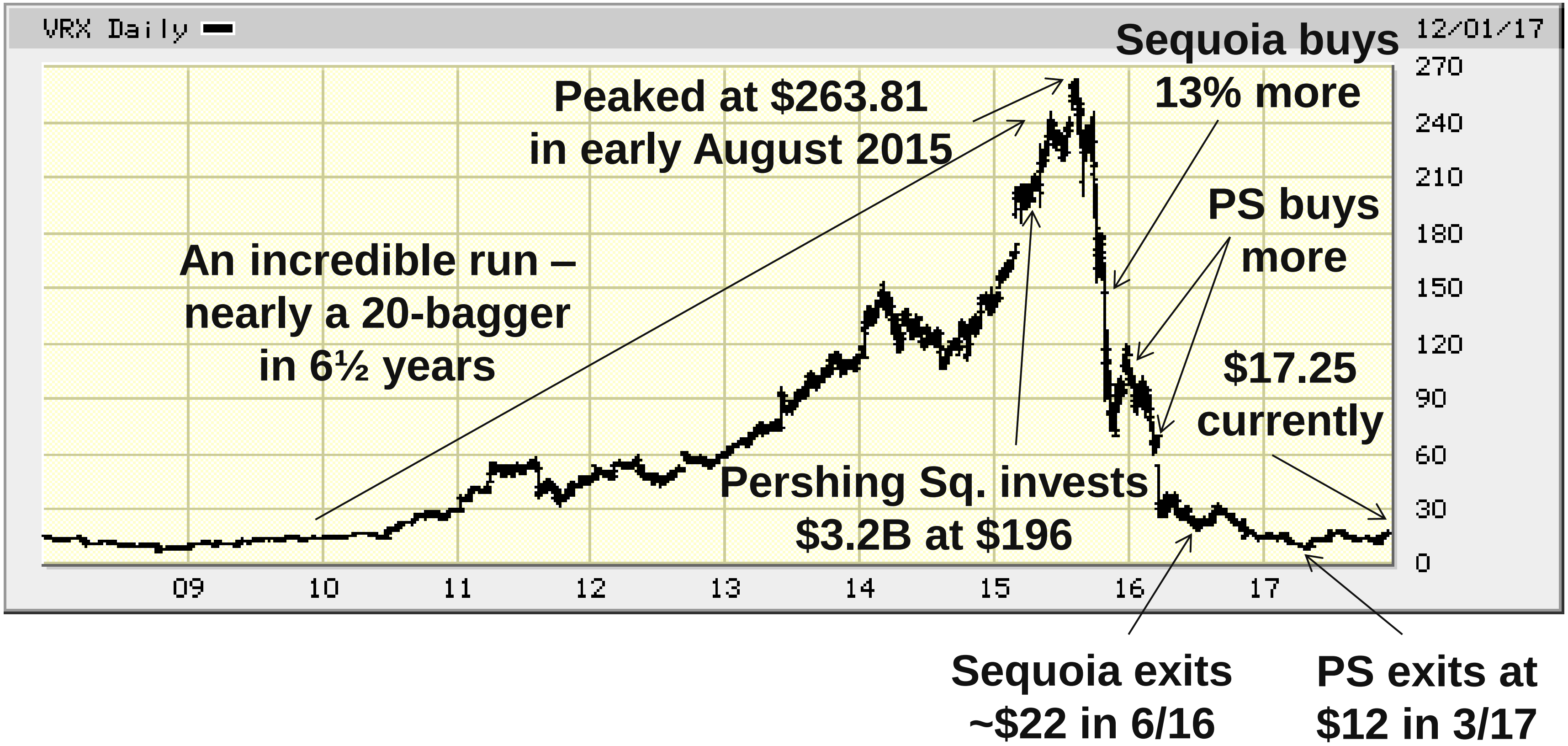
- Bill Ackman, Pershing Square
- Jeff Ubben, ValueAct (they were on the board)
- Bob Goldfarb, Ruane Cuniff/Seqoia Fund

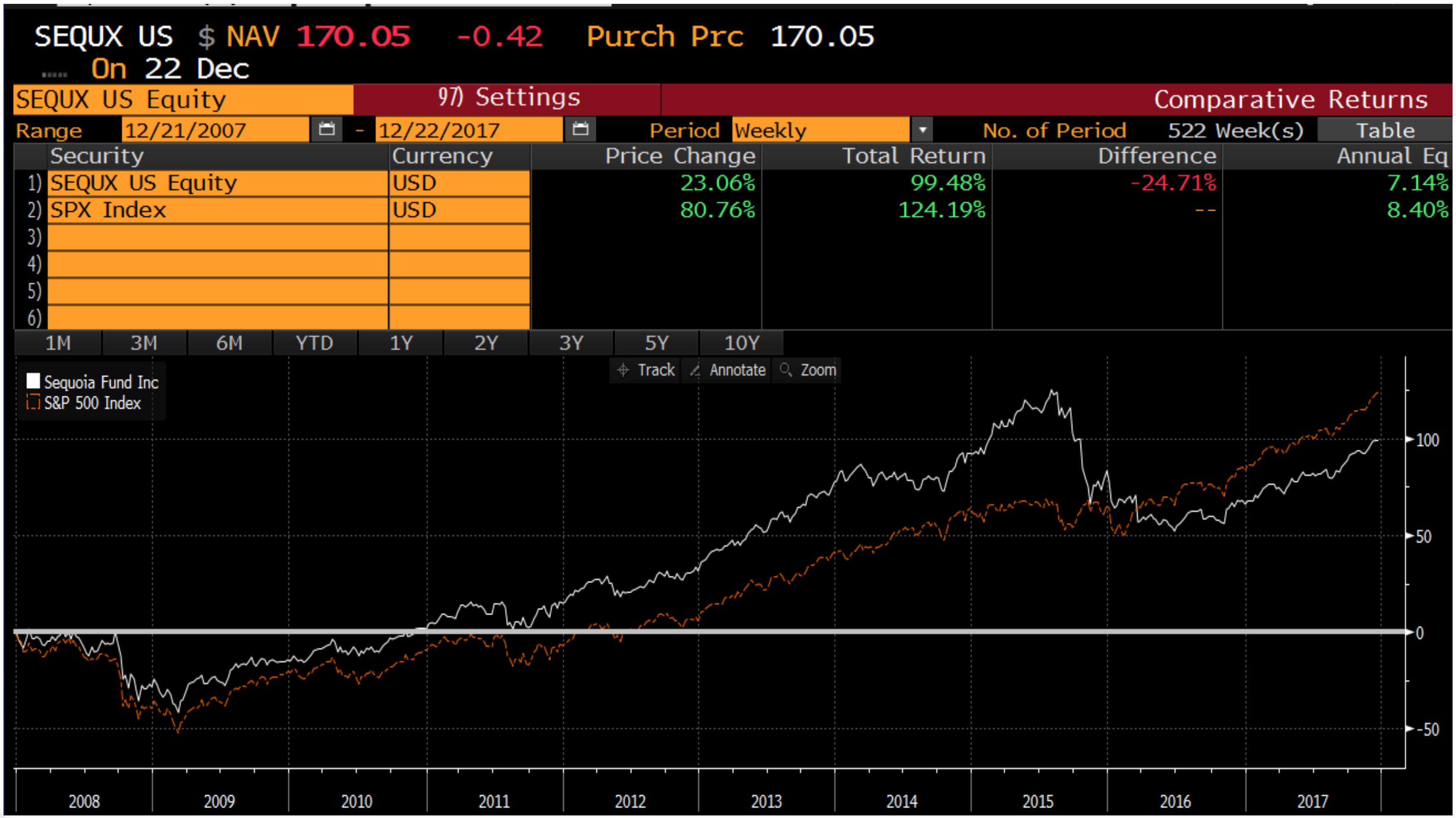
Despite Munger warning them! Here's what he said at the Daily Journal meeting on 3/25/15:

> After a rant about the conglomerate crazy in the 1960s, he continued (unprompted): "And it's still happening. Valeant, the pharmaceutical company, is ITT come back to life under Harold Geneen, except the guy's worse. Worse! So it's like my story about the unnecessary heart surgery in Reading…However bad you think it is, somebody actually comes by and does it worse. It wasn't moral the first time and the second time it's not better. And people are enthusiastic about it! I'm holding my nose. That's the only correct response."

Valeant Over the Past Decade



Sequoia Fund Over the Past 10 Years



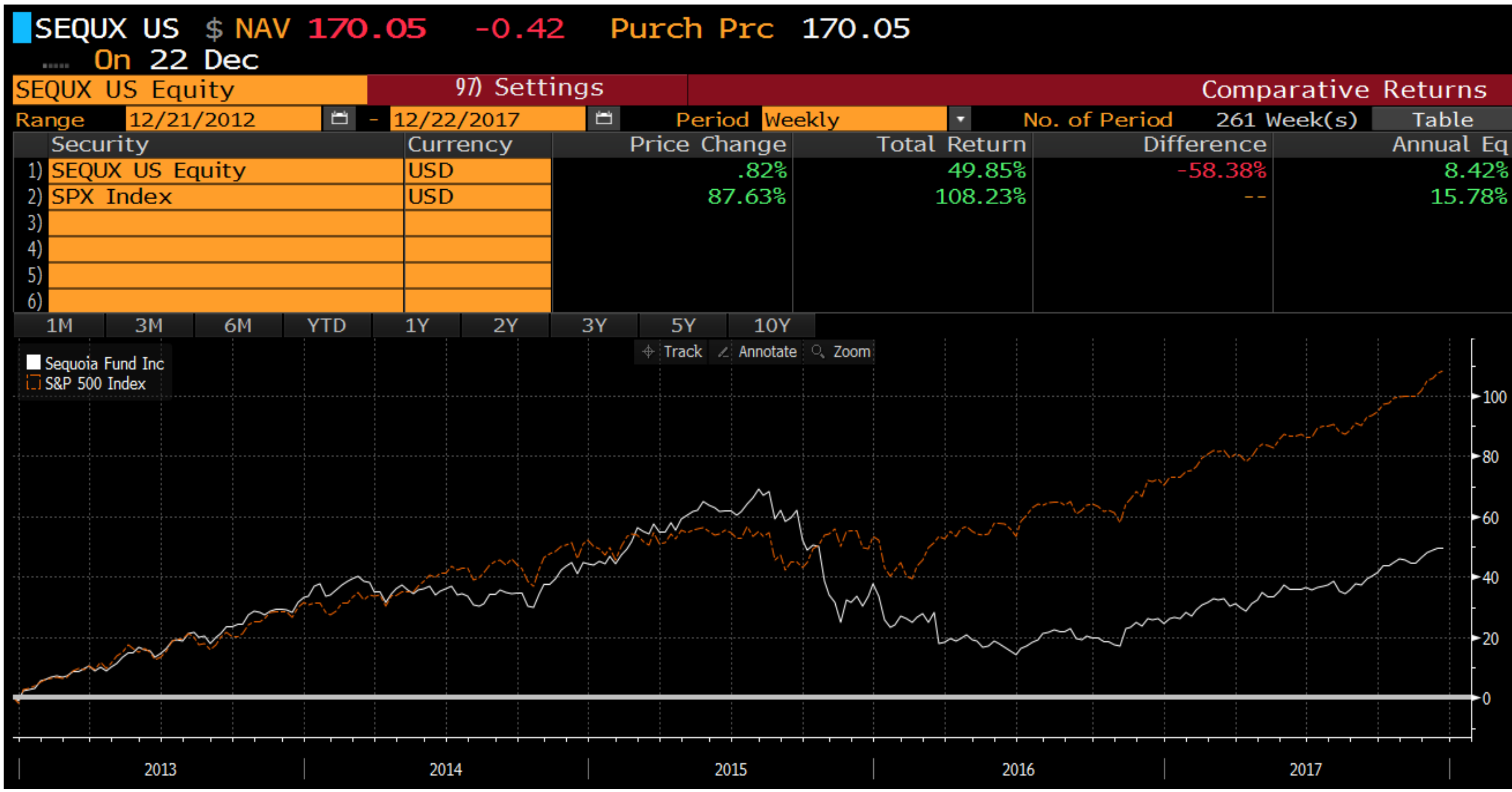
SEQUX US $ NAV 170.05 -0.42 Purch Prc 170.05
On 22 Dec

SEQUX US Equity | 97) Settings | Comparative Returns

Range 12/21/2007 - 12/22/2017 Period Weekly No. of Period 522 Week(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SEQUX US Equity	USD	23.06%	99.48%	-24.71%	7.14%
2)	SPX Index	USD	80.76%	124.19%	--	8.40%
3)						
4)						
5)						
6)						

Sequoia Fund Over the Past 5 Years



Sequoia Fund Since Mid-2015

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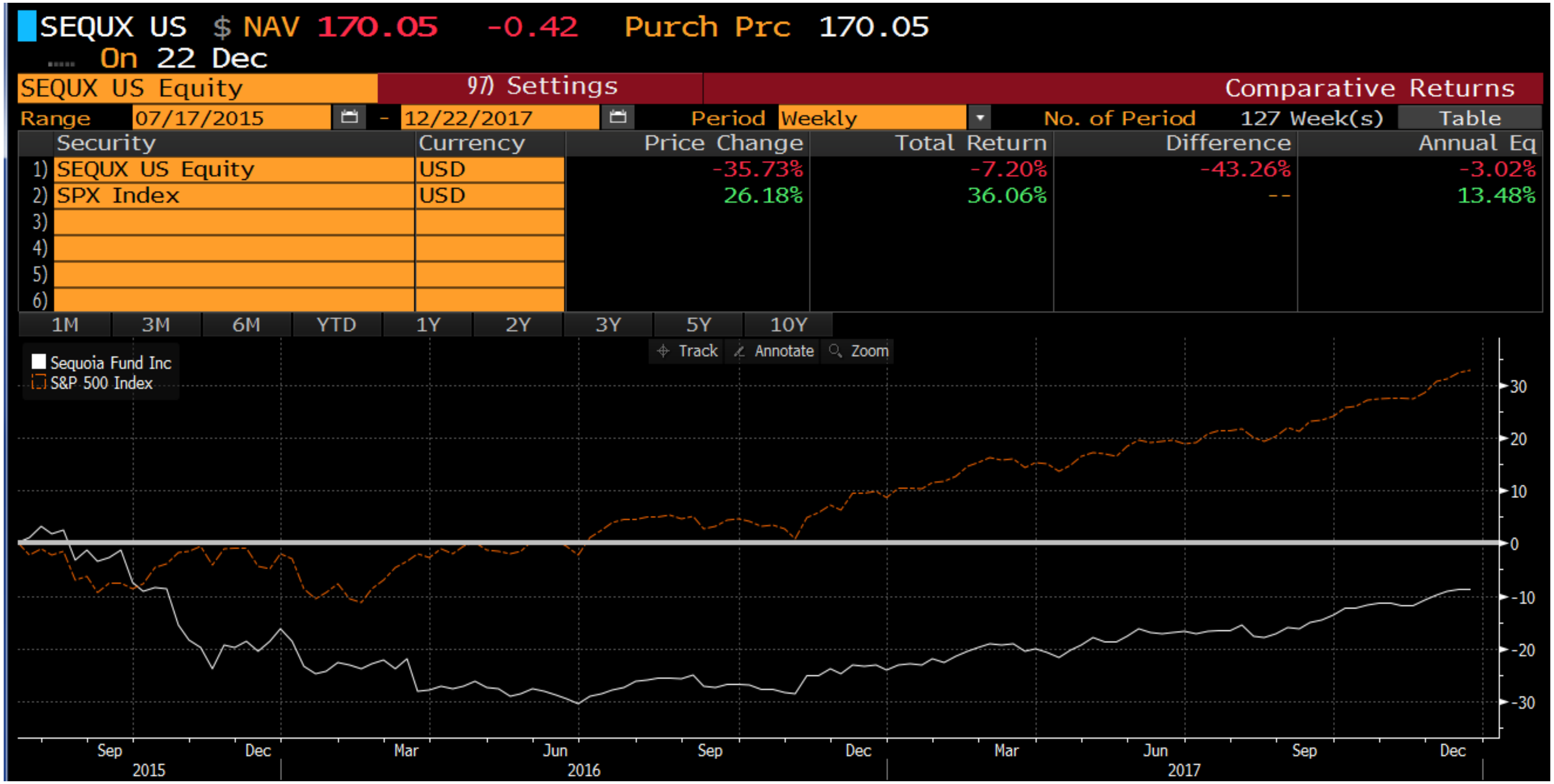

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SEQUX US Equity	USD	-35.73%	-7.20%	-43.26%	-3.02%
2)	SPX Index	USD	26.18%	36.06%	--	13.48%
3)						
4)						
5)						
6)						

Sequoia Fund Sold Its Entire Valeant Stake in Mid-June 2016, But Has (Slightly) Trailed the Market Since Then

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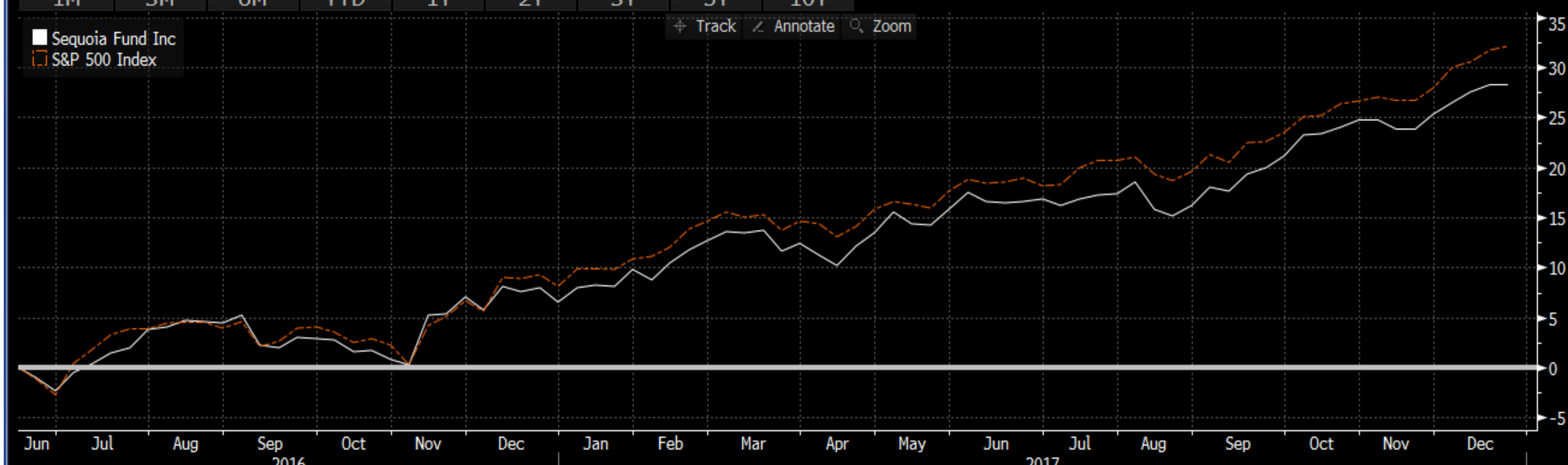
SEQUX US $ NAV 170.05 -0.42 Purch Prc 170.05
On 22 Dec

SEQUX US Equity | 97) Settings | Comparative Returns

Range 06/10/2016 - 12/22/2017 Period Weekly No. of Period 80 Week(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SEQUX US Equity	USD	-6.16%	28.29%	-3.80%	17.63%
2)	SPX Index	USD	28.02%	32.09%	--	19.89%
3)						
4)						
5)						
6)						

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y



Excerpt from 2014 Sequoia Letter to Investors

A topic many shareholders and clients wanted to discuss with us in 2014 was Valeant. It is the largest holding in Sequoia by far. One could argue Valeant wasted much of the year on a quixotic effort to buy Allergan, maker of Botox. Allergan had no interest in being acquired and fought a vicious and savvy public relations campaign to portray Valeant as unworthy of marriage to such a prized catch. In the end, Allergan found a suitor more to its liking in Actavis, and Actavis agreed to pay a substantially higher price than Valeant had offered.

In our opinion, much of what Allergan said was wrong but Valeant seemed unprepared for what it should have known would be an aggressive counterattack. The defenses available to the targets of hostile takeovers are considerable and Valeant has now lost three hostile bids for public companies since 2011. Meanwhile, Allergan's stock price nearly doubled over the past year without so much as a thank you note sent to Valeant CEO J. Michael Pearson.

Some good came out of this defeat. As it fought for Allergan, Valeant stopped making other acquisitions and so stopped taking one-time charges for restructuring and integrating its serial acquisitions. This made its financial reports easier to follow, and more investors came to see Valeant has a fine business. Most of its product categories show strong organic growth, despite claims to the contrary by Allergan. Valeant throws off sizable cash flows. It has very few products vulnerable to patent expirations in coming years. Management has done an excellent job of picking its spots, both geographically and by product category, while avoiding dependence upon a single drug. It integrated the large Bausch & Lomb acquisition flawlessly. And it proved itself capable of launching a new prescription drug, Jublia, with a highly-successful direct-to-consumer ad campaign.

In short, Valeant lost the battle for Allergan but we believe it is winning the war to establish itself among the first rank of global pharmaceutical companies. The stock suffered for much of the year from Allergan's broadsides, but performed better once the takeover battled ended. We think Valeant is poised for more growth, both organic and acquired. We think it is brilliantly managed by Mike Pearson and his team. And yes, we are comfortable with the size of our holding.

Excerpt from 2015 Sequoia Letter to Investors (1)

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Sequoia turned in its second straight year of poor results in 2015.Teasing out the source of our underperformance doesn’t take much work. We began the year with a 20% weighting in Valeant Pharmaceuticals (NYSE:VRX). Valeant rose by more than 80% through the summer, driving very strong gains for the Fund. But the price collapsed in the fall amid revelations and allegations about the company’s business practices. Ultimately, Valeant declined 29% for the year and by more than 70% from its 52-week high to its low. We bought more shares in October, and we calculate that Valeant contributed -6.3% to Sequoia’s return of -7.3% for the year.

At its peak price, Valeant constituted more than 30% of the Fund’s assets. We’ve been criticized for allowing the holding to grow so large, but our feeling before the crisis erupted was that Valeant was executing well on its business model. Earnings were growing rapidly and we believed the company was making intelligent acquisitions that were creating shareholder value. Valeant was taking outsized price increases on a portion of its drug portfolio, but the entire branded pharmaceutical industry routinely has taken substantial annual price increases on drugs for more than a decade.

As you are no doubt aware, Valeant was rocked in the fall by the closure of an affiliated specialty pharmacy, Philidor, after health care payers said they would not reimburse Philidor for claims it submitted. It has been further buffeted by subpoenas from Congress over its pricing strategies and by regulatory and law enforcement scrutiny over practices at Philidor. A committee of Valeant’s board of directors is investigating the relationship with Philidor. Valeant recently said it would restate prior earnings as it improperly accounted for sales to Philidor in late 2014.

Excerpt from 2015 Sequoia Letter to Investors (2)

As these inquiries continue and Valeant remains a subject of intense scrutiny, the share price is very unstable. For the stock to regain credibility with long-term investors, Valeant will need to generate strong earnings and cash flow this year, make progress in paying down some of its debt, demonstrate that it can launch new drugs from its own development pipeline and avoid provoking health care payers and the government. The company has committed to doing all of these things and we are confident interim CEO Howard Schiller and interim board chairman Robert Ingram are focused on the right metrics. Before CEO J. Michael Pearson went out on an extended medical leave, he also seemed committed to this path.

In the end, Valeant's ability to grow earnings over a period of years will determine the stock price. A few months ago, the consensus cash earnings estimate from Wall Street analysts for Valeant in 2016 was about $16 per share. Today, estimates are closer to $13.50. This represents material deterioration, but still good growth over 2015 results. And with strong performance from its gastrointestinal drug Xifaxan and a slate of new product releases in 2016, Valeant has the potential to grow earnings for several years driven more by organic volume increases than price hikes.

As the largest shareholder of Valeant, our own credibility as investors has been damaged by this saga. We've seen higher-than-normal redemptions in the Fund, had two of our five independent directors resign in October and been sued by two Sequoia shareholders over our concentration in Valeant. We do not believe the lawsuit has merit and intend to defend ourselves vigorously in court.

Excerpt from Sequoia Letter to Investors, July 12, 2016

Dear Clients and Sequoia Shareholders:

You may be familiar with the apocryphal Chinese curse, “May you live in interesting times.” Sequoia shareholders have lived through interesting times during the past year. We can assure you that our goal is to be much less interesting in the months and years ahead.

As we have previously reported, our longtime chief executive officer and co-manager of Sequoia, Robert D. Goldfarb, retired from our firm at the end of March 2016. Our new leadership elected to sell our position in Valeant Pharmaceuticals, exiting completely by mid-June. Valeant was our largest position to start the year and its 80% decline through June 30 badly penalized our results. For the first half, Sequoia generated a negative 13.2% return vs. a positive 3.8% return for the S&P 500 Index.* Absent Valeant, the rest of the Fund’s portfolio generated a positive return of 2.3% for the first half. At the end of this letter you will find holdings data for the Fund’s 10 largest holdings in Sequoia as of June 30th.

While we are all disappointed by these results, we have responded by changing our leadership and committing ourselves to restoring the legacy handed down to us from Bill Ruane and Rick Cunniff. This was a very active quarter, at least by our standards. Sequoia exited several positions in addition to Valeant and we added four new stocks. This does not represent a departure from our longstanding philosophy of concentrating on a focused portfolio of businesses we have researched intensively and intend to hold for years. Our team believes in that approach. In fact, we held 38 stocks in Sequoia at the start of the year, including a number of tiny positions that could never be meaningful contributors to returns. We held 29 stocks in the Fund at mid-year.