February 18, 2016

WELLS FARGO SECURITIES

Equity Research

Valeant Pharmaceuticals International

VRX: Underperform -- Too Many Questions

Underperform / V

Sector: Specialty Pharmaceuticals
Overweight

Initiation of Coverage

- We are initiating coverage of Valeant with an Underperform rating and a $65-68 valuation range, which implies 42% potential downside from the current market value. Our 2015 EPS estimate is $10.53, and our 2016 EPS estimate is $13.69.
- Despite our recent meeting with the company to discuss our concerns, we continue to have a number of unanswered questions on what we consider to be important investment considerations, management strategic direction, recent guidance, the mechanics of the Walgreen's deal, the dramatic increases in gross-to-net revenue adjustments, the cause of the rise in days sales outstanding (DSO), and how changes to deferred tax assets and deferred tax liabilities may have affected earnings.
- We believe the Valeant board and management have made decisions that may have put Valeant at significant business and reputational risk. While it is often noted that Valeant's management team has created a huge amount of value, our perspective is different: Valeant has lost approximately $60 billion of market value from its peak, yet its current market value is approximately $30 billion.
- On the positive side, Valeant has several key brands that are showing strong growth, which should continue in 2016, such as Xifaxan, which we estimate will top $1.0 billion in 2016E. This, as well as franchises in ophthalmology, dental, and consumer products, appears to have good prospects. In addition, while Valeant has not provided a lot of insight into its pipeline, the sheer number of pipeline products Valeant lists, could provide upside potential to our forecasts.
- Overall, we believe that Valeant's self-proclaimed "new business model" for pharma has been reliant upon low-cost debt for deals, cost-cutting for acquired companies, price increases, and based on recent press reports, specialty pharmacy practices that are now under scrutiny. We believe that following recent intense scrutiny of its practices, Valeant's growth may be impeded. Can Valeant adapt to the new environment? We are not sure, but with too many unanswered questions, we believe investors are better off deploying capital elsewhere.

Valuation Range: $65.00 to $68.00 from NE to NE
Our valuation range of $65 to $68 is based on our DCF analysis using a terminal EV/EBITDA multiple of 7x and a discount rate of 9%, which we believe reflects the current cost of capital and the risks outlined in this report.
Risks to our thesis and valuation include: successful execution of a turnaround strategy, better-than-expected launches of late-stage pipeline, and the elimination of political and regulatory risks that lead to sudden multiple expansion.

Investment Thesis:
We believe Valeant shares currently carry too much risk for us to be comfortable recommending them as an investment. Our concerns stem from a number of factors, including opaqueness related to acccounting issues, what we see as balance sheet risks, unanswered questions related to business practices, and confusion over how the Walgreens deal actually benefits Valeant.

CASH EPS	2014A	2015E Curr.	2015E Prior	2016E Curr.	2016E Prior
Q1 (Mar.)	$1.76	$2.36 A		$3.23	
Q2 (June)	1.91	2.56 A		3.45	
Q3 (Sep.)	2.11	2.74 A		3.46	
Q4 (Dec.)	2.58	2.88		3.55	
FY	$8.34	$10.53		$13.69	
CY	$8.34	$10.53		$13.69	
FY P/E	11.4x	9.0x		7.0x	
Rev.(MM)	$8,264	$10,674		$12,730	

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
V = Volatile, = Company is on the Priority Stock List

Cash EPS is a non-GAAP measure that excludes certain items, such as restructuring, integration, and acquisition-related expenses, among others.

Ticker	VRX
Price (02/18/2016)	$95.24
52-Week Range:	$69-264
Shares Outstanding: (MM)	351.0
Market Cap.: (MM)	$33,429.2
S&P 500:	1,917.88
Avg. Daily Vol.:	6,125,590
Dividend/Yield:	$0.00/0.0%
LT Debt: (MM)	$30,176.0
LT Debt/Total Cap.:	84.0%
ROE:	60.0%
3-5 Yr. Est. Growth Rate:	9.0%
CY 2016 Est. P/C. EPS-to-Growth:	0.8x
Last Reporting Date:	10/19/2015 Before Open

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters

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Please see page 32 for rating definitions, important disclosures and required analyst certifications
All estimates/forecasts are as of 02/18/16 unless otherwise stated.

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Together we'll go far

TABLE OF CONTENTS

Introduction 3
Governance 5
Unanswered Questions on Deferred Tax Liabilities 7
Use of Working Capital 9
Gross-To-Net Revenue Adjustments 12
The Problem with Valeant's Guidance 13
Intangibles 13
Accounting/Beneish Model 15
Valeant's Poor F-Score Should Concern Shareholders 16
Balance Sheet Risk 16
Financial Leverage Risk 19
Financial Statement Analysis 20
Walgreens Deal 22
Sprout Deal 23
Key Products Facing Risks 24
Pipeline 28
Risks 30
Valuation 31
Summary 32

Introduction

Valeant Pharmaceuticals International, Inc. is a specialty pharmaceutical and medical device company engaged in the development, manufacture, and marketing of branded, generic, and branded-generic pharmaceuticals, as well as over-the-counter (OTC) products and medical devices, such as contact lenses and ophthalmic surgical equipment. Valeant markets more than 1,600 different products in more than 100 different countries. Valeant has approximately 21,000 employees and is headquartered in Laval, Quebec, Canada, legally domiciled in the Province of British Columbia, and maintains an administrative presence in Bridgewater, New Jersey. Valeant reported total revenue of $8.3 billion in 2014. We are forecasting total revenue of $10.7 billion in 2015E and $12.7 billion in 2016E.

Valeant operates an acquisition-focused business model that has deemphasized R&D. This business strategy has been credited to its CEO, Michael Pearson. Valeant has acquired more than 100 companies and products since Mr. Pearson took the helm in 2008. Valeant expects to achieve its first $1 billion brand in 2016 with Xifaxan, a gastrointestinal drug it acquired after purchasing Salix in 2015. Other large Valeant products include Jublia, Solodyn, and CeraVe. Valeant operates in two reported segments: developed markets and emerging markets. In 2014, developed markets accounted for approximately 75% of total revenue and approximately 86% of operating profit.

Investment Thesis

We believe Valeant shares currently carry too much risk for us to be comfortable recommending them as an investment at current levels. Our concerns stem from a number of factors, including opaqueness related to accounting issues, what we see as balance sheet risks, unanswered questions related to business practices, and confusion over how the Walgreens deal actually benefits Valeant.

Our discounted cash flow (DCF) valuation leads us to a $65.00-68.00 valuation range, based on a 9% discount rate and a 7x terminal multiple, which implies 42% downside risk from the current share price, resulting in our Underperform rating.

Key Points

We believe Valeant shares currently carry a significant amount of risk and uncertainty. This concern arises from our lack of clarity on a number of key issues, including accounting, rapidly expanding gross-to-net ratios, balance sheet leverage, business outlook, and the recent Walgreen deal. As a result, we are uncertain about what the future might hold for Valeant. We believe Valeant has made business decisions that have led to increased scrutiny and share price decline, which makes us believe that these risks are not commensurate with the perceived reward, and this substantiates our discomfort with recommending the shares as an investment.

First, The Positives

While we have concerns, as outlined in this report, it should be underscored that Valeant also possesses many positives, including a large growth engine in the $1 billion Xifaxan franchise, key franchises in ophthalmology, including the well-recognized and trusted Bausch & Lomb brand, a large pipeline, and sizable cash flow. We believe that if Valeant wanted to de-lever more quickly, several of these franchises may be attractive to others.

If Valeant is successful in doing what it aims to do, including paying down debt, arresting the negative impact of the recent Philidor situation, making Addyi into a large product, and launching several large-market opportunity drugs, then the shares would reflect fewer of the risks and more of what we would consider a more optimistic outlook. Our DCF value is based on a 9.0% discount rate and a 7x terminal value, and is reflective of what we consider the marginal cost of capital at this point and the business uncertainties.

Reasons We Are Not Recommending Valeant Shares

- **Valuation.** Valeant currently trades at approximately a 46% premium to our DCF value.

- **Board and Governance.** Based on what we consider to be a number of serious issues and the stock price decline, we believe investors are likely questioning the judgement and the decision making of management team and board. We believe board-level decisions such as those surrounding the Medicis deal and subsequent sale of the key assets, the failed hostile bid for Allergan, the acquisition of Sprout, and the establishment of Philidor have contributed to a decline in the share price. Valeant shares declined 65% from August 1, 2015 to February 16, 2016, while the S&P 500 Index was down 10% during this same period. In our opinion, the share price decline of the past year has been a direct result of management decisions. We understand how investors could be skeptical about Valeant's recent statements acknowledging that "mistakes were made" and that it is making substantial changes to its business model, as corporate cultures and investor sentiment are difficult to change without management and board changes.

- **We remain unclear on several business and accounting-related factors,** such as what appears to be a dramatic increase in gross-to-net revenue adjustments, possible increasing inefficiency with working capital accounts, and a rapid rise in DSO, as receivables growth has outstripped sales growth over the past several years. In addition, we have asked Valeant to further explain how changes to deferred tax assets and deferred tax liabilities may have affected earnings in recent years. We worry that intangible assets as a percentage of total assets might indicate an elevated risk of impairment.

- Management seems unable to answer key questions on guidance and other items. We explain the difficulty reconciling Valeant's updated guidance with previous statements about the impact of Philidor.

- **Valeant does not screen well on certain liquidity and accounting risk screens.** For example Valeant has a very low Altman Z-score, 0.95, indicating an increased potential of default. By comparison, a peer group we constructed for Valeant has an average Altman Z-score of 3.42. Valeant's F-Score, or a screen used to predict the likelihood of accounting misstatements, puts Valeant in the "substantial risk" category. As far as potential for default, on the one hand, it appears to us that Valeant's free cash flow (FCF) would be sufficient to meet its obligations; however, there are two things investors should be aware of in this regard: (1) according to Valeant, legal and tax settlements are included in the debt covenant EBITDA calculations. As such, we believe legal settlements are critically important to monitor; and (2) because of the high level of debt, we believe much of Valeant's FCF is to be used for debt payment, a significant change to its historical business model.

- **We believe there is significant uncertainty and a lack of clarity regarding the distribution agreement with Walgreens and how it benefits Valeant.** We do not believe Valeant has provided enough detail on the Walgreen's deal to allow an investor to determine the financial impact of the deal. Our discussion with Walgreens leads us to believe that Walgreens was in an advantageous positon given the timing of the deal.

- **We have significant skepticism over Valeant's past deals,** including the Sprout deal.

- Since we have little visibility as to the current and future state of Valeant's business, we cannot recommend Valeant shares. Our lack of clarity on several items cause us concern and this, with our DCF-based valuation, results in our Underperform investment rating.

Exhibit 1. Adjusted EPS Estimates – Wells Fargo Securities Versus the Consensus

	2015	2016	2017	2018	2019	2020
Wells Fargo Securities Estimates	$10.53	$13.69	$14.69	$14.24	$13.97	$14.76
Consensus Estimates	$10.26	$13.46	$16.16	$18.33	$20.24	$22.24

Source: FactSet consensus estimates and Wells Fargo Securities, LLC estimates

Governance

Overall, there are two primary ways we judge boards: by its qualifications and by the results of its actions. In our view, the slide in Valeant's shares is directly related to decisions that the board and management have made, whether it is the decision to partner with a hedge fund in an unprecedented (the practice is the subject of ongoing litigation) takeover attempt of Allergan, which became a distraction for management and investors, or the board review and approval of a relationship with Philidor, which later caused a significant decline in shareholder value and corporate reputation, in our opinion.

Currently, according to Valeant's quarterly 10-Q filing, Valeant has more than 10 active investigations and legal proceedings pending and we consider this an important risk factor to monitor.

Given the performance of the shares and board-approved transactions such Philidor and Sprout, we believe that investors may become more vocal for management or board changes unless significant progress is made to re-establish investor confidence that lasting changes have been made.

- **The shares have declined substantially.** We believe the results of the board and management's decisions are reflected in the stock price: the shares have fallen dramatically from prior highs, down 65% from August 1, 2015 to February 16, 2016, vs. the S&P 500, down 10%, and the company's reputation has been significantly damaged. We believe the share price decline is in large part a result of decisions on key issues, such as deals (e.g., Philidor, Sprout), as well as a pricing strategy about which Valeant testified to Congress admitting that "mistakes were made."

- **What did the board know about Philidor?** Valeant has stated that prior to the Philidor deal, the board conducted due diligence. However, recently, to better investigate the Philidor situation, an independent committee of the board has been appointed to determine who, if anyone, was aware of Philidor business practices.

Unanswered Questions on Deferred Tax Liabilities and or Other Tax-Related Accounts

Income tax obligations are considered an expense and are charged as income in the period the income was earned. However, due to timing differences between income tax and GAAP accounting, a company can decide to defer a portion of current income tax payment (or obligation) to future periods and capitalize it as a deferred tax asset instead of booking it as an expense against current income. We believe there is considerable subjectivity in setting up deferred tax asset accounts. A company can, for example, reduce income tax expense by charging current tax obligations to a deferred tax asset account instead of charging it as an expense against current net income.

A simple example illustrates this. Let's say total current income tax obligation is $500 million. Ordinarily, this would be considered an expense and charged against income as after-tax earnings. However, a firm could decide that the revenue on which it was assessed (the $500 million) has not been earned under GAAP accounting, and then exclude the $500 million as a charge to current earnings and instead create a deferred tax asset valued at $500 million. The reported after-tax earnings for the period would then increase by $500 million.

Deferred tax liabilities muddy up things even further and provide further opportunities for earnings management. These liabilities arise when revenue is recognized for GAAP accounting, but deferred for tax reporting. The tax expense associated with the revenue is recognized as a charge to current income and a deferred tax liability account is set up to absorb the future tax liability. Basically, deferred tax liability is a mirror image of deferred tax assets: GAAP revenue is recognized in the current period and a tax provision is made and charged against current income. Revenue recognition for tax purposes, as well as the associated tax obligation, is deferred to a future date, hence the term, "deferred liability." Normally, an increase in deferred tax liability would be accompanied by a corresponding increase in the current-period tax expense.

Business combinations and acquisitions generally require asset and liability revaluation adjustments; these adjustments at times do alter the relative GAAP-accounting and tax-accounting basis of the acquired assets and liabilities, and may result in the creation of deferred tax assets and deferred tax liabilities to reflect future tax implications of the adjustments.

- In our recent meeting with Valeant, we asked management to walk through, in broad strokes, whether changes in deferred tax liabilities and/or recovery of income taxes affected GAAP and adjusted earnings. Valeant's CEO and CFO both indicated they had no knowledge of how changes may have affected results.

By our analysis, it appears that Valeant's revaluation adjustments may have resulted in increases in deferred tax liabilities and deferred tax assets in the past few years. Valeant had more than $6.0 billion of total deferred tax liabilities and approximately $1.8 billion of total deferred tax assets as of September 30, 2015.

If a company, for whatever reason, decides it will not earn sufficient future pretax income to use its Deferred tax assets, it can write them down. Ordinarily, write-downs of deferred tax assets increase income tax expense and reduce earnings. However, a reduction in deferred tax assets could be charged to "other accounts" and not to income tax expense so as not to "encumber" reported after-tax earnings. Companies can also revalue deferred tax liabilities downward for similar reasons.

Valeant's valuation allowance for deferred tax assets increased from $478 million in 2013 to $859 million in 2014. However, only $273 million was charged to 2014 expenses. The remaining $109 million was charged to "other accounts." According to footnotes in its filings, the "other accounts" are related to Valeant's merger and acquisitions activities during the year.

Valeant had approximately $2.0 billion in total deferred tax assets at the end of 2014. Deferred tax assets increased by more than $1.0 billion between 2012 and 2013. This means that Valeant treated the tax obligation of approximately $1.0 billion as a tax expense on future income yet to be earned.

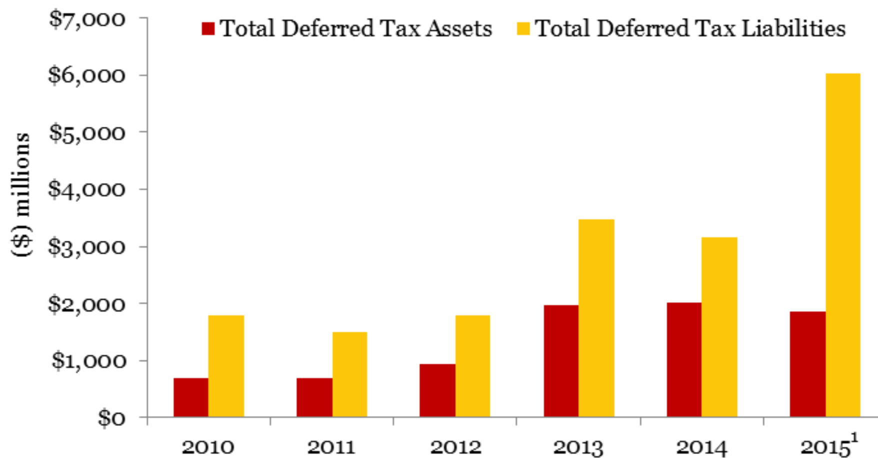
Companies are required to set up valuation allowance accounts for deferred tax assets. A company can use the valuation allowance to reduce or eliminate this potential future expense by following a GAAP rule that allows it to write down the book value of deferred tax assets if the company considers it "more likely than not" that some portion or all of the deferred tax asset will not be realized. The increase of approximately $381 million from 2013-14 in the valuation account seems to us to be indicative of such a write-down of deferred tax assets in 2014 (see Exhibit 3).

It seems as if Valeant's "recovery of income taxes" could be, in effect, additional income, or recognition of portions of the deferred tax liability account as income. While in 2014, Valeant recorded a GAAP income tax expense of $180 million, from 2008 to 2013, Valeant recorded "recovery of income taxes" on its income statement. This "recovery" amounted to $451 million in 2013 and $278 million in 2012. We believe these recoveries are effectively the result of changes in deferred tax liabilities and deferred tax assets. Considering the fact that Valeant had approximately $3.2 billion in deferred tax liability and approximately $2.0 billion in deferred tax assets at the end of 2014, "recovery of income taxes" as a source of income for Valeant could continue.

Currently, Valeant has an IRS investigation into its previous tax filings. Valeant is also under examination by the Canada Revenue Agency, and Valeant's subsidiaries in Australia are being reviewed by the Australian Tax Office. There is no reliable method of predicting the outcome of such a review. Previous outcomes with IRS reviews for other companies have ranged from finding no violations to settlements in the billions of dollars e.g., in 2006, GSK paid the IRS $3.4 billion).

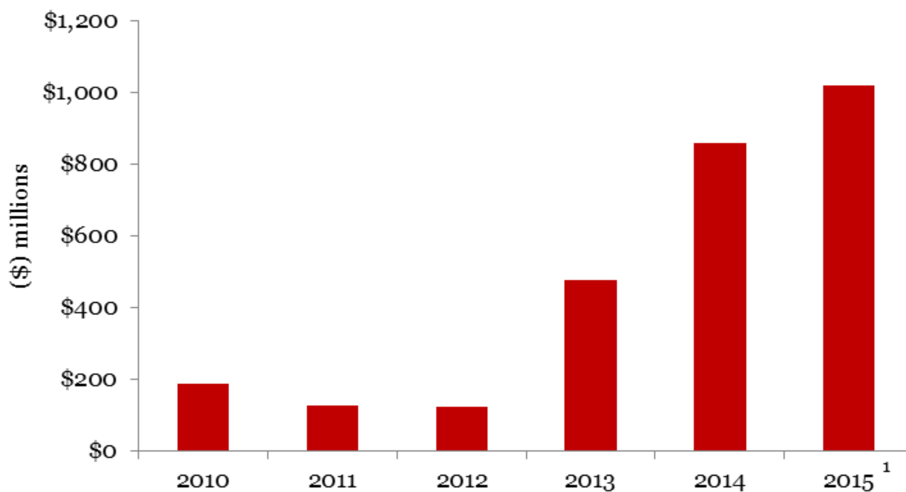
Whether these adjustments affect adjusted and/or reported earnings is a key question we have posed to Valeant; however, equally as important, in our view, is that these items appear to have become much larger over time, and as such, any adjustment may negatively affect balance sheet asset-based metrics.

Exhibit 2. Deferred Tax Assets And Deferred Tax Liabilities



Source: Company reports and Wells Fargo Securities, LLC
[1]2015 through FQ3 2015

Exhibit 3. Valuation Allowance For Deferred Tax Assets



Source: Company reports and Wells Fargo Securities, LLC
[1]2015 through FQ3 2015

Use of Working Capital

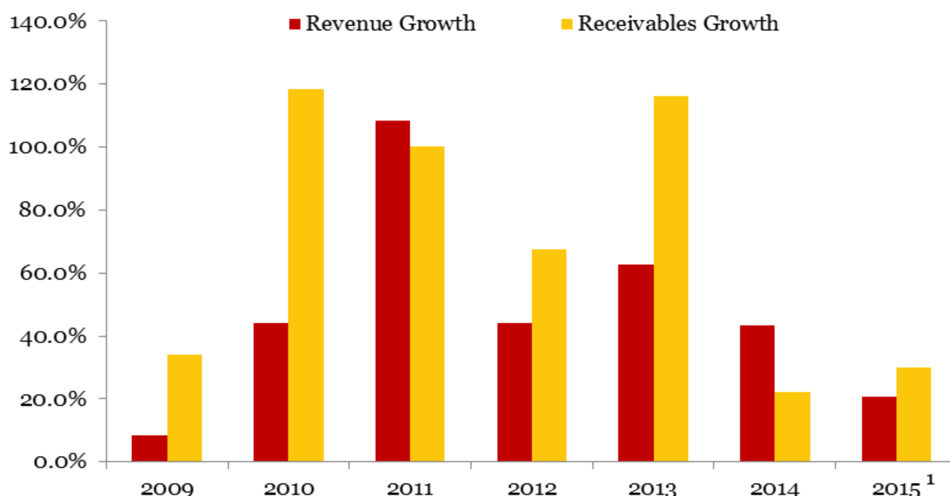
When we review the financial statements of a company, we often look at working capital. Inefficient management of working capital accounts not only hurts shareholder returns, it can foreshadow weakness at a company years before that weakness makes its way to the headline numbers.

- **Since 2009, sales have grown 1,118% and receivables have grown 2,303%.**

It appears that Valeant's accounts receivable have increased dramatically in recent years. As a percent of total revenue, Valeant's accounts receivable have increased from 19% in 2011 to 27% in the 12 months ending September 30, 2015. Exhibit 4 compares the year-over-year growth in total revenue to accounts receivable, while Exhibit 5 displays the ratio of growth in receivables to the growth in total revenue.

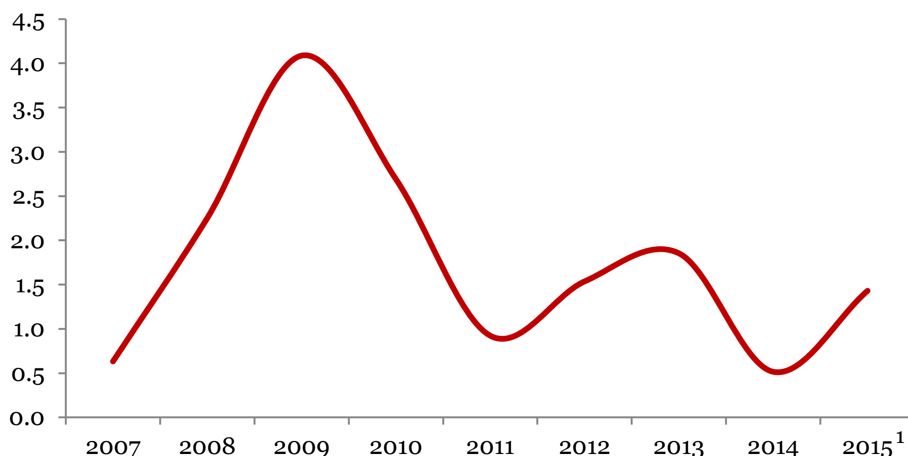
Receivables have been growing considerably faster than total revenue. In Exhibit 5, we create a ratio of receivables growth to revenue growth. A number above 1.0 means that the receivables account is growing faster than total revenue, while a number below 1.0 means that revenue is growing faster. There have only been three instances of revenue growing faster than receivables since 2007.

Exhibit 4. Revenue And Receivables Growth (Yr/Yr)



Source: Company reports, FactSet, and Wells Fargo Securities, LLC
[1]2015 through FQ3 2015 and uses trailing 12-month revenue

Exhibit 5. Ratio Of Change In Receivables To Change In Revenue



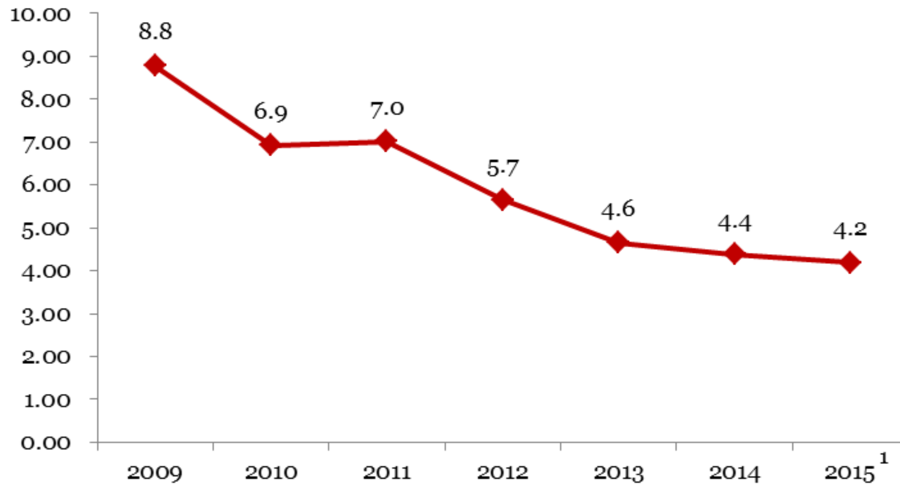
Source: Company reports, FactSet, and Wells Fargo Securities, LLC
[1]2015 through FQ3 2015 and uses trailing 12-month revenue

As a result of this significant growth in accounts receivable, Valeant's receivables turnover and days sales outstanding (DSO) have both shown significant deterioration. In 2011, the year after Valeant acquired Biovail, it was turning over its accounts receivable by 7.0x per year, while in the 12 months ended September 30, 2015, it turned its receivables just 4.2x.

- Valeant had 52 days of sales outstanding in 2011, while that has increased to 87 days of sales in the 12 months ended September 30, 2015, according to our own calculations of sales and receivables data from Valeant's public filings.

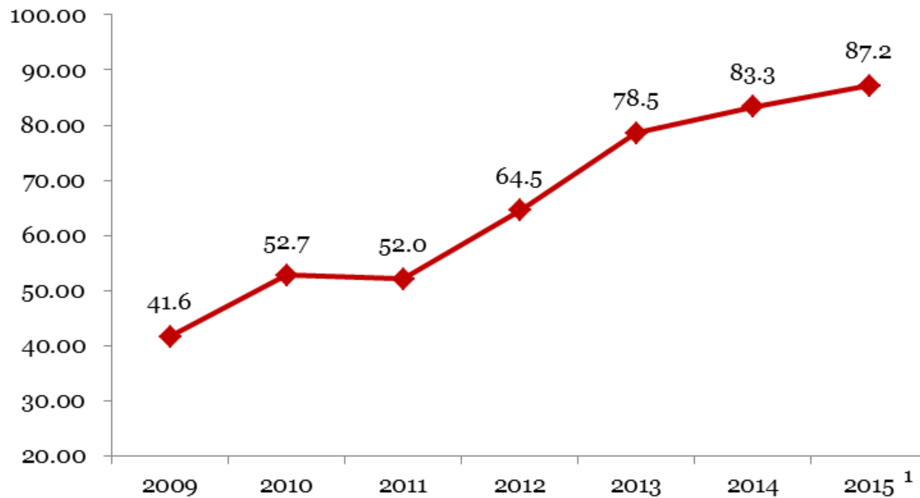
- Management stated that it did not believe DSO's have risen, but we show that they have in fact risen as shown in the following exhibits.

Exhibit 6. Accounts Receivable Turnover



Source: Company reports, FactSet, and Wells Fargo Securities, LLC
[1]2015 through FQ3 2015

Exhibit 7. Days Sales Outstanding



Source: Company reports, FactSet, and Wells Fargo Securities, LLC
[1]2015 through FQ3 2015

Increased inefficiency hurts shareholder returns; however, it may have much worse implications. When receivables are increasing faster than revenue, it can often indicate that customers are hesitant to pay for products. This could mean that demand for Valeant products is waning. If this is the case, bad debts are accumulating, and a write-down of receivables could occur. An alternative explanation for a dramatic rise in receivables is a company's improperly timed recognition of revenue.

For highly acquisitive companies, DSOs often rise temporarily as a company adjusts its balance sheet for the addition of receivables, but the associated revenue is not yet to be booked. When we have attempted to adjust Valeant's DSOs for the Salix transaction, it appears as if the overall multiyear trend of lower turnover remains. We believe shareholders should be concerned about this trend and its implications, especially as VRX has shown significant increases in recent quarters of non-U.S. growth.

Valuation Of Accounts Receivable – Small, But Interesting, In Our View

We examined the allowance for doubtful accounts for 2011-14. This valuation account directly determines the bad debt expense reported in the income statement. Generally, the lower the allowance set aside for anticipated future bad debt, the lower the expense, and the higher the reported net income.

Although the amounts in Valeant's statements are relatively small and generally on the order of 0.3% of sales revenue, there do seem to be some interesting changes in these numbers. We found that about 60-75% of the estimates that would normally have been charged as an expense to income were charged to "other accounts" instead. According to Valeant, "other accounts represents obsolescence reserves assumed as part of acquisitions consummated during the year."

We estimate that Valeant's bad debt expenses were reduced by about 60-75% in 2011, 2013, and 2014 by transfers to acquisition-related valuation accounts. Although the amounts are small and the impact on reported earnings is minimal, it seems as if this has curiously changed in the past several years. For example, the valuation allowances in 2013 and 2014 amounted to just 1.6-1.7% of gross accounts receivables, which implies that the company expects just 1.6-1.7% of outstanding accounts receivable to default. We went back and examined the allowance for doubtful accounts provisions from 2004 to 07, which averaged about 3.0% of gross accounts receivable during this period. It could be that the business environment has changed to warrant the 45% reduction (from 3.0% to 1.65%) in allowance, but we think that is unlikely.

Exhibit 8. Allowance For Doubtful Accounts ($ Millions)

Year	Beginning Balance	Charged to Costs & Expenses	Charged to Other Accounts	Deductions	Ending Balance
2014	$27.6	5.2	7.9	(4.8)	$35.9
2013	$12.5	5.8	10.2	(0.9)	$27.6
2012	$12.3	0.8	(0.5)	(0.1)	$12.5
2011	$6.7	1.5	4.7	(0.5)	$12.3

Source: Company reports and Wells Fargo Securities, LLC

Gross-To-Net Revenue Adjustments

As is customary in the pharmaceutical industry, Valeant makes gross-to-net revenue adjustments in order to account for a variety of deductions such as discounts, allowances, distribution fees, and rebates, which can be paid to direct and indirect customers.

Exhibit 9 shows the history of these adjustments from 2012 through Q3 2015. The provision to reduce gross revenue to net revenue has increased significantly as a percentage of gross revenue over this time period, rising from approximately 19% in 2012 to approximately 36%, on average, in the first three quarters of 2015.

Exhibit 9. Gross-To-Net Revenue Adjustments ($ Millions)

Gross to Net Adjustments	2012	2013	Q1 14	Q2 14	Q3 14	Q4 14	2014	Q1 15	Q2 15	Q3 15
Gross Product Revenue	4,068	7,850	2,451	2,750	2,980	3,414	11,594	3,250	3,969	4,666
Provisions to Reduce Gross to Net	779	2,210	599	756	957	1,178	3,490	1,103	1,274	1,918
Net Product Revenue	3,289	5,640	1,851	1,994	2,023	2,236	8,104	2,147	2,695	2,748
Provision as Percentage of Gross	19.1%	28.1%	24.5%	27.5%	32.1%	34.5%	30.1%	33.9%	32.1%	41.1%

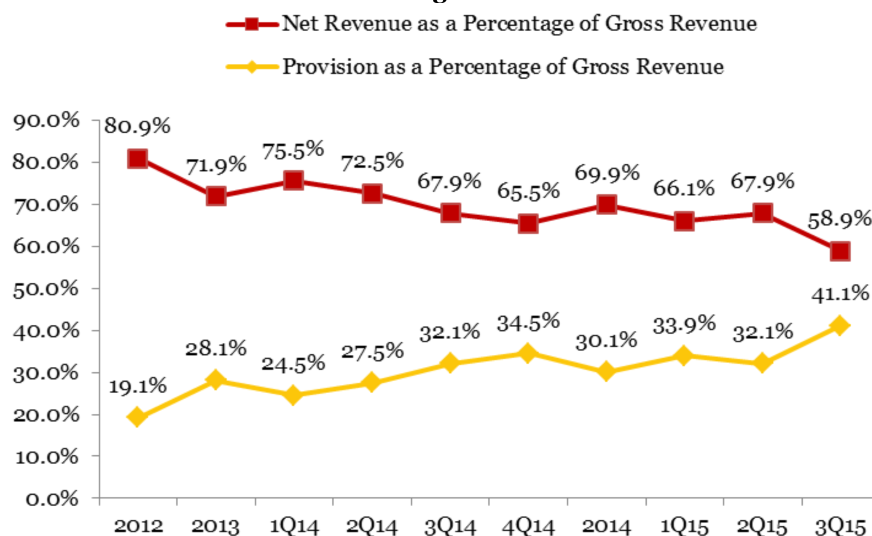
Source: Company reports and Wells Fargo Securities, LLC

The increasing provision means that Valeant is giving up more of its revenue to others in the supply chain, such as pharmacies and wholesalers. Valeant suggests the reason for the increasing provision is growing returns, rebates, and co-pay assistance programs related to select dermatology products, as well as increasing sales of certain generic products, such as Wellbutrin XL, which carry higher rebate percentages.

Exhibit 10 displays how net revenue as a percentage of gross revenue naturally declines as the provision increases.

There are several possible explanations for such changes; however, given that the Salix acquisition closed in April 2015, we do not see why there was such an inflection point (according to filings there was a 9 percentage point increase or nearly a 30% increase in the gross-to-net in just the Q2-Q3 2015 results). In addition the average provision for 2014 was 30%, and in 3Q15, it was 41%, amounting to a 37% increase.

Exhibit 10. Provision To Reduce Gross To Net Revenue As A Percentage Of Gross Revenue Versus Net Revenue As A Percentage Of Gross Revenue



Source: Company reports and Wells Fargo Securities, LLC

We conclude that Valeant's recent guidance update, in which the company lowered guidance for Q4 2015, may have had something to do with the unwinding of Philidor. It may have also had to do with the eventual outcome of a business model that has seen significant growth fueled by aggressive gross-to-net concessions being given to channel.

Investors should note that going forward, gross-to-net ratios may change for Valeant if the dispensing fee paid to Walgreen's is included in SG&A and not gross-to-net.

Valeant's Guidance

On Valeant's October 26 call, management reported that Philidor represented 6.8% of total Valeant sales and approximately 7% of Valeant's EBITDA. However, when management revised its Q4 guidance, total revenue was reduced from $3.25-3.45 billion to a new range of $2.7-2.8 billion. At the low end, this is a reduction of $550 million or 17%, and on the high end is a reduction of $650 million, or 19%.

In addition, the EPS reduction is even larger: the adjusted EPS guidance went from $4.00-4.20 to $2.55-2.65. At the midpoint, this represents a 36.6% decline.

Valeant has not explained how the unwinding of a business that represents only approximately 7% of total revenue, and is, according to Valeant, less profitable than traditional prescriptions, results in a 36.6% reduction in EPS.

In addition, if Valeant has approximately 351 million shares outstanding, and the decline at the midpoint of EPS is $1.50 per share, it would mean a $526.5 million decline in cash earnings, as Valeant defines it.

According to Valeant's presentation, Philidor represents only 6.8% of revenue, or approximately $227.8 million at the midpoint of the previous revenue guidance, then how can the unwinding of Philidor have a $526.5 million impact on earnings if its revenue was only approximately $227.8 million? Also, we wonder how good a proxy is Valeant's adjusted cash EPS to real cash when we see that this adjustment represents 71.5% of cash flow reported in the Q3 2015 results.

Overall, we believe the new guidance is not compatible with the data presented by Valeant. In other words, the reduction in guidance does not match the impact, as described by Valeant.

Intangibles

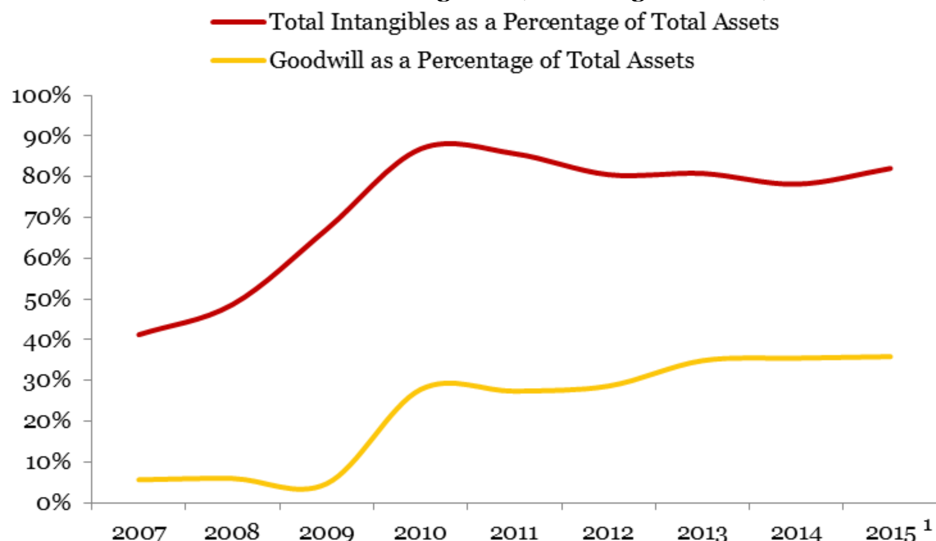
We think Valeant shareholders should be aware of Valeant's high percentage of goodwill and total intangibles as a percentage of total assets. Whenever we see a large and growing amount of goodwill, we wonder whether goodwill is currently impaired and if not currently impaired, whether it will be in the near future.

Goodwill is traditionally viewed as an asset because it represents superior earnings, due to the business acquisition. Goodwill is the present value of these future earnings, the yield of which returns greater than the normal returns of the firm. Even if superior earnings are forthcoming, the business model adopted by Valeant limits the life of goodwill. That is, when Valeant buys a company and then cuts R&D, it reduces the value of some of those future products because some of the products would not come to the marketplace, thereby limiting the period over which the goodwill can persist. Perhaps each acquisition would have goodwill for, say, ten years and then disappear. The very business model employed by Valeant creates impairment losses because of the inability of the subsidiary to generate new products because its R&D has been enervated by the parent company.

We believe that the likelihood of weakening financial performance has increased as Valeant's strategy and business model appears to have been disrupted by recent events, limiting the company's ability to raise drug prices. We are concerned that weakness in Valeant's performance could lead to material write-downs of goodwill.

Exhibit 11 displays goodwill as a percentage of total assets and intangibles plus goodwill as a percentage of total assets. Total intangibles are a remarkable 82% of total assets as of September 30, 2015.

Exhibit 11. Goodwill And Total Intangibles (Including Goodwill) As A Percentage Of Total Assets

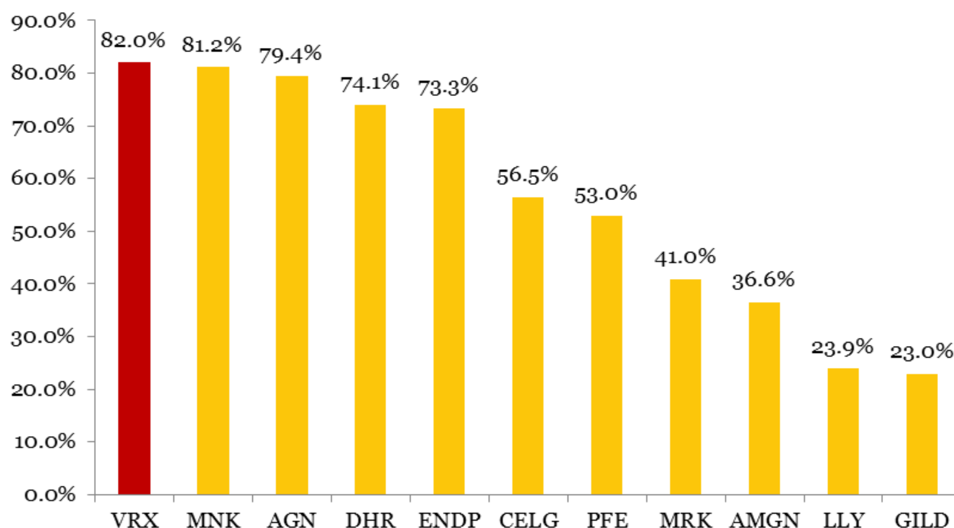


[1]2015 through FQ3 2015
Source: Company reports and Wells Fargo Securities, LLC

As of September 30, 2015, Valeant has $17.4 billion of goodwill and $22.4 billion of intangibles. Combined, goodwill and intangibles make up $39.8 billion of Valeant's $48.5 billion of total assets. Of the $22.4 billion of intangibles, $16.9 billion, or 75%, is made up of finite-lived product brands.

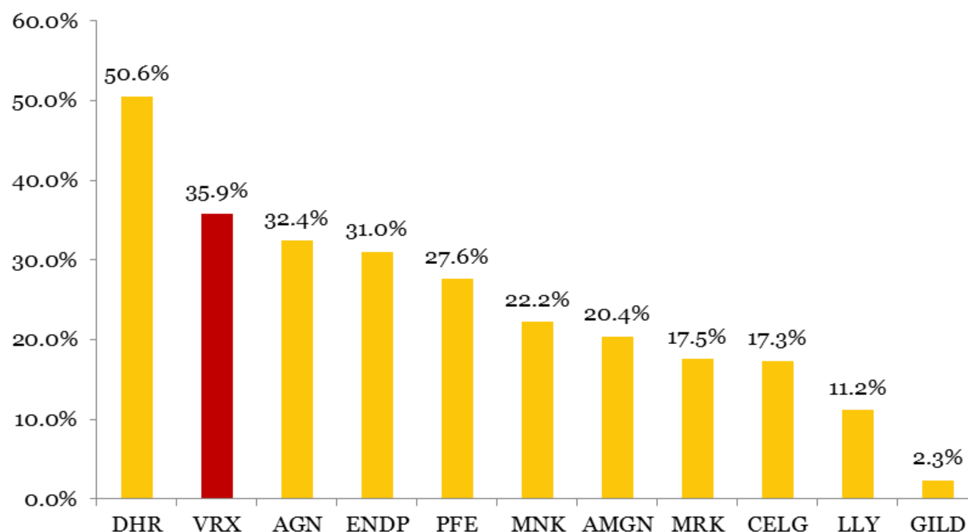
Approximately 82% of Valeant's total assets are made up of goodwill and intangibles. We calculate Valeant's tangible assets, plus cash, as $6.7 billion as of September 30, 2015. When we subtract total debt, we arrive at a value of approximately ($24) billion. If Valeant is forced to impair goodwill or certain intangibles, its leverage ratios and balance sheet risk could further increase. Given the significant leverage that Valeant's balance sheet is currently supporting, we find this possibility to be very concerning and believe investors should be aware of this risk.

Exhibit 12. Total Intangible Assets As A Percentage Of Total Assets (FQ3 2015)



Source: Company reports and Wells Fargo Securities, LLC

Exhibit 13. Goodwill As A Percent Of Total Assets (FQ3 2015)



Source: Company reports and Wells Fargo Securities, LLC

Accounting/Beneish Model

The Beneish model attempts to determine the extent to which a business entity resembles those that have been named in past SEC Accounting and Auditing Enforcement releases. To underscore, neither the Beneish mode, nor the Dechow F-score identify earnings misstatements, but instead, attempt to identify companies at greater risk of misstatement. We think the Beneish model, as well as the F-Score, which we describe further on herein, should be part of many financial reviews.

The result of the Beneish model review is shown in Exhibit 14.

According to the Beneish model, an M-Score of greater than -2.22 (i.e., less negative than this) indicates a likelihood of a firm being at risk of accounting misstatements.

The good news is that the probability of misstatement is low; nevertheless, there may be concerns if any of the indexes have values greater than 1. There are two such indexes for Valeant: the Days' Receivable Index is more than 1 in three of the six periods and the Sales Growth Index exceeds 1 in all six periods. These results suggest that one should research further the quality of the company's revenue.

Exhibit 14. Beneish Model – Weighted Predictor Ratios For Valeant (2010 – YTD 2015)

Weighted Predictor Ratios	2010	2011	2012	2013	2014	2015[1]
Days' Receivables Index	1.57	0.91	1.03	1.04	0.80	0.99
Gross Margin Index	0.59	0.49	0.51	0.57	0.49	0.51
Asset Quality Index	0.45	0.40	0.38	0.40	0.39	0.42
Sales Growth Index	1.28	1.86	1.28	1.45	1.28	1.08
Depreciation Index	0.23	0.09	0.11	0.14	0.08	0.12
SG&A Index	0.20	0.17	0.16	0.18	0.19	0.17
Total Accruals/Total Assets	(0.20)	(0.17)	(0.20)	(0.32)	(0.25)	(0.18)
Leverage Index	0.46	0.48	0.40	0.33	0.32	0.34
Constant	(4.84)	(4.84)	(4.84)	(4.84)	(4.84)	(4.84)
Beneish M-Score	(1.58)	(1.91)	(2.28)	(2.07)	(2.56)	(2.41)
Probability of Manipulation	5.65%	2.80%	1.13%	1.93%	0.52%	0.79%

[1]2015 through FQ3 2015
Source: Company reports and Wells Fargo Securities, LLC

Valeant's Poor F-Score Should Concern Shareholders

We decided to look into this even further and use the DeChow F-Score model. In 2000, DeChow and Skinner published in the American Accounting Association's Accounting Horizons an interesting paper on earnings management. In addition, DeChow's research "Predicting Material Accounting Misstatements" (coauthored with Weili Ge, Chad Larson, and Richard Sloan), published in 2011, included a model for assessing risk of misstatement. DeChow's F-Score is a complementary approach for detecting misstatements.

A short review of the pros and cons of the DeChow F-score can also be found in this *Forbes* article (http://www.forbes.com/forbes/2007/1029/072.html) (please see disclaimer at end of this report).

We reached out to Ms. DeChow and, with her permission, used a model she provided to calculate Valeant's F-scores. Using 2013–15 data Valeant's F-Score was 2.37, which means that Valeant is at substantial risk of misstatement. While Ms. DeChow states that her model could produce false positives, Valeant is in the tier that represents approximately 32.6% of all misstatement firms from her back-tested data.

On the basis of the Beneish model and our calculations of the DeChow F-score, we believe Valeant investors should be aware of the risks raised by these screens.

Balance Sheet Risks

We use the Altman Z-score model as a first approximation to determine whether there is any serious potential risk of a default. The Altman Z-score is a five-factor model developed by Edward Altman in the 1960s that attempts to measure the probability of bankruptcy.

Professor Altman's original paper, published in the Journal of Finance, can be found here:

http://www.defaultrisk.com/_pdf6j4/Financial_Ratios_Discriminant_Anlss_n_Prdctn_o_Crprt_Bnkrptc.pdf (please see disclaimer at end of this report).

We calculated the Altman Z-score for Valeant and the public companies that Valeant considers its peers in its proxy statements using data from 2011 through September 30, 2015. The results of our calculations are in Exhibit 15.

An Altman Z-score below 1.8 signals some level of distress. Valeant's Altman Z-score is below 1.8 in each of the periods analyzed, and its probability of bankruptcy has been elevated for years. In review of the individual factors that contribute to the overall Altman Z-score, the rise in Valeant's Altman Z-score in 2014 was largely driven by the rising market value of Valeant stock.

While the Altman Z-score may produce false positives, its predictive accuracy is greater than 70% two years prior to a bankruptcy. Even so, we consider this ratio as a signal for further questioning.

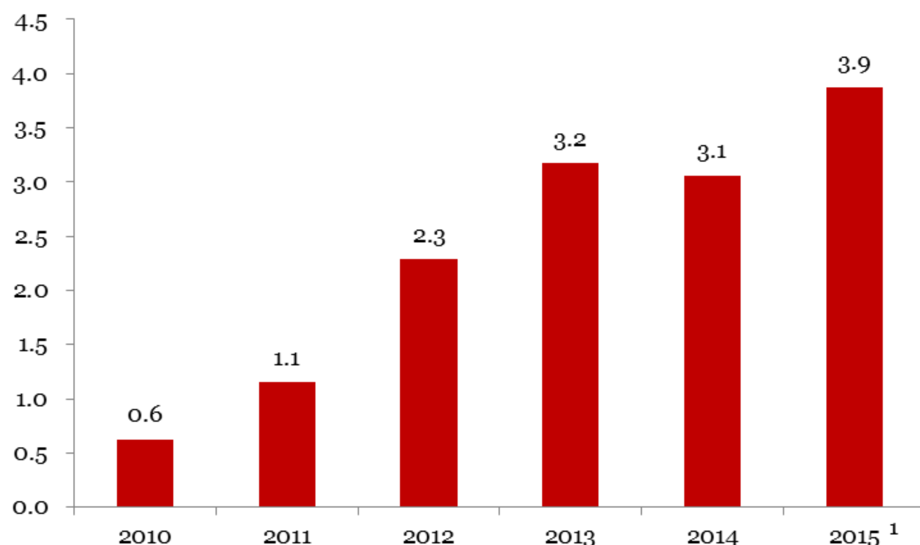
Exhibit 15. Altman Z-score Analysis Of Valeant And Proxy Peer Group

Altman Z-score Analysis		2011	2012	2013	2014	2015[1]
Valeant	Z-score	0.95	0.76	0.93	1.76	0.79
	Probability of Bankruptcy	52.2%	59.6%	52.7%	22.3%	58.4%
Allergan	Z-score	2.94	1.39	1.75	1.84	1.26
	Probability of Bankruptcy	2.6%	34.8%	22.7%	20.0%	39.9%
Amgen	Z-score	1.73	1.79	1.72	2.35	2.48
	Probability of Bankruptcy	23.4%	21.4%	23.7%	8.8%	6.9%
Danaher	Z-score	2.91	3.21	4.25	4.23	2.62
	Probability of Bankruptcy	2.8%	1.4%	0.1%	0.1%	5.3%
Celgene	Z-score	4.82	4.42	12.45	6.11	3.21
	Probability of Bankruptcy	0.0%	0.0%	0.0%	0.0%	1.3%
Eli Lilly	Z-score	3.13	3.28	3.49	3.09	3.72
	Probability of Bankruptcy	1.6%	1.1%	0.6%	1.8%	0.3%
Gilead	Z-score	3.74	4.21	7.70	7.00	5.12
	Probability of Bankruptcy	0.3%	0.1%	0.0%	0.0%	0.0%
Bristol Myers	Z-score	4.47	3.00	3.67	4.58	5.55
	Probability of Bankruptcy	0.0%	2.3%	0.4%	0.0%	0.0%
Peer Group Average	Z-score	3.39	3.04	5.00	4.17	3.42
	Probability of Bankruptcy	4.4%	8.7%	6.8%	4.4%	7.7%

[1] 2015 through FQ3 2015
Source: Company reports and Wells Fargo Securities, LLC

Valeant is among the largest high-yield healthcare issuers and currently has more than $30 billion in debt on its balance sheet. Debt as a proportion of the capital structure has swelled. Exhibit 16 shows Valeant's debt-to-equity ratio, which has dramatically increased from 0.6x in 2010 to 3.9x as of September 30, 2015.

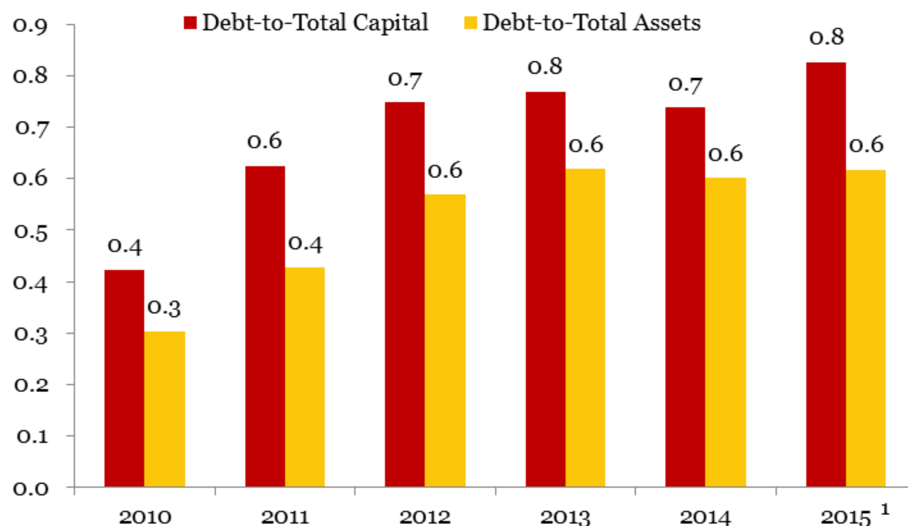
Exhibit 16. Debt-To-Equity Ratio



[1] 2015 through FQ3 2015
Source: Company reports and Wells Fargo Securities, LLC

Another way to look at this increasing leverage is in Exhibit 17, which shows Valeant's debt-to-total capital and debt-to-total assets ratios.

Exhibit 17. Debt-To-Total Capital And Debt-To-Total Assets

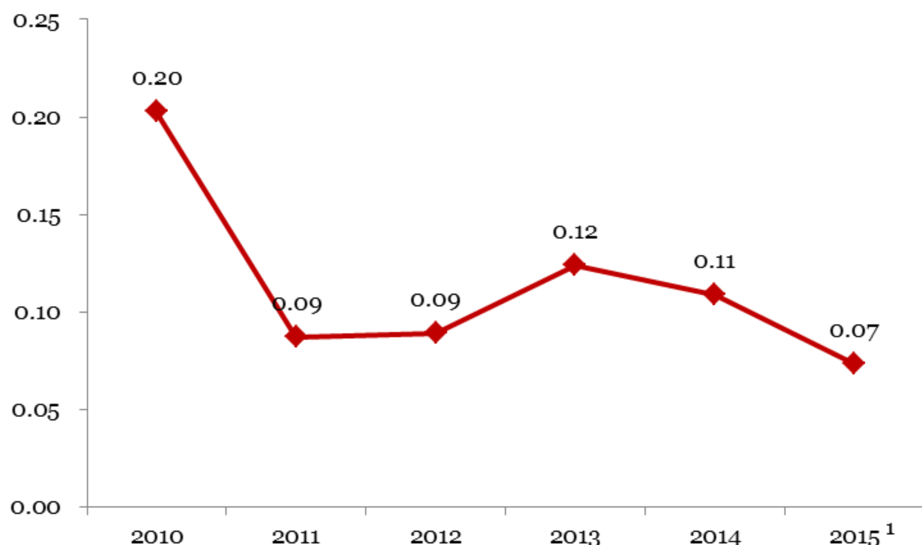


[1] 2015 through FQ3 2015
Source: Company reports and Wells Fargo Securities, LLC

One aspect of this leverage is its impact on Valeant's return on equity. High amounts of leverage can dramatically skew a company's returns either positively or negatively. Another element of this leverage is the concern whether the business enterprise is capable of paying the debt as it comes due.

One metric we use to analyze this risk is a company's operating cash flow as a percentage of its total liabilities. As Exhibit 18 shows, Valeant's operating cash flow as a percentage of total liabilities has been declining over the same period in which it has been amassing its large debt burden.

Exhibit 18. Operating Cash Flow As A Percent Of Total Liabilities



Source: Company reports and Wells Fargo Securities, LLC
[1] 2015 through FQ3 2015

Taking this a step further, we built the table shown in Exhibit 19. We modeled Valeant's debt maturities in each year over the next ten years and looked at its ability to cover these maturities with our estimates for free cash flow.

On the basis of this analysis, it appears Valeant would cover its maturity obligations. In order to do so, Valeant would need to dedicate essentially all of its free cash flow in the coming years to debt repayment. This would hinder, if not completely stop, Valeant's ability to complete acquisitions, all else being equal. Furthermore, these cash flows do not take into consideration potential increases in Valeant's tax rate or other disruptions stemming from ongoing government and regulatory investigations, such as fines, penalties, and loss of revenue.

Exhibit 19. Free Cash Flow Versus Debt Maturities ($ Millions)

	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Free Cash Flow	2,376	4,105	3,953	3,961	4,352	4,596	4,853	5,125	5,412	5,715
Debt Maturities	276	0	3,467	1,920	8,384	3,148	4,604	5,860	0	3,212
Running Cash	4,617	8,722	9,208	11,249	7,217	8,665	8,914	8,178	13,590	16,093
Remaining Debt	30,595	30,595	27,128	25,209	16,825	13,677	9,073	3,212	3,212	0
EBITDA	5,357	7,011	7,174	7,388	7,686	8,116	8,571	9,051	9,557	10,093
Debt to EBITDA	5.7x	4.4x	3.8x	3.4x	2.2x	1.7x	1.1x	0.4x	0.3x	0.0x

Source: Wells Fargo Securities, LLC estimates

Financial Leverage Risk

Valeant's debt-to-total capital ratio was 82.7% at the end of Q3 2015 and 82.5% at the end of Q2 2015. The times interest earned (TIE) metric reveals the stress caused by this much debt in the capital structure.

Exhibit 20. Times Interest Earned ($ Millions, Except Times Interest Earned Ratio)

	1Q 2015	2Q 2015	3Q 2015
EBIT	$452	$346	$412
Interest Expense	$298	$413	$420
Times Interest Earned	1.52	0.84	0.98

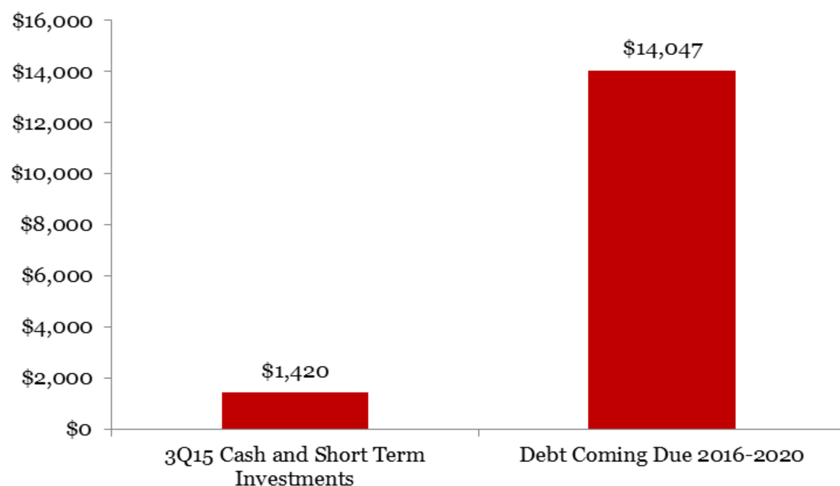
Source: Company reports and Wells Fargo Securities, LLC

Exhibit 21. Times Interest Earned Analysis ($ Millions, Except Times Interest Earned Ratio)

	2009	2010	2011	2012	2013	2014	2015[1]
EBIT	199	(153)	311	81	(481)	2,060	1,209
Interest Expense	25	84	333	482	844	971	1,131
Times Interest Earned	8.01	(1.82)	0.93	0.17	(0.57)	2.12	1.07
Cash Flow from Operations	361	263	677	657	1,042	2,295	1,638
Cash Interest Paid	4	38	248	421	653	934	N/A
Times Interest Earned (Cash)	85.93	6.98	2.73	1.56	1.60	2.46	N/A

[1] 2015 through FQ3 2015
Source: Company reports and Wells Fargo Securities, LLC

Exhibit 22. Current Cash And Debt Coming Due ($ Millions)



Source: Company reports and Wells Fargo Securities, LLC

We find it concerning that EBIT has covered interest expense in only three of the seven periods outlined in Exhibit 21. An alternative to using EBIT and interest expense is to employ cash flow numbers and recalculate times interest earned with cash flow from operations divided by cash interest paid. This cash times interest earned metric is encouraging in 2009 and 2010, in our view, but significantly deteriorates in more recent years.

Analysts and investors need to keep an eye on the capital structure of Valeant, in our view. With more than $30 billion in debt outstanding, according to public filings, and $1.6 billion in interest expense expected for 2016E, according to Valeant's Investor Day presentation (December 2015), we are concerned that the risk of default or restructured debt at higher rates could be greater than the market is currently appreciating.

Financial Statement Analysis

As Valeant has losses in 2010, 2012, and 2013, it has negative returns on equity (ROE) and negative profit margins (net income/sales) in those years. There are also large leverage factors. The ROE is amplified because the leverage (measured by total assets/average stockholders' equity) factors are greater than one. This demonstrates the double-edged nature of leverage: if the return on total assets is positive, leverage augments ROE; but, if the return on total assets is negative, leverage magnifies ROE.

Exhibit 23. Du Pont Analysis

	2009	2010	2011	2012	2013	2014	2015[1]
Return on Equity	14%	-7%	4%	-3%	-19%	17%	10%
Profit Margin	22%	-18%	6%	-3%	-15%	11%	6%
Asset Turnover	0.43	0.18	0.21	0.23	0.25	0.30	0.26
Leverage	1.50	2.06	2.68	4.03	5.13	5.09	6.29

Source: Company reports and Wells Fargo Securities, LLC
[1] 2015 through FQ3 2015

Cash EPS Versus GAAP

We believe shareholders should be particularly wary of Valeant's "cash EPS," or at least view these while considering other financial information and GAAP results.

The problem with Valeant's cash EPS, in our opinion, is that they are created by Valeant and employed only by Valeant; and because of the self-creation and self-referencing, this metric seems somewhat arbitrary. We say this not because we are against all use of adjusted EPS for Valeant or other companies, but we believe that several approaches may be needed to get a fuller picture of any company's business model.

If investors want to use non-GAAP pro forma metrics, it might be better to apply those well known to the investment community, such as EBITDA or free cash flow. If a company's management wants investors to analyze cash flow instead of earnings, it should focus on cash flow that is either disclosed on the cash flow statement, or calculable from that statement and similar disclosures. Free cash flow is a well-known and widely used metric that we believe is quite helpful in assessing a firm's ability to generate cash.

A number of adjustments that management applies in its press releases are the same as those found in the cash flow statement, such as an adjustment for in-process research and development (IPR&D) impairments. Other adjustments do not follow GAAP, such as the adjustment for restructuring, integration, acquisition-related expenses, and other costs.

We must also point out that such an adjustment is not consistent with Valeant's business model, in our opinion. Since Valeant's strategy embraces business combinations, acquisition-related costs are critical in assessing management's success in that strategy and should not be eliminated in this metric. In fact, Valeant has recently stated that its acquisitions of late-stage pipeline programs and companies are its R&D; we agree. We think adjusted earnings should not remove these items. Furthermore, some adjustments seen on a cash flow statement are not made in Valeant's calculation, such as adjustments for working capital items. We find this curious, as adjustments for working capital do convert GAAP income to cash flow.

Quite simply, while we do not mind assessing "adjusted EPS" for companies in our sector, Valeant's business model makes us believe that a clear focus on additional standard metrics should also be considered closely.

Free Cash Flow

Traditional free cash flow is equal to the cash flow from operating activities found on the cash flow statement minus capital expenditures (CAPEX). In Exhibit 24, we provide Valeant's net income, its cash flow from operations, and compute its free cash flow.

Exhibit 24. Traditional Free Cash Flow Analysis ($ Millions)

	2009	2010	2011	2012	2013	2014	2015[1]
Net Income	176	(208)	160	(116)	(866)	914	70
Cash Flow from Operations	361	263	677	657	1,042	2,295	1,638
Capital Expenditures	7	17	386	181	185	471	212
Free Cash Flow	354	246	291	476	857	1,824	1,426

Source: Company reports and Wells Fargo Securities, LLC
[1] 2015 through FQ3 2015

However, another way to look at free cash flow, adjusting it to include how much Valeant spent for property, plant, and equipment, intangibles other than goodwill and IPR&D, and IPR&D in business combinations (BC), is an interesting exercise. Our adjusted free cash flow metric is shown in Exhibit 25.

Exhibit 25. Adjusted Free Cash Flow Analysis ($ Millions)

	2009	2010	2011	2012	2013	2014	2015[1]
Cash Flow from Operations	361	263	677	657	1,042	2,295	1,638
Capital Expenditures	7	17	386	181	185	471	212
Free Cash Flow	354	246	291	476	857	1,824	1,426
BC: Property, Planet, and Equipment	0	185	141	20	780	57	96
BC: Intangibles except Goodwill and IPR&D	158	3,619	879	2,439	5,069	721	7,763
BC: IPR&D	0	1,401	747	190	437	63	5,333
BC: Total Capital Expenditures	158	5,205	1,767	2,649	6,286	841	13,191
Adjusted Free Cash Flow	196	(4,959)	(1,476)	(2,174)	(5,429)	983	(11,765)

Source: Company reports and Wells Fargo Securities, LLC
[1] 2015 through FQ3 2015

We believe shareholders could consider these approaches to analyzing adjusted free cash flow as another way to view Valeant's business model. Valeant's strategy is to acquire other firms, use their products, and harvest products near completion from the R&D process, and then slash R&D activities. In other words, instead of spending money on R&D and the ancillary assets to support R&D activity, Valeant spends funds on targets that are engaged in the R&D processes. This implies that the acquisition of property, plant, and equipment, and intangibles other than goodwill, including IPR&D, in business combinations are, in fact, capital expenditures to Valeant. For example, when Valeant acquired Bausch & Lomb in 2013, it purchased property, plant, and equipment for $766 million, intangible assets except for goodwill and IPR&D for $4.3 billion, and IPR&D for $418 million. Via this business combination, Valeant purchased these capital assets. As such, we believe they should be included within capital expenditures when computing free cash flow.

Valeant has a positive adjusted free cash flow in only two of the seven periods outlined in Exhibit 25. These results lead us to question the advertised successes of Valeant's business model and support our concerns about the strategy's future viability.

The limitation of this approach is that it negatively affects the company in the year the acquisition is completed as a hit to cash flow, but the future benefit of the deal is not reflected in the results. That stated, perhaps considering both methods would be the most prudent approach.

Walgreens Deal

On December 15, 2015, Valeant announced a distribution and fulfillment agreement with Walgreens.

As part of the 20-year agreement that starts in Q1 2016, Valeant is to reduce the prices of its branded prescription-based dermatology and ophthalmology products by 10%. The price reductions are to be applied to the wholesale list prices of these products and are expected to be phased in over a 6-9 month period.

In a separate agreement, Valeant is to distribute more than 30 branded products at generic competition prices. These prices are expected to be available to patients starting in Q2 2016. Valeant has stated that the weighted average price decrease across these 30 products is to be greater than 50%.

Given that this deal came shortly after Valeant terminated its relationship with Philidor following allegations of improper business practices widely covered in the press, which included aggressive mail order refills and payer optimization, we believe that Walgreen's held an advantage in any negotiations.

In other words, Valeant had effectively eliminated its largest specialty pharmacy and mail-order pharmacy and needed another firm or firms to take its place. In an interview on CNBC on December 15, 2015, Valeant CEO Michael Pearson explained how this arrangement is good for Valeant. A video of the interview can be found via the following link: http://yhoo.it/1SdxEiV (please see disclaimer at end of this report).

We do not believe that Valeant has provided sufficient clarity of the business arrangement with Walgreens or how this is better for Valeant than the previous Philidor arrangement.

- In our recent meeting with Valeant, management stated that it did not know what the dispensing fee will be and where it will be booked (in SG&A or as an adjustment to gross to net). Without knowing what the dispensing fee and the related costs of consignment inventory will be, and whether Walgreens can drive a similar volume as Philidor, it is difficult to determine whether the distribution arrangement with Walgreens is better or worse for Valeant.

What Did Walgreen's Say?

For more clarity, we reached out to Walgreens. Walgreens explained that it cannot speak for Valeant, but that it believes what Valeant must mean is that the Walgreens deal is better for Valeant than the situation would be without Walgreens and without Philidor, which would be essentially having no specialty pharmacy representation and no mail order.

We believe Valeant would see significant leakage from the transition, and many patients that have recurring prescriptions would opt out of having them refilled. Walgreens confirmed that there is no way for it to reach out to previous Valeant/Philidor patients, as it would violate laws aimed at keeping patient information private.

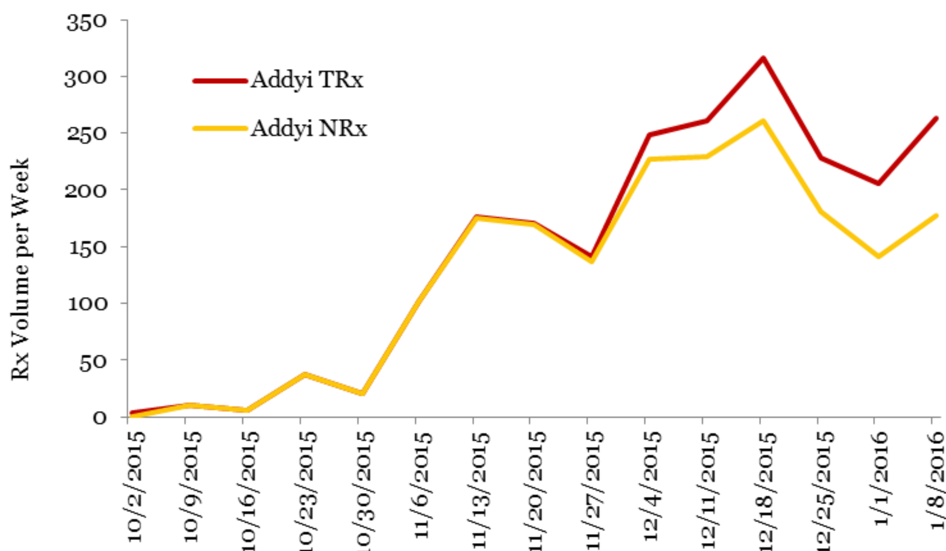
Walgreens described the arrangement as being good for Walgreens, but not a core driver, especially since Walgreen's is so large. After our discussion with Walgreens, it is our opinion that the deal is not an evolutionary move of the wholesaler channel, but instead, a deal struck out of Valeant's need to replace its former pharmacy.

Was The Sprout Deal A $1 billion Mistake?

Valeant purchased Sprout Pharmaceuticals in August 2015, just one day after Sprout had announced FDA approval of its only product, Addyi, a female libido drug. Addyi is not comparable to its male-targeted counterparts as it deals with complex neurological mechanisms instead of simple blood flow. In addition, Addyi must be taken by patients on a daily basis, and patients are also advised to avoid alcohol. Furthermore, the FDA requires Addyi to have a risk evaluation and mitigation strategy (REMS) program in which every doctor and pharmacist must be certified to prescribe the drug.

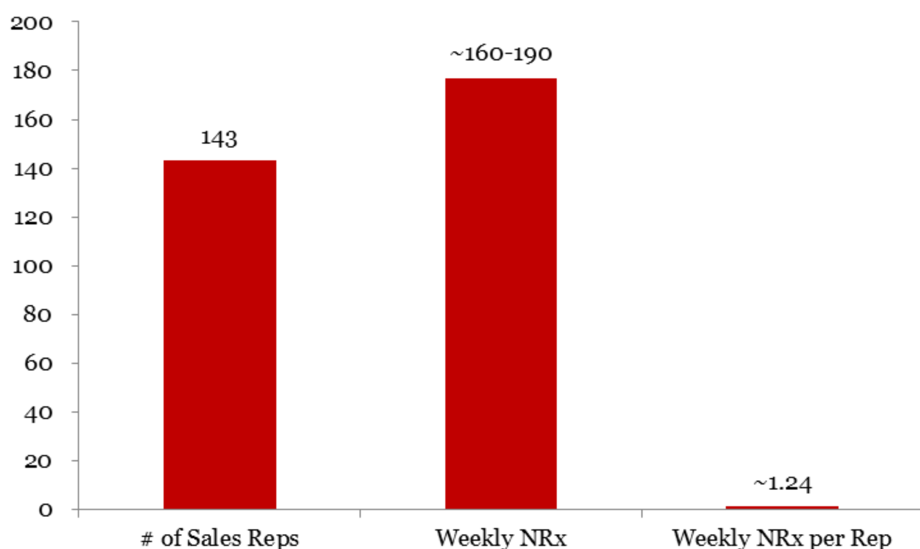
Valeant admits that Addyi is off to a slow start. The drug launched in October 2015 and, according to data from IMS Health, is running at only approximately 240 to 290 total prescriptions (TRx) per week as of January 8, 2016. Exhibit 26 shows the weekly TRx and NRx of Addyi.

Exhibit 26. Addyi TRx and NRx, Weekly (October 2, 2015, to January 8, 2016)



Any analysis is independently arrived at By Wells Fargo Securities, LLC, on the basis of the data and other information, and IMS is not responsible for any reliance by recipients on either the data, or any analyses thereof.
Source: IMS Health and Wells Fargo Securities, LLC

Exhibit 27. Addyi Sales Representatives And Weekly NRx



Note: Weekly NRx figure is as of January 8, 2016.
Source: Company reports, IMS Health, Wells Fargo Securities, LLC estimates

According to data from Medi-Span, Clinical Drug Information, LLC, one bottle of 30 100mg tablets of Addyi currently has a wholesale acquisition cost (WAC) of $800. Based on the current weekly prescription run rate, we estimate that Addyi is generating annualized sales of approximately $11 million.

Assuming a modest cost of capital of 5%, the acquisition of Addyi costs Valeant $50 million per year. At our current estimated run rate of approximately $11 million of annual sales, Valeant is to lose at least $39 million on the Sprout deal in 2016 before including the marketing and regulatory costs, which we estimate at approximately $28 million or 143 Addyi sales representatives at $200,000 per year.

We are concerned that Valeant has overpaid for Addyi and would ultimately need to impair this asset. According to Valeant's Investor Day presentation from December 16, 2015, Valeant has made it a 2016 goal to achieve $100-150 million of total revenue from Addyi. At the current WAC price of $800 per bottle, the midpoint of this range would equate to approximately 3,000 weekly total prescriptions. We are not confident that Valeant will achieve this goal.

When we noted our concerns about the Sprout deal, management explained that it is early days, and only time will tell whether it was mistake.

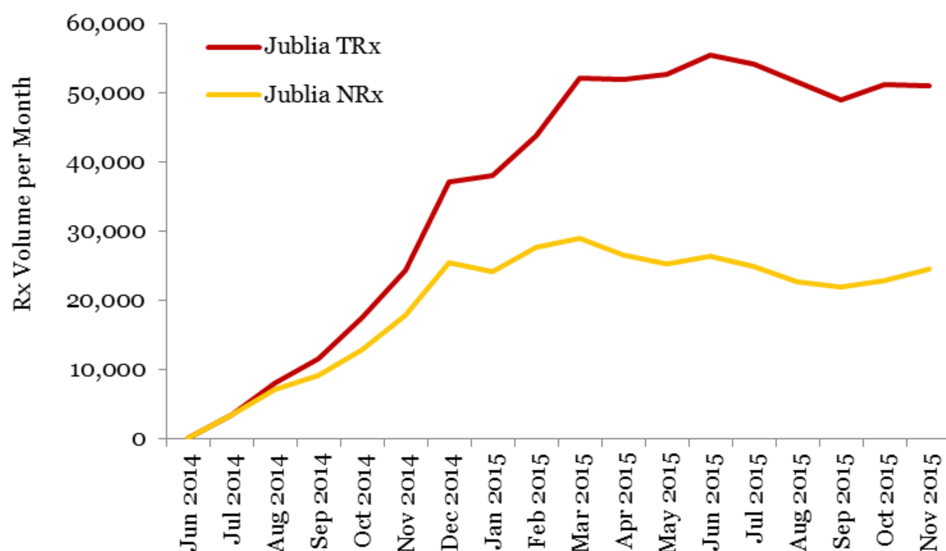
We believe that for single-product companies launching a product, the likelihood of success or failure can be judged pretty clearly in the first 1-2 years, and while we agree that these first few weeks are not the time to render a verdict, we believe the early signs are not good.

Key Products Facing Risks

We do not review each Valeant product herein; however, following are our comments on some of the company's largest revenue generators. To the extent that Valeant keeps to its announced strategy that it will not be a price-driven growth company, we believe some products will go from large growers to flattish products.

Jublia TRx and NRx have stagnated since early 2015. However, according to Valeant, Jublia revenue increased to $106 million in Q3 2015 from $62 million in Q1 2015, making it the company's second-largest revenue generator in Q3 2015. We believe that a substantial portion of Jublia's growth was fueled by Philidor and anticipate a significant negative impact to Jublia from the termination of Philidor and shift to Walgreens. While Jublia has patent protection into 2030, its exclusivity ends in 2019, and we believe competitors may be keen on introducing a less expensive version of the drug.

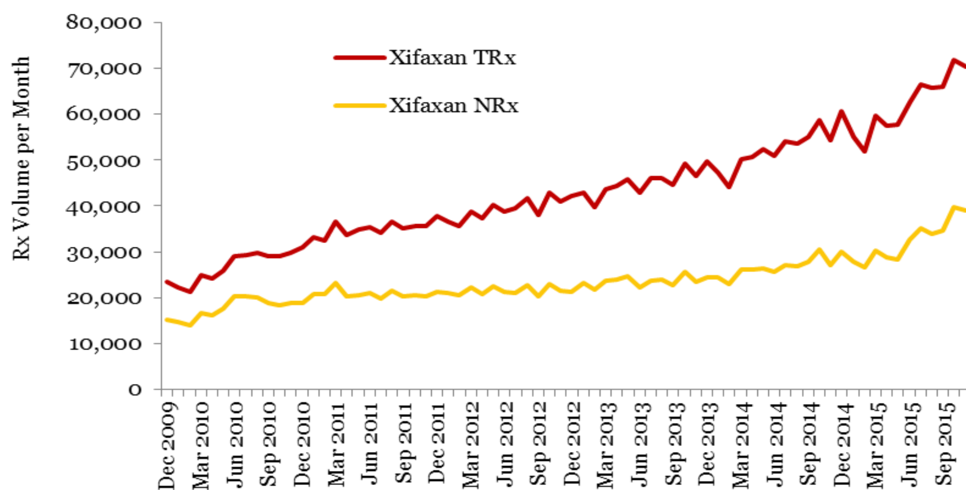
Exhibit 28. Jublia TRx and NRx, Monthly (June 2014 to November 2015)



Source: IMS Health and Wells Fargo Securities, LLC

Xifaxan is currently Valeant's largest revenue generator. In Q3 2015, Xifaxan generated revenue of $220 million, according to Valeant. Xifaxan received FDA approval for an IBS-D indication in May 2015, which we believe is supporting the growth in prescriptions. However, also in May 2015, the FDA approved Viberzi for the same indication.

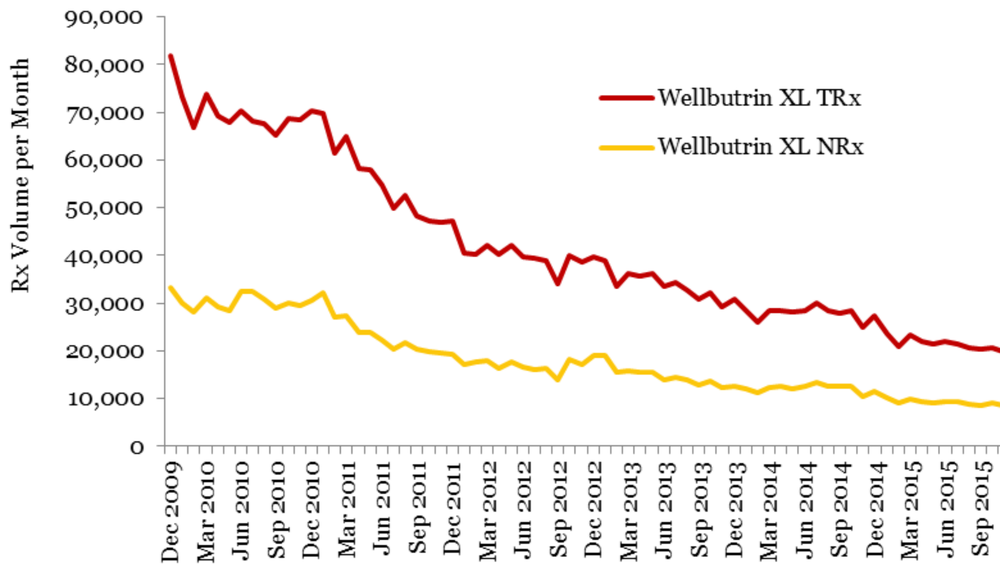
Exhibit 29. Xifaxan TRx And NRx Trends, Monthly (December 2009 to November 2015)



Source: IMS Health and Wells Fargo Securities, LLC

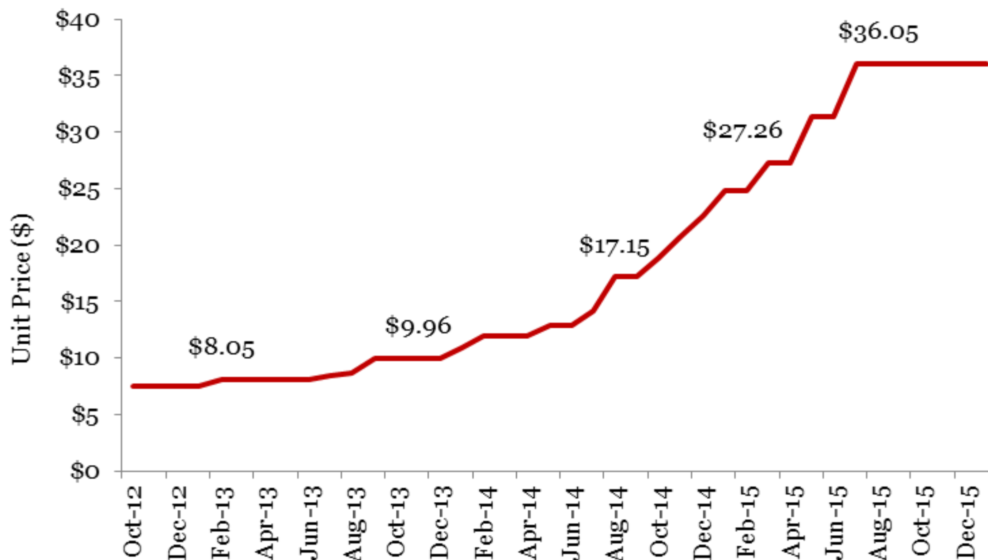
Wellbutrin XL was Valeant's third-largest revenue generator in Q3 2015, with total sales of $92 million. Wellbutrin XL revenue was up 37% sequentially and 15% year over year, which is impressive, in our view, especially when compared to the TRx figures (see Exhibit 30). We attribute this revenue growth to price increases--a bottle of 30, 150mg Wellbutrin XL pills increased from $677 in December 2014 to $1,081 in 2016, according to data from Medi-Span, Clinical Drug Information, LLC. According to data from Medi-Span, Clinical Drug Information, LLC, there have been 13 price increases in Wellbutrin XL since the beginning of 2014. At year-end 2013, Wellbutrin XL cost approximately $10 per pill. Today, Wellbutrin XL costs approximately $36 per pill. We expect Wellbutrin XL revenue to decline in 2016, as prescriptions are declining, and Valeant has indicated that it does not plan to take significant price increases in 2016.

Exhibit 30. Wellbutrin XL TRx and NRx Trends, Monthly (December 2009 to November 2015)



Source: IMS Health and Wells Fargo Securities, LLC

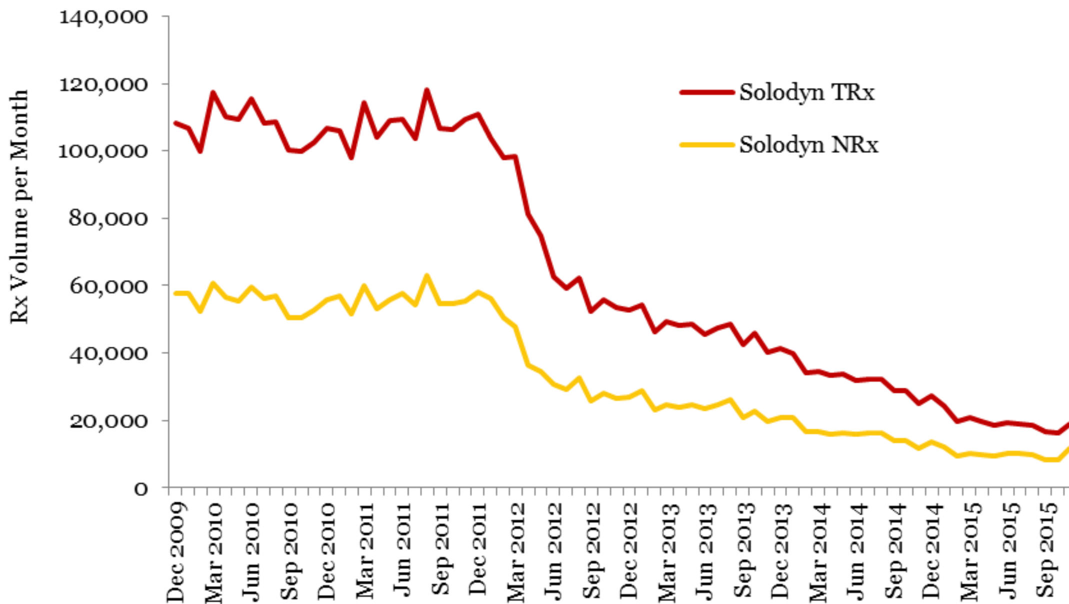
Exhibit 31. Wellbutrin XL Unit Price, Monthly (October 2012 to January 2016)



The attribution to CDI of the data from Price Rx in Wells Fargo research notes does not constitute CDI's endorsement of the data, views, opinions, or findings expressed, shared or otherwise reported in Wells Fargo research notes.
Source: Medi-Span, Clinical Drug Information, LLC and Wells Fargo Securities, LLC

Solodyn is Valeant's second-largest dermatology product, generating approximately $66 million of revenue in Q3 2015. Solodyn prescriptions have been declining, while revenue from the drug has still been growing. As with Jublia, we believe sales through specialty pharmacy channels, and Philidor, specifically, account for the vast majority of Solodyn's revenue growth and generation. We anticipate that revenue from Solodyn will more closely track prescription trends now that the drug is to be sold through a distribution agreement with Walgreens.

Exhibit 32. Solodyn TRx And NRx Trends, Monthly (December 2009 to November 2015)



Source: IMS Health and Wells Fargo Securities, LLC

- We note that we recently discovered that a generic company (Amphastar) has already started work on generic versions for two of Valeant's growth products, Isuprel and Nitropress.

Pipeline

We believe that Valeant has disclosed very little about its pipeline. In a recent analyst meeting, Valeant disclosed that it had 32 products in a listed pipeline chart of U.S. prescription and generic drugs. However, approximately 28 of the products listed are undisclosed compounds that Valeant has not described in any detail. If a company wants to get credit for a pipeline or wants investors to believe in significant growth opportunities in the pipeline, then it should disclose more information, in our view. Exhibit 33 provides a snapshot of what Valeant disclosed, as well as our assessment of one of the programs highlighted and our assessment of its prospects.

Exhibit 33. U.S. Prescription And Generic Drugs Pipeline

Product	Treatment	Phase	Potential Peak Sales
SAL-020	HAE	Pre Phase 3	Unknown
SAL-021	RA	Pre Phase 3	Unknown
SAL-022	Diabetes	Pre Phase 3	Unknown
SAL-023	Cirrhosis	Pre Phase 3	Unknown
BLO-020	Inflammation	Pre Phase 3	Unknown
SPT-201	HSDD	Pre Phase 3	Unknown
IDP-120	Acne	Pre Phase 3	Unknown
IDP-125	Actinic Keratosis	Pre Phase 3	Unknown
IDP-126	Acne	Pre Phase 3	Unknown
IDP-127	Anti-Fungal	Pre Phase 3	Unknown
IDP-128	Actinic Keratosis	Pre Phase 3	Unknown
IDP-129	Acne	Pre Phase 3	Unknown
IDP-130	Acne	Pre Phase 3	Unknown
IDP-131	Psoriasis	Pre Phase 3	Unknown
IDP-118	Psoriasis	Phase 3	Unknown
IDP-121	Acne	Phase 3	Unknown
IDP-122	Psoriasis	Phase 3	Unknown
IDP-123	Acne	Phase 3	Unknown
IDP-124	Atopic Dermatitis	Phase 3	Unknown
VAL-BRO-03	Psoriatic Arthritis	Phase 3	Unknown
BLO-021	Cystoid Macular Edema	Phase 3	Unknown
SAL-024	Crohn's Disease	Phase 3	Unknown
Brinzolamide Gx	OAG	Phase 3	Unknown
BLG020	Disclosing Agent	Phase 3	Unknown
BLG021	Anti-Infective	Phase 3	Unknown
BLG022	Anesthetic	Phase 3	Unknown
BLG023	Anti-Infective	Phase 3	Unknown
EGP-437	Anterior Uveitis	Phase 3	Unknown
BLO-022	Post-Operative Inflammation	Phase 3	Unknown
Relisor Oral	Opioid-Induced Constipation	PDUFA Date of April 2016	Unknown
Latanoprostene Bunod	OAG	PDUFA Date of July 2016	Unknown
Brodalumab	Psoriasis	PDUFA Date of November 2016	<$500m

Source: Company reports and Wells Fargo Securities, LLC estimates

Key Pipeline Products

We Believe Brodalumab Will Face An Uphill Battle, If Approved
Brodalumab was filed in January and is a product developed for the treatment of patients with moderate to severe plaque psoriasis and psoriatic arthritis. The plaque psoriasis market is estimated to be more than $4.0 billion in the United States, based on recent sales data for plaque psoriasis treatments from IMS Health.

- **Brodalumab has a storied past. In May 2015, Amgen announced that it was discontinuing development of the program after seeing suicide ideation and suicidal behavior in the Phase III program.** It was originally developed without Valeant's involvement, as part of a co-development and co-commercialization program between Amgen and AstraZeneca. Amgen noted that it believed that the label would need to be restrictive. In a very competitive market, we believe that even if approved, brodalumab would find very little use given the risks and other options.

But why would AstraZeneca sign a deal with Valeant if the product would be a dud? In September 2015, AstraZeneca signed a deal with Valeant for brodalumab, which Valeant was granted an exclusive license to develop and commercialize. Under the terms of the agreement, Valeant made an up-front payment to AstraZeneca of $100 million, as well as additional pre-launch milestones of up to $170 million, and further sales-related milestone payments of up to $175 million following launch. If the product is approved, AstraZeneca and Valeant are to share profits.

In our view, this is a no-lose deal for AstraZeneca and a windfall for AstraZeneca. It had a development-stage program on its hands that could have significant risks to approval and successful commercialization. Along comes Valeant with a lot of cash and a deal that helps preserve AstraZeneca's profit participation and provides the company a significant amount of up-front cash.

Novartis, with the approval of Cosentyx in January 2015, has an effective IL-17 drug on the market without any warning for suicide ideation, and several other companies, including J&J and Lilly, are working on developing IL-17 inhibitors. We do not see why physicians would prescribe brodalumab with a warning of suicidal ideation when there may be several products in the same class approved from other companies. In addition, if commercialized, we are not sure that Valeant would be able to recoup its costs to acquire the rights to the drug and the costs to market it.

Overall, we see significant risk to approvability, due to safety, and expect a 40% chance of approval. We believe that if it is approved, there is less than a 20% chance that the product would generate more than$300 million.

- We have concerns about other pipeline programs, including latanaprostene, for which we see limited commercial prospects given effective and trusted generic prostaglandins, as well as our concerns about the uncertain role of chronic nitric oxide delivery to retinal pigment epithelial cell proliferation.

Generic Exposure

Valeant expects approximately $750 million of sales in 2016 to be exposed to generics, $350 million in 2017, and $450 million in 2018. We do not believe that Valeant's pipeline will generate enough sales to offset the loss of these products, several of which have been contributors to growth in the past two years. We believe this puts greater reliance on the base business for growth, and this may be more difficult than in the past as Valeant's price-driven model comes under pricing pressure.

Risks

Reputational risk.
We believe Valeant is subject to significant operational and reputational risk, much of which stems from its changing business strategy and the challenges of being in the media and regulatory spotlight. We suggest that investors be aware of these risks as they could further depress Valeant's trading multiple and lead to deteriorating financial performance.

Execution risk.
Valeant faces execution risk as it shifts its business strategy. The media and regulatory spotlight has shined on excessive drug price increases, putting Valeant front and center after years of successfully acquiring products and businesses and subsequently profiting from rising prices. Not only does this create a challenging environment for Valeant, as we believe it will continue to be scrutinized by the media, regulators, and politicians, but it has also forced Valeant to change its business strategy. Valeant's management has said that it is not planning to complete any acquisitions in 2016, nor is it planning to raise prices excessively. We believe this will pose significant risk for a company that was dependent on both.

Operating risk.
Valeant's balance sheet is highly leveraged and a deterioration of its operating business could cause financial stress. Valeant has approximately $30 billion in debt on its balance sheet, giving the company a debt-to-equity ratio of approximately 4x, according to its latest public filings, and Valeant has announced that it is committed to using the majority of its 2016 free cash flow to pay down debt. We believe this magnitude of leverage creates substantial risk of financial stress if Valeant's operating business does not perform as the market is expecting. If 2016, EBITDA and cash flow are materially below current expectations as a result of business disruptions stemming from the transition to traditional channels from specialty channels and a shifting strategy. As such, Valeant could fall under great financial stress.

Key product risk.
If key pipeline products such as brodalumab, reslistor oral, and latanoprostene bunod do not gain FDA approval or experience weak commercial launches, it could signal that Valeant's pipeline is not as robust as the company has claimed and could call into question the company's organic growth potential. Furthermore, weak commercial launches could put additional financial pressure on Valeant as expected cash flow ultimately does not materialize.

Valuation

Our discounted cash flow analysis results in a valuation range of $65.00-68.00, which is approximately a 42% discount to where Valeant is currently trading, resulting in our Underperform rating. We are using a terminal EV/EBITDA multiple of 7x, which is a discount to Valeant's long-term historical average of 10x, and a weighted average cost of capital of 9%.

The midpoint of our valuation range represents approximately 14x our estimated 2017 GAAP net income.

- Some of Valeant's acquisition and in-licensing payments are excluded by Valeant from adjusted earnings. We think some consideration of these payments as R&D and capital spending is appropriate. Valeant's CEO testified to Congress in February 2016 that acquisitions of late-stage assets are Valeant's R&D. We agree and believe that adjustments to GAAP earnings related to eliminating costs associated with deals fail to recognize the R&D expense that is taking place with the deals.

We have initiated coverage of Valeant with an Underperform rating and a $65.00-68.00 valuation range.

Exhibit 34. Discounted Cash Flow Analysis ($ Millions, except per share amounts)

Valeant VRX
Discounted Cash Flow Analysis
$ millions, except per share

WACC	9.0%
Terminal Value EV/EBITDA Multiple	7.0x

Unlevered Free Cash Flows

		2013	2014	2015E	2016E	2017E	2018E	2019E	2020E	2021E
GAAP Net Income		(866)	914	549	747	2,027	1,763	1,546	1,696	1,846
Plus: Depreciation		114	187	243	250	250	250	250	250	250
Plus: Amortization		1,902	1,551	2,148	2,551	2,771	2,877	2,997	3,126	3,255
Less: Capital Expenditures		(115)	(292)	(238)	(318)	(343)	(355)	(369)	(384)	(398)
Free Cash Flow		1,034	2,360	2,702	3,230	4,705	4,535	4,424	4,689	4,953
Cumulative Value ('16-'20)	26,535				0.5	1.5	2.5	3.5	4.5	5.5
Terminal Value	56,593									
PV of Free Cash Flows	20,420		Present Value -->		3,093	4,134	3,656	3,272	3,182	3,083
PV of Terminal Value	32,321									
Implied Enterprise Value	52,742									
Plus: cash & equivalents (3Q15)	1,420									
Less: Total Debt (3Q15)	30,883									
Implied Value of Equity	23,278									
Diluted Shares Outstanding	350									
Implied Value per Share	**$66.45**									
Valuation Range High	$68.00									
Valuation Range Low	$65.00									
Current Price (as of close on 2/17/2016)	$94.65									
Potential Downside From Current Price	-42.4%									

Implied Equity Value Sensitivity Table

		EBITDA Multiple		
	$66.45	6.5x	7.0x	7.5x
WACC	8.5%	63.25	70.04	76.83
	9.0%	59.86	66.45	73.04
	9.5%	56.57	62.97	69.37

Source: Company reports, FactSet, and Wells Fargo Securities, LLC estimates

Summary

For years, Valeant claimed that it was on to a new business model, one that saw itself gobble up a company and cut its spending, including massive cuts to R&D. This was done based on the premise repeated often by Valeant management that as an industry, pharma R&D has been unproductive and may be value destroying. Even if one agrees with this premise, which we do not, it does not mean that all R&D is bad.

To us, the model of cutting R&D and spending, and dramatically raising prices, in pursuit of higher and higher EPS to fuel a roll-up strategy built on earnings accretion for deals is shortsighted, as often the cuts undermine the longer-term prospects of the business.

But how did so many investors believe this? We wonder this, but we have found that when a stock is rising, especially a roll-up, there are very few that will question the sustainability of how the numbers are being achieved.

The Approach of Cutting R&D May Be Based on a Faulty Conclusion

We believe the strategy of the past several years (acquire and cut) was based on what we would describe as a seriously questionable and flawed analysis, which appeared in the scientific journal *Nature Reviews* entitled, “Diagnosing the decline in pharmaceutical R&D efficiency.” We believe the study was flawed in several ways, including not using a statistically relevant number of companies in the drug industry, only covering a small slice of time, and failing to match R&D expenses to returns on particular drugs.

We believe Valeant shares currently carry a significant amount of risk and uncertainty. This concern comes from our lack of clarity on a number of key issues, including accounting, rapidly expanding gross-to-net ratios, balance sheet leverage, business practices and governance, and the recent Walgreen deal.

Valeant bulls like to point out that the company has created a staggering amount of value, even with the recent decline in share price, down 65% from August 1, 2015 to February 16, 2016, while the S&P 500 was down 10%. We note that Michael Pearson became CEO in February 2008 with a strategy to grow through acquisitions of established products and limited R&D spending. At the time, Valeant had a market value of approximately $2 billion. At its peak, in 2015, Valeant had a market value of approximately $90 billion. Valeant’s current market value is approximately $30 billion. By our calculations, risk-taking under the leadership of Michael Pearson has led to the creation of $28 billion of market value over eight years, while in a matter of months, it destroyed approximately $60 billion.

Our DCF gets us to a valuation range of $65.00-68.00. Our DCF assumes no tripping of covenants and no lasting impact from ending the Philidor relationship. Return potential is only part of any recommendation, and risk is another key component. We cannot help but believe that future decision making will not be exceptionally different from the past if the management remains unchanged.

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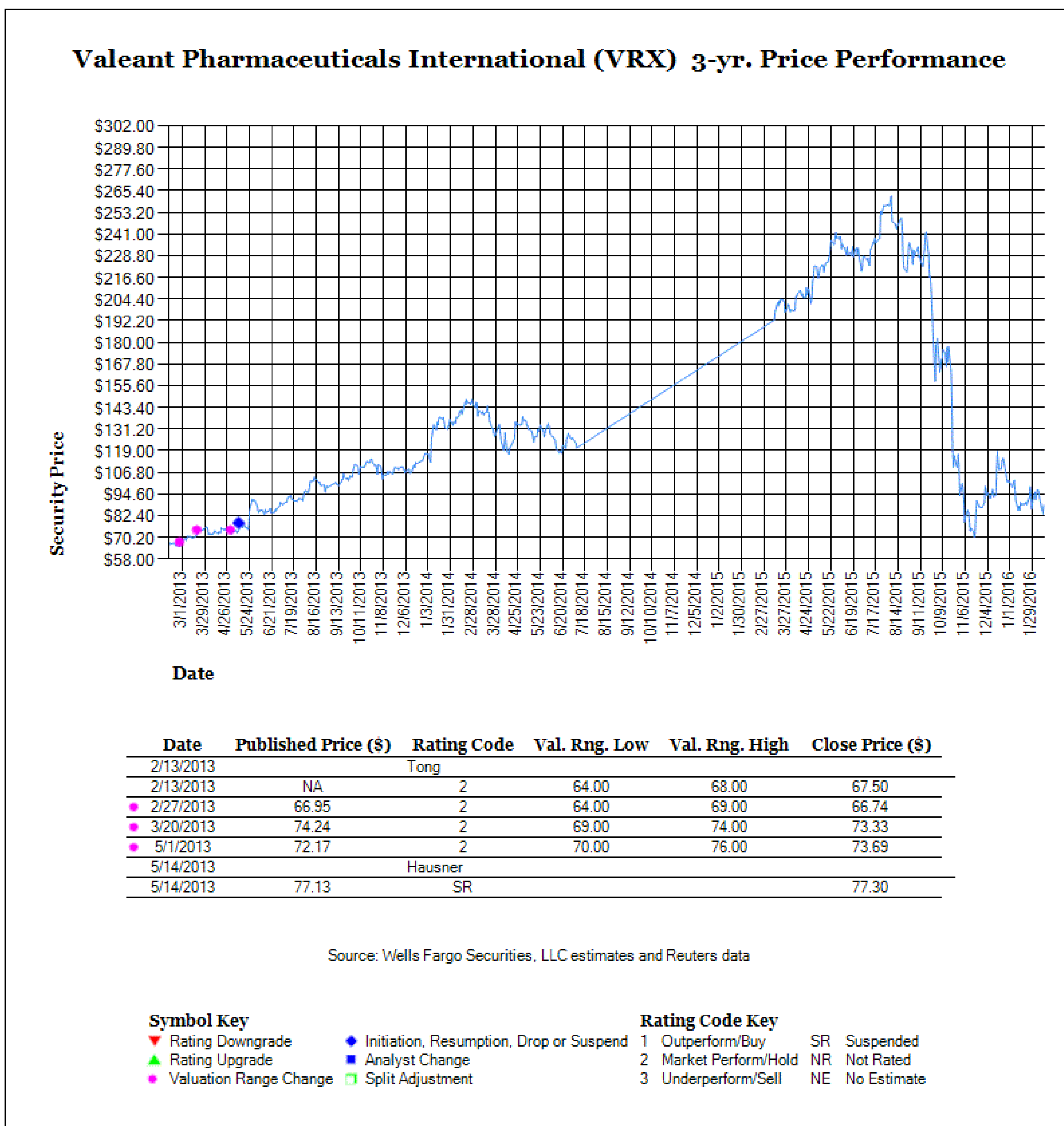
Valeant Pharmaceuticals International, Inc. (VRX) is a multinational specialty pharmaceutical company that develops, manufactures, and markets a broad range of pharmaceutical products primarily in the areas of dermatology, gastrointestinal disorder, eye health, neurology, and branded generics.

Required Disclosures



Date	Published Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
2/13/2013		Tong			
2/13/2013	NA	2	64.00	68.00	67.50
2/27/2013	66.95	2	64.00	69.00	66.74
3/20/2013	74.24	2	69.00	74.00	73.33
5/1/2013	72.17	2	70.00	76.00	73.69
5/14/2013		Hausner			
5/14/2013	77.13	SR			77.30

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

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- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
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  - Nancy Hilliker 212-214-5017
  - Lauren Frasch 212-214-5024

ENERGY

Exploration & Production
- David R. Tameron 303-863-6891
- Gordon Douthat, CFA 303-863-6920
  - Mark A. Engelmeyer 303-863-4754
  - Jay M. Mondrick, CFA 303-863-5859
  - Chris M. Baker, CFA 303 863-6816

Master Limited Partnerships
- Michael J. Blum 212-214-5037
- Sharon Lui, CPA 212-214-5035
- Praneeth Satish 212-214-8056
  - Eric Shiu 212-214-5038
  - Ned Baramov, CFA 212-214-8021
  - Nicholas Daly 212-214-8012
  - Zachary Cantor 212-214-5050

Utilities
- Neil Kalton, CFA 314-875-2051
- Sarah Akers, CFA 314-875-2040
  - Jonathan Reeder 314-875-2052
  - Glen F. Pruitt 314-875-2047
  - Peter Flynn 314-875-2049

Oilfield Services and Equipment
- Judson E. Bailey, CFA 713-577-2514
- Coleman W. Sullivan, CFA 713-577-2510
  - Christopher Voie, CFA 713-577-2515
  - Nick Ohmstede 713-577-2516

ENERGY (*CONTINUED*)

International E&Ps/Independent Refiners
- Roger D. Read 713-577-2542
  - Lauren Hendrix 713-577-2543

FINANCIAL SERVICES

BDCs
- Jonathan Bock, CFA 704-410-1874
  - Finian P. O'Shea 704-410-1990
  - Joseph Mazzoli, CFA 704-410-2523
  - Jamie Sirockman 704-410-2197

Brokers/Exchanges/Asset Managers
- Christopher Harris, CFA 443-263-6513
  - Robert Ryan, CFA 212-214-5025

Insurance
- John Hall 212-214-8032
- Elyse Greenspan, CFA 212-214-8031
  - Kenneth Hung, CFA, ASA 212-214-8023
  - Rashmi H. Patel, CFA 212-214-8034

Specialty Finance
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- Vivek Agrawal 443-263-6563
  - Charles Nabhan 443-263-6578
  - Max Maier 443-263-6573

U.S. Banks
- Matt H. Burnell 212-214-5030
- Jason Harbes, CFA 212-214-8068
- Jared Shaw 212-214-8028
  - Timur Braziler 212-214-5048

HEALTH CARE

Biotechnology
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  - Chuck Whitesell 212-214-5067
  - Nick Abbott 206-542-2492
  - Yanan Zhu 415-396-3194

Healthcare Facilities
- Gary Lieberman, CFA 212-214-8013
  - Ryan Halsted 212-214-8022

Digital Health
- Jamie Stockton, CFA 901-425-5301
- Stephen Lynch 901-425-5375
  - Nathan Weissman 901-425-5397

Life Science Tools, Services, & Diagnostics
- Tim Evans 212-214-8010
  - Sara Silverman 212-214-8027

Managed Care/Ancillary Benefits
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  - Polly Sung, CFA 617-603-4324
  - Brian Fitzgerald, CFA 617-603-4277

Medical Technology
- Larry Biegelsen 212-214-8015
- Craig W. Bijou 212-214-8038
  - Lei Huang 212-214-8039
  - Adam C. Maeder 212-214-8042

Health Care (*continued*)

Specialty Pharmaceuticals

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Katie Brennan	212-214-8060
Patrick Trucchio, CFA	212-214-5064

Industrial

Aerospace & Defense

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Gary S. Liebowitz, CFA	212-214-5055
Ronald Hou	212-214-5056

Automotive/Electrical and Industrial Products

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Deepa Raghavan, CFA	443-263-6517
Ronald Jewsikow	443-263-6449

Chemicals

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Rory Blake	212-214-8011

Containers & Packaging

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Gabe S. Hajde	216-643-2967
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Diversified Industrials

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Machinery

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Jorge Pica	617-603-4376

Engineering & Construction

Justin Ward	617-603-4268

Shipping, Equipment Leasing, & Marine MLPs

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Hillary Cacanando, CFA, CPA	212-214-8040
Donald Bogden	212-214-8037

Transportation

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Media & Telecommunications

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Media & Cable

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Satellite Communications

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Telecommunication Services - Wireless/Wireline

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Caleb Stein	312-845-9797
Eric Luebchow	312-630-2386

Real Estate, Gaming & Lodging

Gaming

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Daniel Adam	212-214-8066

Healthcare/Manufactured Housing/Self-Storage

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Philip DeFelice, CFA	443-263-6442
Jason S. Belcher	443-462-7354

Lodging/Multifamily/Retail

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Dori Kesten	617-603-4233
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Tamara Fique	443-263-6568

Office/Industrial/Infrastructure

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Technology & Services

Applied Technologies

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Communication Technology

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E-commerce

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Information & Business Services

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Internet

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IT & BPO Services

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IT Hardware – Wireless Equipment

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Munjal Shah	212-214-8061
Jason Ng	212-214-8007

Semiconductors

David Wong, CFA, PhD	212-214-5007
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Keith Kan, CPA	212-214-5066
Joy Zhang	212-214-8017

Transaction and Business Services

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Robert Hammel	314-875-2053
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Strategy

Equity Strategy

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Economists

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Retail Research Marketing

Retail Research Marketing

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