



Valeant (VRX) Bonds with Tighter Liens Covenants (for those expecting an early take-out)

We broadly rate VRX's bonds Hold. That said, we continue to believe bonds with the more restrictive liens covenants (7% of 2020, 6.375% of 2020, 6.75% of 2021, and 7.5% of 2022) could be attractive if taken out prior to maturity. This yield-to-most likely (YTML) could provide incremental yield to investors relative to the yield implied in the YTW. For example, at an offer price of 100.5, the YTW on the 7.25% bonds of 2022 is 6.90%. For those who assume VRX may take these bonds out sooner to free up additional secured capacity (we assume on 7/15/18 for illustrative purposes), the YTML would be 8.44%. We note that even with incremental secured capacity per the bond indentures, it's our view that VRX would still need a waiver from the banks to utilize this incremental capacity given the secured incurrence covenant in the bank debt. This YTML of 8.44% is wide of the yields on long-dated paper, and we argue the 7.25% would have significantly less default risk given the shorter maturity.

We acknowledge that leverage should remain high for a while. Management has quantified a \$467 mm EBITDA impact in 2018 from LOE on products expected to see competition prior to 12/31/17. And we expect additional LOE impact in 2018 as certain products could see competition during the year (Cuprimine, Elidel, etc.). While we acknowledge bonds should respond favorably to VRX addressing additional maturities (especially if it has attractive access to the unsecured debt market), we would note that at current leverage and FCF levels (our 2018E net leverage estimate is 7.5x) there is relatively little room for error. That said, on a TEV/EBITDA basis we believe VRX should trade at a higher valuation than certain other HY peers due to the durability of a large portion of its business (BOL / International was 57% of Q317 revenue) and its lower dependence on generics. In addition, we expect the proportion of revenue coming from BOL should continue to grow as VRX experiences additional competition on its branded drug portfolio.

Q317 results were ahead of expectations, and this should add further to management's credibility. In addition, per IMS data, Xifaxan scripts continue to show improvement throughout the first 2 months of Q417 and into early December. If the stay was lifted and the Xifaxan infringement case proceeded in the spring of 2018, we would view this as an incremental and potentially significant risk. On the other hand, VRX has a number of new products that have either recently launched (Siliq, Vyzulta, etc.) or could potentially launch upon approval (Luminesse, which has a PDUFA date of 12/27/17, and IDP-118, which has a PDUFA date of 6/18/18, among others).

The risks to our Hold rating are largely focused around the stability and direction of operations, trends in the loan and high yield bond markets, and to a lesser degree the potential for additional asset sales. We acknowledge more broadly that investors could outperform in VRX bonds if VRX navigates operational challenges through 2018 and if it is able to access debt capital at reasonable rates. Conversely, we believe that investors could underperform if VRX's operations deteriorated more than expected over the coming year or two, if the company was unable to consummate asset sales over this time, and/or if the debt markets deteriorate and this leaves VRX with a higher cost of capital to refinance upcoming maturities.