Bausch Health – The Textbook Turnaround

Giving Credit Where Credit is Due – Target Price $40

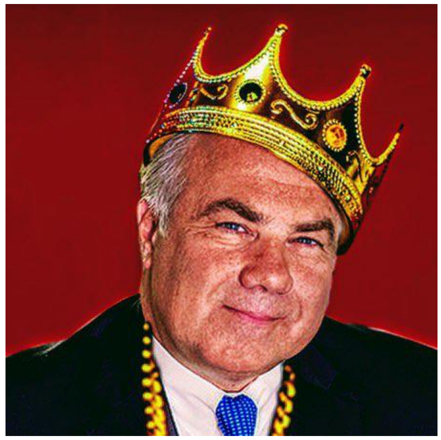
It was four years ago this month that Citron wrote a series of articles that were instrumental in the unraveling of the Pearson-era Valeant business model. The stock quickly declined by 90% from its highs as the scandals unraveled and many questioned the sustainability of the equity.

Four years later BHC still trades with a "Valeant discount" despite new management's 180-degree turn of corporate culture. To add to the artificially depressed share price, Bausch has been unjustly grouped with Specialty Pharma despite having ZERO opioid exposure and minimal exposure to the generics market.

Citron believes **this quarter** (reporting on Nov 4) will force Wall St. to finally take notice of BHC's "pivot to offense". Once this is considered along with the acknowledgment of the recent M&A spree in pharma, even David Maris will have to admit that BHC is on its way to $40.

*If you are going to stop reading here – scroll down to Fidelity

I Love It When You Call Me Joe Papa



Admittedly when Joe Papa took over as CEO 3.5 years ago Citron thought that this seasoned pharma exec had bitten off more than he could chew and Bausch would be a victim of its own debt.

During that time, Papa has delivered on every promise of execution while never being promotional about Bausch stock… until this year. An interesting chronology can be observed on his annual appearance with Jim Cramer on Fast Money. Since taking over as CEO, Joe Papa has joined Jim Cramer on CNBC for an update every year on the progress of the turnaround at BHC. While many CEOs make false promises and consistently push back targets, Papa has delivered on all of his promises from when he first joined the company in May 2016. Now, Papa is promising that 2019 is the "pivot to offense".

2016 Interview – "First thing I need to do is stabilize the company… then after that I've got to turn it around and that's going to be launching some of these new products. I've got to make sure that I've taken care of the debtholders… and then importantly honestly generate the total shareholder return." – Joe Papa

2017 Interview – "You are a man of your word and then some. I was tough on you. You exceeded everything that I thought was possible." – Jim Cramer

2018 Interview – "We're two years in to a multi-year plan, but importantly, in the last two quarters, we've shown organic growth for the first time since 2015." – Joe Papa

Result:

- ✓ After three years of EBITDA declines, BHC has now posted two consecutive quarters of EBITDA growth and six consecutive quarters of organic growth
- ✓ Successfully launched the Significant Seven with projected peak sales of >$1BN by the end of 2022
- ✓ $8BN debt reduction since 1Q16

2019 Interview – **"We labeled 2019 as the pivot to offense and indeed that's exactly what we've done."** – Joe Papa

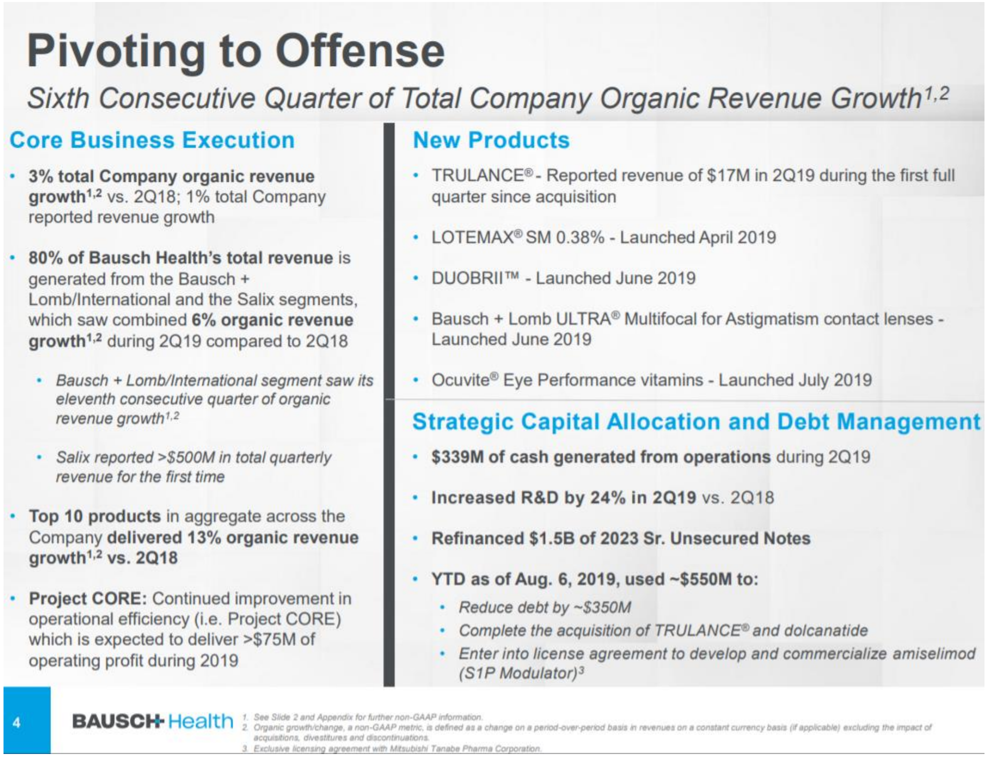
Debt Under Control

As explained by Papa over the past few years, before BHC stock was ready to go higher, the debt had to be mitigated. Today, BHC **does not have any significant debt maturity until 2023.** Looking at the 2023 bonds, there is clear asymmetry in BHC today. While the stock is down 40% since CEO Joe Papa's arrival, the 2023 bonds have actually rallied 35% and are now trading above par value, which is a very good sign that credit investors believe BHC has its debt under control.

Pivoting to Offense – Why Now is the Time to Buy $BHC stock

Bausch management has been reserved over the past 3 years as they have focused on paying down close to $8BN in debt and dealing with legacy legal matters. In 2019, the debt has become manageable and the company is gaining momentum with recent successful launches of new drugs, consistent with its "pivot to offense".

It is important to remember that leverage works both ways. Given the current leverage of BHC, every 1x expansion in the company's EV/EBITDA multiple results in approximately $10 of increased value per share. Below is a chart from their latest earnings presentation that describes the blueprint of the pivot:

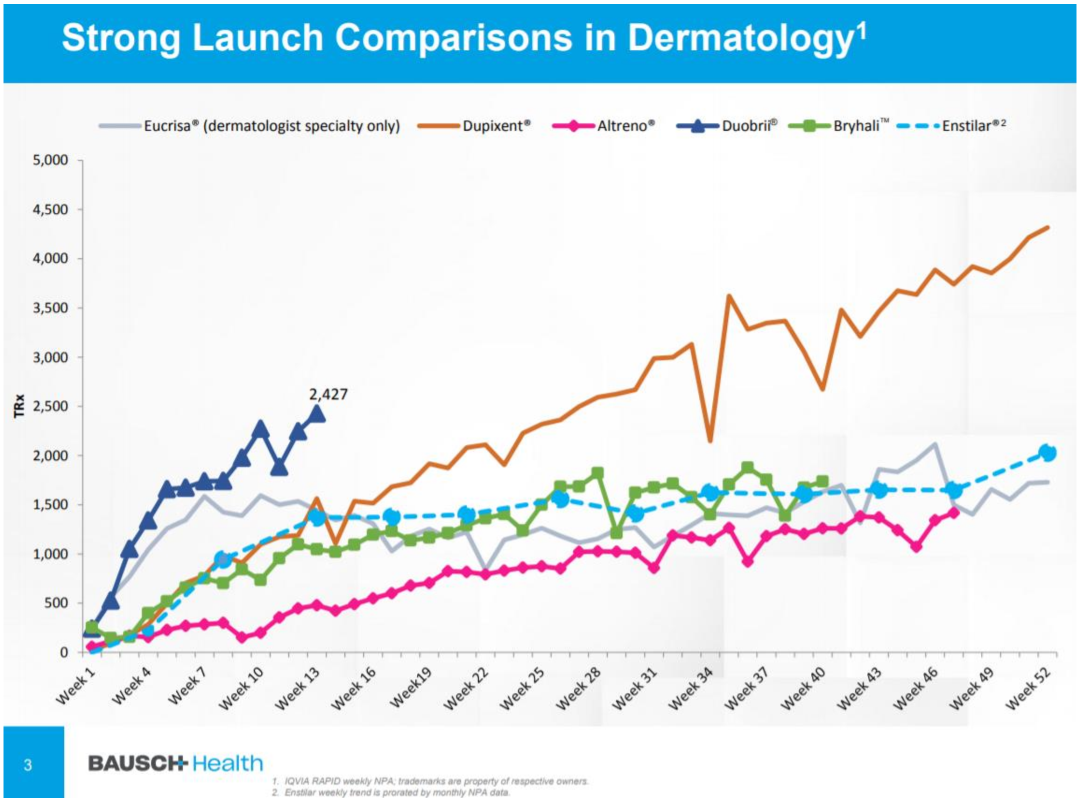


BHC has now posted six consecutive quarters of organic growth. The business has turned. While not currently reflected in BHC's share price, the company's pivot is what makes Citron excited about BHC today.

Citron expects BHC to guide 2020 revenue and EBITDA well ahead of sell-side consensus due to continued strength in Bausch + Lomb and Xifaxan along with successful dermatology launches such as Duobrii.

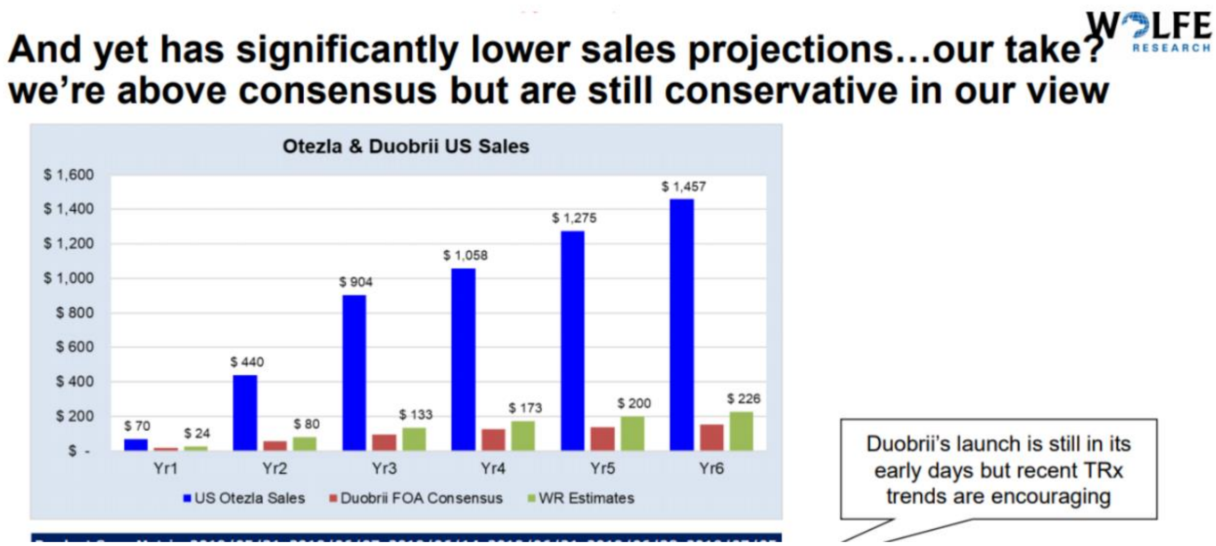
Duobrii – The Catalyst for This Quarter

Of BHC's new product launches under the "Significant Seven", Wall St. has yet to acknowledge the blockbuster launch of Duobrii. While initially criticized as just another "combination drug" with no widespread appeal or reimbursements, in just the past 6 months, Duobrii has become the most successful dermatology drug launch in the last 10 years for ANY dermatology product in the US.

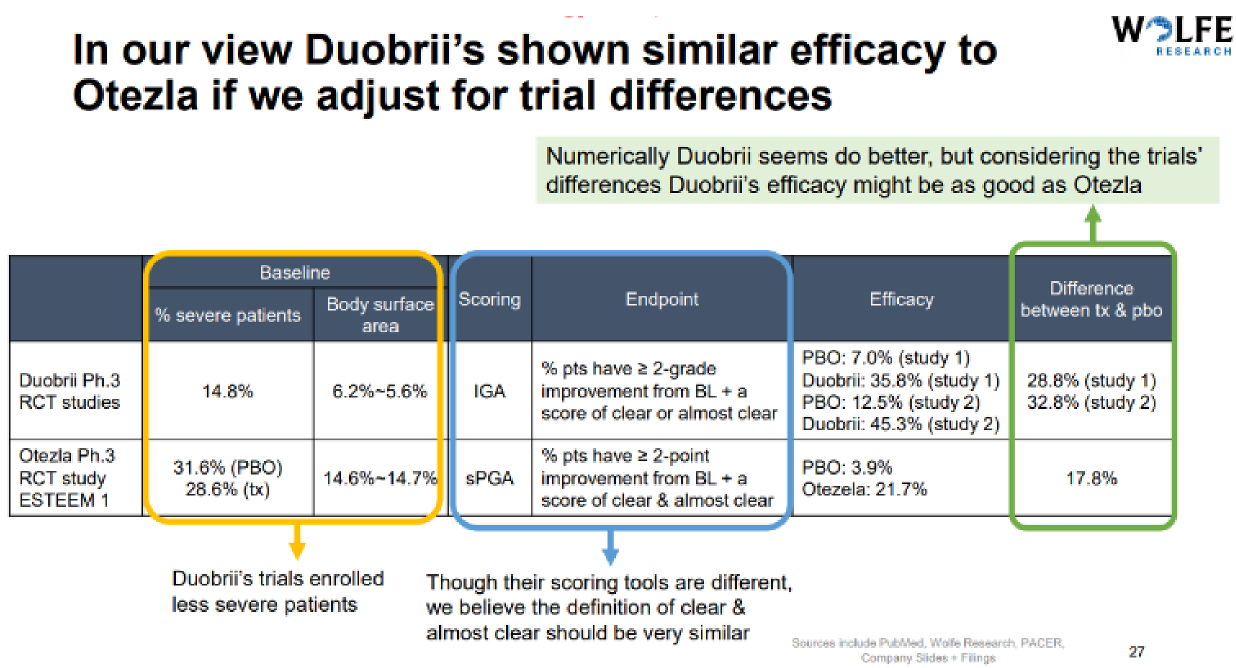


To put this into perspective, BHC's Duobrii is outperforming the launch of Regeneron Pharmaceuticals' Dupixent, which Wall St. analysts expect to be a blockbuster drug with $7BN consensus peak sales.

Wolfe Research is the only group who has acknowledged that Wall St. estimates are way too low for Duobrii and will probably be adjusted after this quarter.



Though Citron does not expect Duobrii to reach $7BN in sales, we think Duobrii can easily reach ~$2BN in sales in-line with Otezla.



WOLFE RESEARCH

In our view Duobrii's shown similar efficacy to Otezla if we adjust for trial differences

Numerically Duobrii seems do better, but considering the trials' differences Duobrii's efficacy might be as good as Otezla

	Baseline		Scoring	Endpoint	Efficacy	Difference between tx & pbo
	% severe patients	Body surface area				
Duobrii Ph.3 RCT studies	14.8%	6.2%~5.6%	IGA	% pts have ≥ 2-grade improvement from BL + a score of clear or almost clear	PBO: 7.0% (study 1) Duobrii: 35.8% (study 1) PBO: 12.5% (study 2) Duobrii: 45.3% (study 2)	28.8% (study 1) 32.8% (study 2)
Otezla Ph.3 RCT study ESTEEM 1	31.6% (PBO) 28.6% (tx)	14.6%~14.7%	sPGA	% pts have ≥ 2-point improvement from BL + a score of clear & almost clear	PBO: 3.9% Otezela: 21.7%	17.8%

Duobrii's trials enrolled less severe patients

Though their scoring tools are different, we believe the definition of clear & almost clear should be very similar

Sources include PubMed, Wolfe Research, PACER, Company Slides + Filings

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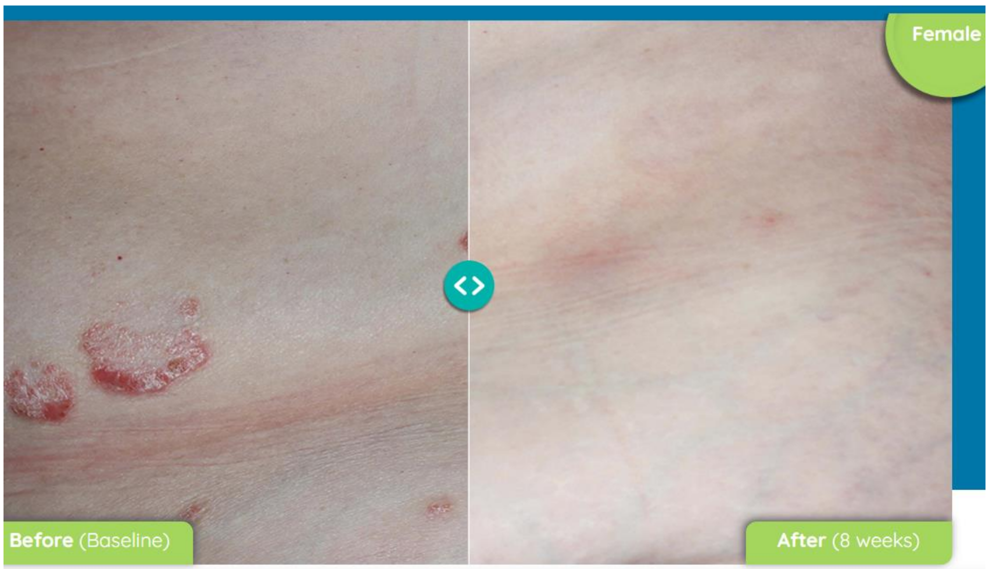
Not only is efficacy similar but patients prefer topical treatments vs. pills (i.e., Otezla) as a lotion provides immediate relief. >85% of patients on psoriasis therapy use topical medication (i.e., lotion).

Below are before and after photos of patients using Duobrii lotion during BHC's clinical trials. Note – For eight weeks, patients applied Duobrii lotion to affected areas once a day. These photos represent actual clinical experiences. Photos have not been retouched.



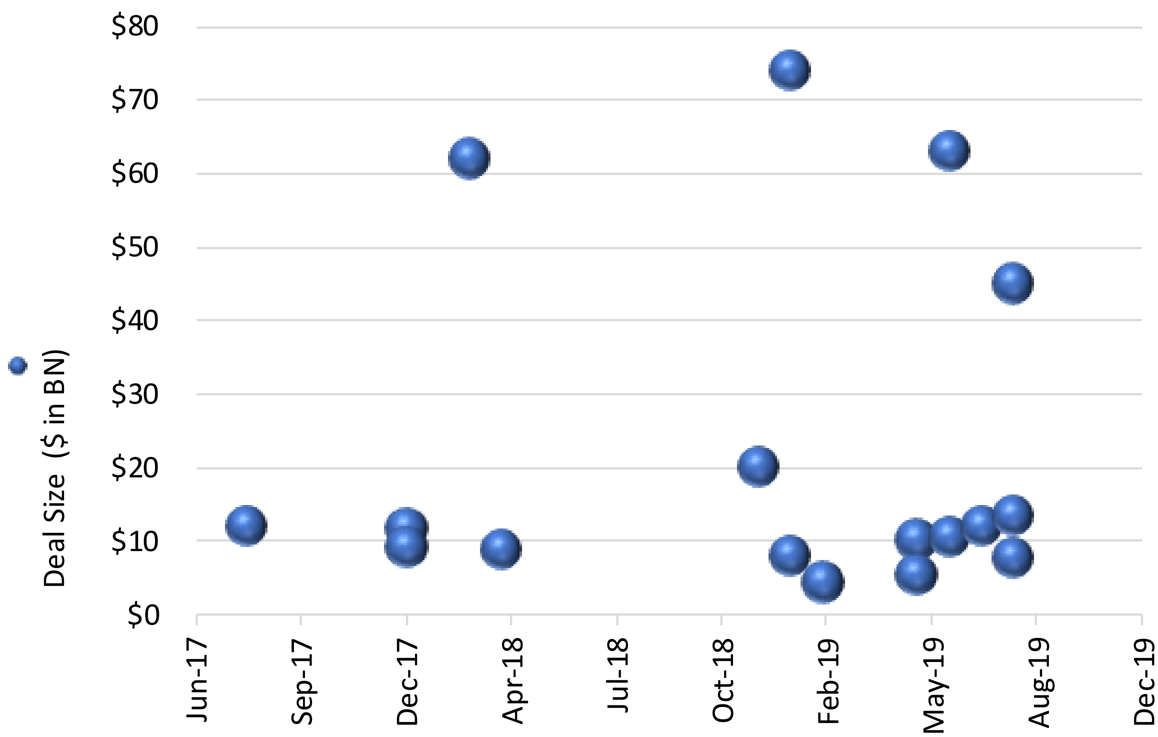
Pharma Merger Mania

Normally, Citron disdains SOTP arguments, but in this case management has made it clear that it will sell any part of the business to increase shareholder value. BHC's CFO at the recent Citi Global Healthcare Conference best expresses this:

"For Joe, myself as responsible stewards of our stakeholders' capital, if someone comes to the table and says, they want to own one of our assets that we call core today and they're willing to pay a price that exceeds the value of that asset in our hands, they're going to own it. That's just the way at least our -- my view. That's the way you should be. If someone is willing to pay a value greater than what it is in your hands, they can own it."

This comes at a good time as an industry-wide big pharma M&A spree has begun. In just the past year, we have witnessed a dozen $5BN+ acquisitions:

Date Announced	Date Completed	Deal Size ($ in BN)	Acquirer	Target
Aug-17	Oct-17	$11.9	Gilead	Kite Pharma
Jan-18	Mar-18	$11.6	Sanofi	Bioverativ
Jan-18	Mar-18	$9.0	Celgene	Juno Therapeutics
Mar-18	Jan-19	$62.0	Takeda	Shire
Apr-18	May-18	$8.7	Novartis	AveXis
Dec-18	Aug-19	$20.0	Pfizer's Consumer Health	GlaxoSmithKline
Jan-19	Feb-19	$8.0	Eli Lilly	Loxo Oncology
Jan-19	TBD	$74.0	Bristol-Myers Squibb	Celgene
Feb-19	TBD	$4.3	Roche	Spark Therapeutics
May-19	Oct-19	$10.1	Consortium	Nestle Skin Health
May-19	Jul-19	$5.3	Novartis	Xiidra (Drug)
Jun-19	TBD	$63.0	AbbVie	Allergan
Jun-19	Jul-19	$10.6	Pfizer	Array BioPharma
Jul-19	TBD	$12.0	Mylan	Upjohn
Aug-19	TBD	$13.4	Amgen	Otezla (Drug)
Aug-19	TBD	$45.0	Amgen (Rumor)	Alexion
Aug-19	TBD	$7.6	Elanco	Bayer's Animal Health



Most Likely Scenario – Sale of Salix

Papa and Herendeen have setup BHC for a sale of Salix that will unlock tremendous shareholder value and allow the company to focus on growing its crown jewel asset of Bausch + Lomb.

The recent sale of Otezla, which has the same profile of Xifaxan (e.g., ~$2BN of revenue, growing DD%, small molecule) would value Xifaxan at $10BN based on Otezla's takeout multiple though most of Otezla's patents expire in 2023 while investors have visibility into 2028 for Xifaxan.

A sale of Salix would force investors to reevaluate BHC with a fresh set of eyes making it clear that the valuation disconnect between Bausch + Lomb and public eye-care peers ALC and COO is unsustainable.

Note – Remember that Takeda was previously in discussions to buy Salix for $10BN in 2016 when scrutiny over the previous pricing practices at Valeant was at its worst. At the time, there was no visibility for Xifaxan exclusivity to 2028, and Xifaxan wasn't performing as well.

https://www.wsj.com/articles/valeant-is-in-talks-to-sell-its-salix-stomach-drug-business-for-about-10-billion-1478028972?mod=BNM

There are many potential buyers for Salix including Gilead, Johnson & Johnson, Roche, Novartis, Pfizer, Eli Lilly, Amgen, Bristol-Myers Squibb / Celgene, AbbVie / Allergan, and Takeda / Shire.

*While BHC recently sold off 10% due to Xifaxan exclusivity concerns, we believe these to be way overblown as we address in the appendix of this report.

Bausch + Lomb – Beneficiary of the Megatrend

A sale of Salix would provide BHC the opportunity to focus on the crown jewel asset of Bausch + Lomb, which is a direct beneficiary of the megatrend of the growth in eye care. Eye care has become the direct second derivative of the most important secular trend globally – increasing screen time and smartphone penetration. As all of us live our lives looking at screens, eye care has become one of the fastest growing trends in healthcare.

We are seeing this trend benefit Bausch + Lomb, which just posted its strongest organic growth since 2013 in 1Q19. After another strong 2Q19 earnings release, the Bausch + Lomb International segment delivered its 11th consecutive quarter of organic revenue growth.

Bausch + Lomb is the most integrated eye care business in the world and will be a growth driver for BHC for the next 20+ years.

BHC has #1 market share in China, India, and Thailand which represent 40% of the global population while Asia is the fastest growing part of the vision care market globally. China and India alone have almost 1.2BN smartphone users or 5x that of the US. This a recession proof, durable business that will benefit from the long-term secular trend of eye care in the digital age.

Wall St. acknowledges the value of the megatrends behind eye care as Bausch + Lomb peers COO and ALC trade at 16x-17x NTM EV/EBITDA. To put it in clear terms, assigning this multiple to the Bausch + Lomb segment after accounting for the segment's associated debt implies BHC's eye care business is worth more than the entire value that the market is ascribing to all of BHC today.

As expressed by CEO Papa recently:

2019 Interview – "I actually think when people look at Alcon they're going to say good business and probably going to trade at a very high EBITDA multiple which I actually think is going to be good for the BHC stock because people will reevaluate the SOTP of Bausch + Lomb. But importantly, we think we have the most integrated eye-care company in the world even including Alcon because we have the surgical business, the prescription business, the OTC consumer business, and clearly have the RX business." – Joe Papa

Insiders Are Already Taking Notice

CEO Joe Papa added to his BHC position in the open market last month. If history repeats itself when Papa buys, earnings will be good and investors should buy!

Date of Purchase	# of Shares	Purchase Price	Date of Earnings	Stock Price as of Earnings	Return Since Purchase to Earnings	Stock Reaction on Earnings
9/13/19	30,000	$23.31	11/4/19	TBD	TBD	TBD
2/28/19	30,000	$23.67	5/6/19	$25.46	7.6%	8.7%
9/14/18	30,000	$22.32	11/6/18	$26.70	19.6%	4.5%
3/13/18	30,000	$16.05	5/8/18	$19.77	23.2%	8.9%
6/10/16	202,000	$24.48	8/9/16	$28.16	15.0%	25.4%
Average					16.3%	11.9%

The Fidelity Phenomenon

We rarely look at Fidelity as a barometer for corporate health and acknowledge that due to their sheer size that Fidelity must own everything but no investor can ignore Fidelity's involvement or lack thereof in BHC/VRX stock.

Fidelity, America's mutual fund, never bought into the Pearson dream or even felt the FOMO of a rising stock price. As a matter of fact, when the Philidor news hit four years ago, Fidelity owned ZERO shares of Valeant. Citron can't think of the last time Fidelity owned zero shares of anything.

Fidelity started to buy in moderate size when Papa joined but after 20 years of inactivity Fidelity in the last quarter alone acquired >14MN shares and now owns >7% of the entire company with 25MN shares. Clearly, Fidelity is comfortable with BHC's leverage and believes in the long-term story now more than they ever have in the past 20 years.

Holding Period	Position	Position Change
2017 Q4	256,154	250,000
2018 Q1	767,173	511,018
2018 Q2	2,849,505	2,082,332
2018 Q3	2,949,711	100,206
2018 Q4	6,221,687	3,271,976
2019 Q1	10,549,965	4,328,278
2019 Q2	24,973,431	14,423,466

Valeant Discount

The legacy problems with the former company that starts with a V are the reason that BHC has become a mispriced asset.

When comparing BHC to eye care business peers, BHC trades @ 4x-5x on NTM P/E vs. COO @ 22x-23x and ALC @ 27x-28x.

When comparing BHC to large cap pharma peers, BHC trades @ 4x-5x on NTM P/E vs. JNJ @ 14x-15x, PFE @ 13x-14x, MRK @ 15x-16x, and LLY @ 16x-17x. As BHC pays down debt and the equity accretes, Citron expects its P/E multiple to expand to at least 12x, which would take the stock well above $50.

Unlocking Shareholder Value

On NTM EV/EBITDA, ALC and COO trade at 16x-17x. Applying a 16x multiple to the Bausch + Lomb / International segment implies a value of $25BN. This would result in a re-rating of BHC's valuation multiple and the stock moving much higher.

Assigning zero value to Ortho Dermatologics (despite the blockbuster potential of Duobrii), Diversified Products, and the rest of Salix, a sale of Xifaxan at $10BN and valuing Bausch + Lomb / International at the low-end of its peer valuation range would take the stock to >$40.

	2020 EBITDA	% of EBITDA	EV/EBITDA Multiple	Valuation Comps
Bausch + Lomb / International	$1,550	43%	16.0x	COO + ALC
Salix	$920	26%	11.0x	US / EU Pharma
Ortho Dermatologics	$350	10%	10.0x	US / EU Pharma
Diversified Products	$770	21%	5.0x	Spec Pharma
Total	**$3,590**	**100%**	**11.8x**	
Enterprise Value	$42,270			
Debt	$24,372			
Minority Interest	$87			
Cash	$878			
Market Cap	$18,689			
Shares Outstanding	350			
BHC Price Target	**$53**			

	2020 EPS	% of EPS	P/E Multiple
Bausch + Lomb / International	$1.40	30%	17.5x
Salix	$1.40	30%	12.0x
Ortho Dermatologics	$0.50	11%	12.0x
Diversified Products	$1.40	30%	5.0x
Total	**$4.70**	**100%**	**11.6x**
BHC Price Target	**$54**		

Conclusion – What a Difference Four Years Make

What many forgot is that four years ago Citron did more than expose the fraud at Philidor. We wrote a series of articles that became a blueprint of what congress would conclude after evaluating the unsavory business practices that underpinned a company that became a poster child for bad pharma. During the past four years we have observed BHC with a healthy dose of skepticism and questioned whether management could turn things around. We have to give credit where credit is due.

The new Bausch Health is not Valeant and investors have an opportunity to buy a well diversified pharmaceutical company with durable products and a healthy pipeline under a world-class management team that has proven their honesty and dedication. The new Bausch can be best described in recent discussion between management and analysts at the Barclays high yield conference.

Analyst

"If you look at where you guys are today, you're obviously a much more stable company at growth rates that are pretty impressive. No opioid exposure. No generic pricing exposure, which is kind of a good thing. How would you characterize where Bausch is today and where do you want it to be in one to two years?"

BHC CFO Paul S. Herendeen

"I love the durability of several of our franchises. You combine that durability of the overall B + L business with the runway that Mark and his Salix team have, and I just look over the course of next – call it three to five years and say, we have a great opportunity to demonstrate that we can put consistent growth on the board and that durability really helps me sleep at night."

Who would have ever thought that Valeant and sleep at night would be in the same conversation?

Appendix #1 – Xifaxan Concerns

Xifaxan is expected to account for around 17% of BHC revenue in 2019. On 10/1/19, BHC's stock price was down 10% on news that BHC was suing Sandoz for patent infringement over its application to sell generic Xifaxan 550 mg tablets. Sandoz is pursuing a skinny label for use in just IBS-D, which means the filing only applies to half of total Xifaxan sales (i.e., 8-9% of BHC total revenue). Therefore, the market priced in the draconian scenario of BHC losing more than half of its Xifaxan revenue overnight though this is a extremely unlikely event.

As a reminder, BHC has a settlement agreement with TEVA that gives TEVA the right to distribute its FDA-approved generic starting January 2028 or the right to distribute an authorized generic (supplied by BHC) with BHC receiving royalties.

Given that TEVA is a stronger competitor than Sandoz, why would TEVA settle for 2028 and how could anyone assume that a weaker Sandoz will do better?

Based on discussions with management and industry experts, Citron remains confident that Xifaxan will maintain exclusivity through 2028. We recommend investors read this well thought out research note from Piper Jaffrey on why the Sandoz filing is not a cause for concern given BHC's extensive patent moat and the high barriers to entry for a generic.

https://piper2.bluematrix.com/sellside/EmailDocViewer?encrypt=303b3b4e-9897-4b95-ae15-2198c35c2af1&mime=pdf&co

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