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Saul Steinberg's second coming

Leasco Data Processing Equipment Corp., Saul Steinberg's establishment-rattling acquisition machine, came into the world in 1961. It was the vanguard of what would prove to be the conglomerate boom of the 1960s. The boom went boom in 1969.

Behold now—after a multi-decade interval suited to wiping away the memories of the go-go bust—Valeant Pharmaceuticals International, Inc., J. Michael Pearson's once-mesmerizing acquisition machine (*Grant's*, March 7, 2014). That Valeant et al., too—the so-called platform companies—will have their comeuppance is the thesis that James Litinsky presented to the *Grant's* fall conference.

Litinsky, founder and head of JHL Capital Group, a Chicago long-short hedge fund that manages $2.5 billion (up from $11 million at its 2006 inception), was not yet born when such business giants as Steinberg, Harold Geneen (ITT Corp.), Charles Bluhdorn (Gulf + Western Industries, Inc.), Jimmy Ling (LTV, Inc.) and Henry Singleton (Teledyne, Inc.) walked the earth. No matter; our speaker had done his homework.

Conglomerates grew by acquisition. Valued at, say, 50 times earnings, they would purchase companies quoted at less than half that multiple in stock-for-stock exchanges. The market applauded the value accretion inherent in the discrepancy between the buyer's heavenly price-to-earnings multiple and the seller's earthly one. And it cheered the efficiencies that were bound to follow the marriage of the merged entities—"synergies" was the word. Besides, the Steinbergs, Geneens, Bluhdorns, Lings and Singletons were demonstrated geniuses of capital allocation. Your money would be grateful if you gave it to them.

Growth was the object of the market's desire, then as now, and the conglomerates dependably grew. In their 1960s heyday, share prices of the Leascos and Teledynes outperformed the S&P 500 by more than 500%. They were larger than life on the down side, too, Litinsky pointed out, plunging by an average of 79% from peak to trough. In so doing, they anticipated, if not precipitated, the broader bear market of the 1970s.

At the heart of Litinsky's thesis are the observed similarities between the present day and the 1960s, between, as he put it, the Valeant-led "Conglomerate Boom 2.0" of the 2010s and the Leasco-led original. He ventured that, if past is prologue, the stock market itself is at risk.

Low nominal bond yields featured in the 1960s as they do today, Litinsky observed. So did low inflation (at least until the Vietnam War hotted up) and aggressive money management. As the 1960s had their go-go mutual funds, so we have our event-driven hedge funds. Conspicuous among the differences between your father's bubble and our own is debt and taxes. Leverage is more prevalent today than it was in the 1960s, and the tax-arbitrage craze of the 2010s had no direct antecedent in the 1960s.

Litinsky produced a table listing two dozen exemplars of the 21st century's platform-company boom (see page 2). *Grant's* readers are familiar with more than a few of the component businesses, especially Jazz Pharmaceuticals plc, Endo International plc and Valeant. Anheuser-Busch InBev SA/NV, Kraft Heinz Co., Spectrum Brands Holdings,

Component Companies of the Platform Boom Index
All figures in $ millions

	market cap		market cap
Allergan plc	$112,489	Kraft Heinz Co.	$93,594
Altice NV	22,240	Liberty Global plc	37,449
AMAG Pharmaceuticals, Inc.	1,311	Mallinckrodt plc	7,968
Anheuser-Busch InBev SA/NV	188,502	Medtronic plc	102,742
Avago Technologies, Ltd.	33,531	Mylan NV	21,679
Concordia Healthcare Corp.	1,259	Perrigo Co. plc	22,871
Danaher Corp.	62,813	Platform Specialty Products Corp.	2,267
Endo International plc	13,249	Post Holdings, Inc.	4,162
Hain Celestial Group Inc.	5,131	Spectrum Brands Holdings, Inc.	5,546
Horizon Pharma plc	2,634	Thermo Fisher Scientific, Inc.	50,524
Jarden Corp.	10,310	TransDigm Group, Inc.	11,615
Jazz Pharmaceuticals plc	7,991	Valeant Pharmaceuticals Int'l, Inc.	37,583

sources: JHL Capital Group, the Bloomberg

Inc. and Thermo Fisher Scientific, Inc. provide a taste of the rest of the list. To be considered for inclusion in the Litinsky index, a company must have built a reputation for rapid growth through acquisition, often debt-financed and tax-advantaged. From the March 2009 stock-market lows to July 2015, the Litinsky names rose by more than 1,000% compared with the S&P 500's 200%. The conglomerateurs of the 1960s, wherever they are, can eat their hearts out.

Ideas, too, not just debt and the tax code, drove the Valeant phenomenon. "The bible for the platform boom is this book called 'The Outsiders,'" Litinsky said, "and it's about these eight unconventional CEOs who were considered to be the best compounders over time. The take-away from the book is that he did a big study that said this is how a CEO should act—'they disdained dividends, made disciplined, occasionally large acquisitions, used leverage selectively, bought back a lot of stock, minimized taxes, ran decentralized organizations and focused on cash flow over reported net income.' Henry Singleton is on here, Warren Buffett, John Malone, Kay Graham of *The Washington Post*." Just as we collectively reach for yield, so we search for heroes; Litinsky called this "our thirst as investors to believe in others."

"Cash flow over net income is a perfect example of where to start," our speaker continued. "I'm a free cash-flow guy, I run a hedge fund, I want to be a thoughtful investor, I focus on free cash flow. But, accounting principles are kind of like prostitution or multi-level marketing—you may think that they're completely wrong, but they've been around forever for a reason, and so when we think about our platform boom companies—the 24 companies on my list—they have an aggregate of $800 billion of equity market value. Their aggregate tangible book value is minus $272 billion. By the way, not a single company on that list has positive tangible book value. This is the creative accounting."

Companies in the health-care wing of the platform cohort own either a branded drug or a generic drug, Litinsky noted by way of illustration. If the former, the average economic life of the product is 20 years. If the latter, high-single-digit annual price declines have been the rule (though, in recent years, they anomalously have proved the exception). "The point is that GAAP earnings are lower for a reason," he said. "The amortization is real. These are declining, finite lived assets. So when you look at one of these pharma conglomerates, you should recognize that their GAAP earnings are really what are real." Yet the pharma companies borrow (and their creditors lend) as if their assets will live forever.

Thanks to Hillary Clinton's "tweet heard round the world," Valeant's pricing strategy has come in for wide-ranging condemnation. Uncondemned, but also questionable, is the price-raising strategy of certain non-pharma products, said Litinsky: "Kay Graham ran a media monopoly, and so did Tom Murphy of Capital Cities Communications. They could comfortably raise prices because they were the only game in town. If you're selling an unhealthy consumer brand—beer, for instance—where you're experiencing quarter-over-quarter declines and yet you're dramatically raising price, that makes sense for a short period of time. The question is if that is truly a sustainable business model. Should we assign the same benefit to a new 'Outsider' CEO for raising price in the midst of volume declines the same way we would assign that genius-ness to Tom Murphy of Cap Cities?"

Another knock on the Litinsky dirty two dozen is that they've landed on journalism's front page. Treasury Secretary Jack Lew criticizes tax inversions, the Justice Department is investigating AB InBev for anti-competitive behavior, Valeant is subpoenaed, state regulators are piling on. The platform companies, Litinsky contended, "are too big now to quietly take advantage of an arbitrage. They're too big to grow."

The platform giants likewise face the risk of rising interest rates, our speaker proceeded. "I have heard some arguments out there that 'you don't have to worry about a bear market until the Fed hikes and because we're at the zero lower bound the show actually goes on,'" he said. "Well, QE ended in October—that's a form of tightening. A year ago was the first hike—the end of QE. I think you could also argue that the emerging-markets unwind that is happening is another form of tightening. So we're actually experiencing this tightening that is typical of the end of these types of booms."

Litinsky's index peaked in July. Valeant, leader to the down side, "is the poster child of the platform boom," our speaker said. "They did their tax inversion, they've been an aggressive acquirer, they did the pricing and you can see the boom/bust cycle. They acquired a bunch of stuff and continue to acquire. It was all a very accretive tax arbitrage, everybody loved it, 'Michael Pearson is amazing'—and then collapse."

What, exactly, is Valeant? Litinsky proceeded to answer. "It's not really necessary to focus on the details," he said. "Sometimes it's just important to really step back and think about what this company really is. It's effectively a stub of assets and then a bunch of stuff that they acquired from 2008 to today, and to do that they spent $43 billion. That's what it cost to assemble what this company has become. I would argue strongly that the significant majority of their assets are declining to zero over a long period of time. They'll tell you that it's a smaller percentage. The fact is that they spent $43 billion to buy it. As of [Oct. 15] the enterprise value was $91 billion. The 'platform value' of this company is the amount that exceeds costs. Now, this $48-billion platform value you have to adjust because they have a tax arbitrage, they have a great CEO who [implements] zero-based budgeting and who is cutting costs, and there is some value to that. But that is all mitigated by the fact that the assets are declining over time. Let's say that each offsets the other; would you pay $48 billion for one person? I'm not recommending it, but you could go buy Blackstone for $40 billion."

Then there's the debt. Litinsky said he could understand, a little, the appeal of the equity story, but why would anyone choose to become a Valeant creditor? "You have a bunch of stuff that costs about $43 billion, the net debt is almost that amount," he continued. "You know that eventually this debt is going to have to roll at likely higher yields. To be a creditor just doesn't really make much sense, and the credit markets are figuring that out."

Litinsky said that his thesis was reducible to a maxim of his own creation: "When an 'outsider' meets a cycle, it's likely the cycle whose reputation will remain intact." In the 1960s, it didn't matter who the outsider was.

The great Singleton and the less great Steinberg each suffered. "I think the way you need to think about the platform boom is that everybody is going to get hit," said Litinsky. "All of these aggressive acquirers. The feedback loop has started to go in reverse."

Litinsky closed with a word on the post-2008 stock market. He said that, when you compare the compound growth in the S&P with the compound growth in GDP over the same span of time, you're left to conclude that the post-2008 stock-price levitation is among the greatest such episodes of all time. Ultra-low interest rates, courtesy of the Federal Reserve, spawned one of the gaudiest eras of deal-doing. He said that when the history of "conglomerate boom 2.0" is written, it will be the story of investors who, starved of yield, sought certainty in the lives and careers of yesteryear's storied capital allocators. "But," Litinsky concluded, "it's a reach too far. They sort of believe that past performance is some kind of guarantee for future performance and have priced it as such."

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