Call a Spade a Spade

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NOVEMBER 2003

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All of us know from a very early age that it is always better to tell the truth. Though the truth may hurt our feelings from time to time, lying will inevitably get each and all of us into hot water sometime down the road of life. If you want to test yourself, try writing your life's story. You will soon discover that at least a few of the attributes you claim to have are, in fact, a packet of little white lies. That is so because everyone of us has a tendency to embellish the truth from time to time!

Notwithstanding, on the day of reckoning, when it comes to investing our own hard-earned savings, or even our ill-gotten gains, we would all much prefer to deal with people who are known to be brutally honest, rather than with those who guild the lily or shade the truth – to their own advantage, not ours. Obviously, none of us ever wants anything to do with a pathological liar or an out-and-out crook!

Unfortunately, many of those we turn to for advice have a difficult time telling the truth, the whole truth and nothing but. Furthermore, very few of the culprits seem to give a damn about you or me, providing they get their pound of our flesh and are not called on the carpet to atone for the error of their way of doing business.

THE AUTHORITIES ARE ON THE WRONG TRACK

Those who have read *The Roles of the Principled Players* will understand my concern about the ethics of almost everyone involved in playing and policing the other-peoples'-money game. As I see it, unless you have owned a well-diversified portfolio of stocks, trust units, preferred shares and bonds, you really do not have a true understanding of just how difficult it is to become a successful investor, and to do better than the various stock market benchmarks over time. After all, very few of the highly paid mutual and pension fund managers can claim to have done so from one year to the next!

The underwriters and their well-meaning research analysts very seldom own more than a smattering of securities at any time. Most CEOs, characteristically, have all their financial eggs in just one basket. On the other hand, there is not a securities industry or government regulator alive who would ever dare to put their own money at risk in the stock market, for fear of coming up short. Though the authorities may claim that to do so would constitute a conflict of interest, until they do, they will never really have the intuition to foresee what needs to be done to protect and enhance the lot of investors before the next wave of scandals rocks the boat.

At the moment, the securities commissions across North America and elsewhere about the globe seem to be hell bent on trying to make amends for the lack of proper supervision during the most recent bull market. They are all scurrying about in an attempt to introduce subjective, rather than meaningful, governance measures, at great expense to long-suffering investors. Unfortunately, the SEC and the OSC commissioners, most underwriters and many CEOs are missing the whole point of the exercise. For the sake of the investing public, it is high time they all fessed up to their failings and misrepresentations of the past, atoned for their mistakes and promised not to be so inconsiderate in the future. It is time they set the record straight, once and for all.

By layering on new regulations the authorities are proving once again that they are on the wrong track. We certainly do not need more red tape to cope with! As the World Bank's *Doing Business in 2004: Understanding Regulation* report suggests, although many entrepreneurs are in favour of less regulation, good regulation is not zero regulation. It is simply less regulation, combined with enforceable laws that protect citizens and governments.

AN INTERESTING CASE STUDY

The financial press has recently been ablaze with stories about Biovail Corporation, a controversy-prone star of the Canadian drug industry, and its president and CEO Eugene Melnyk. Though I am not going to pass judgment, there are a few points I would like to make to complement what has already been said about this tawdry affair.

In keeping with the intent of full, true and plain disclosure, I must report that I acquired Biovail stock by way of a new issue offering in November 2001 at $75-net, and sold my position in January 2002 at $85.15 per share. I got out when my stockbroker's research analyst could no longer easily connect the head to the tail of the financial statements. For the record, the all time high for the stock proved to be $91-even in December 2001, up from less than $1 in the mid-1990s. At the time of reporting its 2003 third-quarter results on October 30, the stock was trading at $35 per share. The mean estimate of eighteen research analysts called for a profit of $0.39 per share. Management's most recent guidance had been $0.35 to $0.45, compared with an earlier forecast of $0.58 to $0.68 per share.

Needless to say, when the final tally came in at $0.08 – or $0.22 per share on a pro-forma basis – before restructuring costs and an acquired research and development writedown – all hell broke loose. At the time, Point & Figure charts suggested that there was a 57 percent chance that the stock could drop to $26; a 30 percent chance it might trade as low as $16 per share. Low and behold, the stock traded down to $26.75, before rebounding to the $32 to $33 level. Only time will tell if the worst is over for this once high-flying stock.

Though I will never claim to be an authority on accounting principles, Biovail's practices have been said by many to be somewhat aggressive. The most recent point being the stated reason why the third quarter earnings came up short of the company's guidance targets. The claim was that a shipment of its heartburn drug failed to get to a customer's loading dock in time, thanks to the delivery truck being involved in an accident along the way. This story kind of reminds me of one I like to tell. Mine goes like this.

A man driving down the New York throughway in a covered truck was observed by the state highway patrol to stop by the side of the road every so often, only to whack the back of his rig with a two-by-four. Once the board was put back in its proper place, the driver would proceed along his way. Curious as to what the truck driver was up to, the police signaled him to pull over. When asked to explain his rather strange behaviour, the hayseed replied, "I have a one-ton truck and two tons of canaries, and I have to keep half of them flying!" Whereupon the officer wished him well and bid him adieu.

The moral of these two stories is this. If you drive in the proper lane, abide by the generally accepted speed limit and something out of the ordinary should happen, the authorities would appear to be willing to give you the benefit of the doubt. However, if you are found to be driving too close to the edge of conventional wisdom, the stock market will inevitably punish the share price if something untoward should come to pass. Furthermore, hiring the likes of one's investment bankers or new issue road show organizers to assist in damage control, given as they are all tainted by the very same brush, will only make matters worse!

The only way for Biovail Corporation to set things right would be to come clean and call a spade a spade. Rather than obfuscatory accounting practices, its financials must become far more transparent and its management far more forthcoming. If Mr. Melnyk sticks to his new-found commitment to full financial disclosure and does as he says he will, the stock could be a "buy" at these levels. However, if he and his outfit fail to do so, not even better results will be enough to make a real difference. Nothing will ever be gained by continuing to threaten the research analyst fraternity.

GOOD CRITICS ARE HARD TO COME BY

Reading the daily newspapers one soon learns why there have been so few research analysts willing to be even somewhat critical of Biovail's operations, accounting practices and prospects. After all, the various underwriting firms involved have made a small fortune, and are not likely to upset the easy-money cart. Since the beginning of 2000 the company has raised something like $728 million in new equity financings, and bought back upwards of $623 million worth of shares in the aftermarket.

All the while, Mr. Melnyk has seen fit to cash in more than $150-million worth of stock options. He has also acquired the Ottawa Senators NHL hockey club and a string of race horses, sure signs of a top in a company's fortunes, never the bottom!

That said, there now appears, at long last, to be another well-informed critic prepared to stand his ground and call a spade a spade. The Banc of America Securities LLC, the second largest firm of its kind in the United States, has very recently resumed coverage with yet another "sell" recommendation with a twelve-month target price of $22. No doubt every line of the twenty-two-page report has been vetted by the firm's lawyers, and three forensic accounting experts have gone over Biovail's public filings, press releases and conference call transcripts with a fine-toothed comb. The research analyst in question has also taken time to review the photos and video clippings of the now infamous delivery truck accident.

Though some may question why a securities firm would have gone to such lengths, others have offered that it could possibly be retribution for what happened to Jerry Treppel, the Banc's previous research analyst, when he dared to say "sell." In that instance, pressure was brought to bear by the issuer on the underwriters. In order to get the critic out of the way, he was summarily placed on administrative leave. He later resigned and is suing Biovail and Mr. Melnyk alleging defamation of character. Or perhaps it is a way to show the SEC that the firm's research analysts are once again allowed to be independent thinkers, no longer having to act in concert with its always-say-"buy" investment bankers.

Notwithstanding these two quite possible explanations, I prefer the third suggestion, to the effect that both of these research analysts were only doing what good critics are meant to do. They were simply delivering a compelling argument about a company's worth, or lack thereof. Though, when all is said and done, a mixture of all three suggestions is the most likely scenario.

Lest we all forget, research analysts are supposed to perform an essential service for investors who are unable to decode corporate financial statements. David Maris's more recent report on Biovail contains the type of time-consuming research rarely done by those worried about jeopardizing investment banking relationships. He, his predecessor and the firm are to be congratulated for having broken the mould, for investors have long been very concerned about the sway investment bankers have had on research analysts. It is also important to realize that an informed critic will always be more helpful in the long run than any glad-hander will ever be. It is high time Biovail Corporation and others of its ilk came clean and told the truth.

LOOKING TO THE FUTURE

While CEOs await a more insightful assessment by investment research analysts, they need not twiddle their thumbs. I suggest that they take up in earnest a thirty-minute Saturday morning exercise which will stand them in good stead for years to come. It is to turn to the stock tables in the Report on Business section of *The Globe and Mail*. Not only are the 365-day high, low and closing price statistics readily available, so too are the stock price trends – be they bullish, bearish or involve a long-term trend reversal – along with all the appropriate stock trading volume parameters.

CEOs will soon gain a clearer understanding about the relative strength performance of their company's stock over the past thirteen weeks, vis-à-vis the S&P/TSX composite index and that of their closest competitor's and friends'. Bragging rights go to the one that outperforms the lot!

If your stock is underperforming, you would be well advised to find out just why the others are doing better. Needless to say, a competent and honest research analyst could very well lend a hand, as they have access to an array of other company's inner thoughts when in the process of writing a "buy" or "sell" report, or assisting in arranging an acquisition, a disposition or a merger.

Thanks to the likes of Messrs. Jerry Treppel and David Maris, research analysts can once again be expected to call a spade a spade. The significance of the popular *Institutional Investor* magazine or Brendan Wood survey rankings will no longer be enough to carry the day. It is all about knowing and telling the truth. So goeth the parable about the crooks and the canaries!