



Smoke Today, Fire Tomorrow?

Description

Making a positive contribution to the S&P/TSX Composite on this fine March day is **Valeant Pharmaceuticals (TSX:VRX,NYSE:VRX)**. Valeant is no stranger to the list of positive contributors as the stock has increased by 19% thus far in 2013 and is up 31% over the past year. Valeant shareholders are surely beaming over these solid returns. However, all shareholders, current and prospective, should be aware of the financial risk embedded within this name.

Background

Valeant, in its present form, was born out of a merger between it and Biovail in 2010. The combined entity is a specialty pharmaceutical company focused on skin care products, neurology medicines, and growing its presence in international markets. Its product portfolio includes branded, generic, and over-the-counter items.

Since the merger, the new Valeant has been, to say the least, rather acquisitive. During 2011 and 2012 the company spent close to \$6 billion on numerous acquisitions. To put this figure into context, this was a company that exited 2010 with a market cap of about \$7 billion. The Valeant shopping spree has included everything from individual products to entire companies.

Financing

The company generated a total of \$1.1 billion in free cash over the two-year 2011/12 period. Good, but not \$6 billion of acquisitions good. The shopping spree was largely financed with debt, as equity issuance has been negligible. In fact, management was so enamoured with acquisitions, \$850 million (net) of stock has been bought back.

Total debt has increased from \$3.6 billion at the end of 2010 to \$11 billion (!!!) at the end of 2012. This has left Valeant's balance sheet in a rather precarious state. As the table below indicates, debt related ratios have clearly deteriorated.

	LTM	2010
Total Debt	11,026.2	3,595.3
Total Debt/Equity	3.0	0.7
Interest Coverage	1.8	2.2
Debt/CFO	16.8	13.7
Z Score	0.91	0.51

Source: Capital IQ

The Z-Score is the only metric on the table that shows an improvement. This ratio has a reasonable track record of predicting insolvency before it occurs. The problem with the improvement that Valeant has shown is that both Z-scores represent a firm in financial distress. Anything below 1.81 qualifies as “distressed”.

Cause for concern

Along with all of this debt, the company has taken on a pile of intangible assets. Goodwill and intangibles have gone from 1.9x book value to 3.9x. A couple of years from now, if Valeant finds that it overpaid for some of its acquisitions and is forced to write-down these intangible assets, its net worth could be completely wiped out.

On the bright side, at least this debt has been added in a historically low rate environment. If however they don’t begin chipping away at this massive pile, as they have to start rolling over the debt in a potentially higher rate environment, interest charges are going to spiral to potentially unaffordable levels.

The Foolish Bottom Line

Analysts love Valeant with 10 of the 17 that cover it giving it a coveted “strong buy”. 2 others have it ranked as a slightly less prestigious “buy”. What sell side firm would be crazy enough not to embrace such an acquisitive, fee generating entity?

Given its short-term performance, investors clearly love it as well. I’m sure you’d be hard pressed to find a growth oriented Canadian portfolio manager that doesn’t own this stock.

This debt situation is a clear red flag in my mind. Valeant is loaded with financial risk, something that can bring a company to its knees. Stacked on top is the execution risk that an extended series of acquisitions brings. There is smoke associated with this story – time will tell if it’s attributed to a red-

hot stock or an exploding business model.

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Fool contributor Iain Butler does not own shares in any of the companies mentioned in this report at this time. The Motley Fool has no positions in the stocks mentioned above.

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1. NYSE:BHC (Bausch Health Companies Inc.)
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