Valeant Pharmaceuticals Shares Jump on Rumoured Deal

Description

Shares of Valeant Pharmaceuticals (TSX:VRX,NYSE:VRX) are surging on this Friday afternoon. Currently up 13% (was up by 17%), the stock caught fire after it was reported that the company is close to a deal to acquire Bausch & Lomb Holdings from Warburg Pincus, a private equity firm.

This is the second whale of a deal that Valeant has been rumoured to be close to sealing in the past month. Valeant was apparently close to acquiring generic drug maker Actavis Inc. in a deal that would have topped the $13 billion mark. Actavis' recent purchase of Warner Chilcott helped pour cold water on the Valeant angle.

Why's the stock up?

There are two contributing reasons for today's surge. One, growth oriented investors were probably ticked off when the apparent Actavis deal fell through. Now that another big "growth" opportunity is on the table, their mood has shifted and they're back in love with this serial acquirer.

Another reason is that there is a sizeable amount of institutional money in this country that is managed by those who may call themselves "active managers", but in reality are nothing more than closet indexers. They don't like to stray from the safety of their sacred benchmark, the S&P/TSX Composite.

Valeant essentially makes up the entire Healthcare sector in the S&P/TSX Composite Index and therefore when it jumps, it hurts the relative return of all investors who are "underweight" this sector. They are forced to buy shares and reduce this underweight exposure to help dull the pain. Especially as we approach month end, when performance stats are logged.

Why the stock shouldn't be up

Valeant has been on an acquisition spree since 2010 and has racked up a pile of debt. If more debt is added to complete a deal of this size, it could lead to significant issues down the road if interest rates don't co-operate.

Also, private equity folks aren't the dullest knives in the drawer. If they're indeed selling, they're doing it for a reason. Either Valeant is over-paying or there is something wrong with Bausch and Lomb. Given Warburg Pincus bought B+L for just $4.5 billion in 2007, which was a pretty frothy time in its own right for private equity deals, a $9 billion price tag certainly brings the over-pay scenario into play.

Foolish Takeaway

Serial acquirers have a knack for making spread-sheet models look fantastic. The theory and reality behind this strategy however can have dire implications for investors. Valeant is currently a market darling. The financial risk tied to this name however could turn it into a goat very quickly.

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

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