Valeant Pharmaceuticals Intl Inc.: This Risky Stock Has Huge Upside

Description

The fall from grace for **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) has been nothing short of amazing.

A year ago the company was riding high. Shares were above $300 each on the Toronto Stock Exchange. Management was actively shopping for more acquisitions to bolster its already impressive lineup of medical products. And many of the world's top investors were long the stock.

We all know what happened next. The company collapsed under pressure from regulators, fraud allegations, and a number of other issues. Then CEO Michael Pearson fell ill under suspicious circumstances before getting replaced earlier this year. Shares collapsed to less than $30 each, a fall of over 90% from all-time highs.

The company is now focused on a turnaround plan, which includes selling non-core assets, paying down debt, and executing a six-part plan to emerge from this scandal as "The New Valeant." Key parts of this plan include selling non-core assets, making changes to the management team, and paying down some of the US$32 billion the company owes to creditors.

Investors are skeptical this plan will work. Many argue Valeant overpaid for assets and will eventually get crushed under its debt, leaving bankruptcy as the only option. But others are seeing the company as a massive value opportunity, worth way more than the current share price.

Here's the case for Valeant as a value investment.

Great assets

The company officially announced its non-core assets were for sale during Tuesday's conference call with analysts. Approximately 80% of the company's assets–which consist of its Bausch + Lomb and its Branded RX divisions–are identified as core assets. Management thinks the sale of the other 20% of the company could be worth as much as US$8 billion.

The tricky part is valuing the rest of Valeant's business. The good news is some of Wall Street's smartest analysts have been doing the work for us. The bad news is they don’t even get close to agreeing to a number.

BMO Capital Markets analyst Alex Arfaei estimates the sum of Valeant’s parts is worth US$118 per share. Annabel Samimy of Stifel thinks Valeant’s assets are potentially worth US$65 per share. Meanwhile, Gregg Gilbert of Deutsche Bank thinks the company’s break-up value is closer to US$35 per share.

Nobody really knows how much Valeant’s assets are worth, partially because the company doesn’t disclose the performance of each part of the company. Still, it has some great brands that dominate their respective markets. Other healthcare companies will be interested in them, even the non-core brands.

Nice cash flow

In the first six months of 2016 Valeant reported adjusted earnings of $2.80 per share. It reiterated guidance that it’ll earn between $6.60 and $7.00 per share in adjusted earnings for 2016. That puts shares at just 5.4 times adjusted earnings at the mid-point of that guidance.

GAAP earnings were significantly worse. The company reported a loss of more than $2 per share thus far in 2016 using generally accepted accounting principles.

Why such a big difference? The company has massive depreciation and amortization expenses that weigh on the bottom line but don’t affect cash flow. The company also routinely writes off millions in other non-cash expenses that it categorizes as unusual expenses.

So even though Valeant’s net income is negative, the company is actually generating large amounts of cash. Thus far in 2016 the company has been able to increase its cash position from approximately US$600 million to US$850 million and repay some US$1.3 billion in debt. Management plans to pay back US$1.7 billion in debt by the end of the year.

So although Valeant doesn’t generate any net income, it still has plenty of cash flow.

Still risky

Valeant is a risky investment; that much is obvious. The company has many things going against it, including its massive debt pile, the still lingering accusations of fraud, and negative goodwill. But there’s certainly an argument to be made for it as a value investment–at least for investors who aren’t faint of heart.

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