



The Smart Money Is Buying Valeant Pharmaceuticals Intl Inc.: Should You Buy Too?

Description

Francis Chou might be the best mutual fund manager you haven't heard of.

Chou started out in 1981 with \$51,000 in an investment club started with six of his coworkers at Bell Canada. It then ballooned into a position working for Prem Watsa when he started **Fairfax Financial**. He still considers Watsa a friend and confidant today.

In 1986 Chou branched out on his own, launching the Chou Associates Fund. Using a Benjamin Graham-inspired deep-value approach, his returns have been nothing short of remarkable: \$10,000 invested in the fund on inception day would be worth nearly \$190,000 today—good enough for an annual return of more than 10%. And that's after weak performances in both 2015 and 2016.

A similar investment made in the TSX Composite Total Return Index would be worth approximately \$103,000.

Chou's Associates Fund recently took on a controversial position, buying approximately one million **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) shares. Let's take a closer look at why Chou thought the troubled company was a good buy.

Chou's reasoning

Like Warren Buffett and Prem Watsa, Chou shares his thoughts with investors in detailed and entertaining annual reports. Chou takes it a step farther and writes a semi-annual report as well. In his latest semi-annual report, he lays out the case for buying Valeant.

Chou points out Valeant has a ton of debt—owing US\$31 billion versus US\$10 billion of approximate annual revenue and US\$5 billion in earnings before interest, taxes, depreciation and amortization, or EBITDA. That is the big risk with Valeant.

But at the same time, the company is quite profitable. Adjusted earnings per share for 2016 are expected to be between \$6.60 and \$7.00, putting shares today at a price-to-earnings ratio of

approximately 5.5. You won't find better value than that in the market today.

Chou believes the true value of shares is closer to \$100 using a very simple method. Average valuations for the past century for blue-chip stocks have been about 14 times earnings. If we assign a similar valuation to Valeant, we have a company selling for approximately \$100 per share.

That's nice potential upside for a stock selling at less than \$38 today on the TSX.

Even from an enterprise-value perspective, Valeant is still relatively cheap. According to Chou's calculations, as of June 30 the stock traded at a 31% discount from that perspective, although shares have rallied since then.

The key to Valeant's success could very well be how management handles its debt situation. If they are successful in selling off non-core assets and reducing debt by as much as US\$8 billion, it will certainly help. Investors will begin to view it not as a high-risk name close to bankruptcy, but as a stock implementing a successful turnaround.

What about regulators?

Since Chou penned his semi-annual report, some pretty important news has come out about Valeant. According to sources, U.S. Attorney prosecutors have opened up a case against the pharma giant, alleging that some of its moves may have defrauded medical insurance companies.

Specifically, prosecutors are looking into the relationship between the company and Philidor RX Services—the smoking gun that started Valeant's massive decline back in 2015. Although it's pretty likely this investigation will end in a settlement—as most do—there's always a risk surrounding investigations like this one.

Should you buy?

Ultimately, Valeant is still in a very complex situation. For that reason, I've personally decided not to add it to my portfolio. It is in my "too hard" pile.

But at the same time, Francis Chou isn't the only smart money manager who is bullish on shares that are much cheaper than they were a year ago. This is exactly the kind of situation smart value investors look for.

CATEGORY

1. Investing

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