Why Valeant Pharmaceuticals Intl Inc. Is the Best Contrarian Pick for 2017

Description

The worst may be over for **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX), a once-juggernaut and Canadian pharma gem. A new strategy has been proposed by recently hired CEO Joseph C. Papa–one which focuses on core business fundamentals and driving revenue through the company's exceptionally strong pipeline of new drugs, which will be brought to market over the next year.

First, let's start off with what got Valeant in this mess and the move to what Mr. Papa is doing to fix the company.

Why did Valeant crash?

Valeant has seen its share price plummet by over 90% since mid-2015. A number of factors are at play with the company's share price drop.

The company's previous aggressive growth strategy, implemented by former CEO Michael Pearson, involved focusing on the distribution of drugs and growing the company's pipeline through acquisition rather than R&D. This strategy involved buying companies with products that were "under-priced," and Valeant would follow by raising drug prices on average by 66% to boost revenues and justify the acquisitions.

An inquiry into the drug-price increases was brought to light by former Democratic presidential candidate Bernie Sanders and 18 Democratic leaders, leading to a hearing before the House Committee on Oversight and Government Reform and scrutiny from a number of analysts.

Subsequently, the company's distribution platforms (specifically Philidor, a specialty pharmacy chain connected with Valeant) were exposed for potential fraud by famous (or infamous) short-seller Andrew Left at Citron Research. Left publicly accused the company of accounting fraud, comparing it to Enron, and announced his short position accordingly. The company relationship to Philidor (including the option to purchase the pharmacy chain) was not disclosed in filings leading to further inquiry and investor scrutiny.

Valeant later announced that it indeed paid $100 million to purchase Philidor and would cut ties with the pharmacy chain, divesting its holdings.

The company has since been plagued with legal scrutiny, and the majority of traditional long-term investors have pulled out of Valeant, leading to large downward swings in the company's stock price.

Where is Valeant today?

The company reports revenue and earnings via a "non-GAAP" method, adjusting figures upward to account for large reconciliations related to acquisitions or divestitures, making the financial statements especially hard to digest.

That said, the company's stock is currently trading at 1.4 times book value and is no longer seen as a "growth gem." A long-term investor such as myself looks at Valeant as a newly minted value opportunity should the company grow revenues organically through its existing pipeline of products.

CEO Joesph Papa announced the company's turnaround strategy, which relies heavily on R&D of the company's current pipeline of 15 drugs which will be brought to market over the next year. This strategy is markedly different from Pearson's strategy and needs to be scrutinized heavily over the short term. If the company is indeed willing and able to follow through on this strategy, the company will very likely be able to move toward hitting its forecasted forward EPS of $7.70 per share.

Free cash flows from operations (CFFO) are strong with second quarter CFFO increasing 9% from Q2 2015. If the company is set on executing this long-term turnaround plan, most of these cash flows will be used to pay down debt and further divestitures are likely. The long-term investor will need to assess if these asset sales will be able to assist in growing the profitability of core operating assets. For the time being, the situation looks promising.

Pershing Square CEO and activist investor Bill Ackman has publicly stood by Valeant, announcing his support for the company long term. His reputation for driving company profitability through cutting costs and increasing margins brought him to Valeant.

The company's current situation makes the stock attractive to me for the following reasons:

- New management and a long-term strategy have shown some short-term success and will likely continue to bring improved profitability and earnings over the long run.
- Investors such as Bill Ackman, who have shown long-term attachment to Valeant, provide me with assurance the company's turnaround plan is likely to succeed.

The price to book value of assets at 1.4 times makes the company a steal at current prices. I will be assessing the stock in the short term and any dips toward P/BV of one would make this stock a guaranteed buy. Buying the stock for around what the assets are worth provides a significant moat to a value investor.

CATEGORY

1. Investing

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