Another Cut for Valeant Pharmaceuticals Intl Inc.

Description

With another earnings release in the rear-view mirror, shares of **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) have declined once again, this time to under $18 per share. The question is not *if* the company will go under (or be sold off into tiny pieces), but *when* will it happen.

The company was in positive cash flow territory, but the reality is the loss still amounts to $1.47 per share, making things even worse from last year's loss of $1.04 per share. Cash flow from operations (CFO) was $2.087 for the year, but it decreased by $170 million from the previous year.

Although certain costs can be contained, it is extremely difficult for a company to hide the bad news with declining revenues. For fiscal 2016, revenues declined by approximately 7.4%, while the debt saga continued. For a large number of pharmaceutical companies, the percentage of revenues going to fund R&D and interest expenses combined is often upwards of 15%, but in the case of Valeant, the reality is that 2016 interest expenses alone were closer to 18%. In 2015, interest expenses accounted for a reasonable 12%.

Although management has pounded the table about paying down an additional $5 billion in debt, only $1 billion has been repaid so far. As of December 31, 2016, the company had debt on the balance sheet close to $30 billion. Assuming the company is successful in paying down the $5 billion, another $25 billion will still remain. If Valeant cuts 2016 interest expenses by 17% (one-sixth), the total interest expense would work out to approximately $1.43 billion, or 14.8%, of 2016 revenues.

Although this may seem reasonable to long investors, there are a few things we must remember. First, the company must repeat 2016 revenues, which is not a sure thing given the sell-off of several drugs over the past few months. The potential for revenues to decline still wouldn't solve the interest expense problem, even after paying off $5 billion of debt.

The second and more important thing to consider is the mix of interest expense vs. R&D when looking at this 15% metric. When a company invests a portion of their revenues in R&D, it is a sign of things to come. New drugs are being developed and moving through the pipeline. Although not all of these drugs will be profitable, the ones which generate positive cash flows will most often cover those which do not become profitable.

Looking at the situation of Valeant, however, the red flags go up in conjunction with the ringing of a bell. If the entire 15% of revenues is going to interest expenses and none is going to R&D, then the question becomes, “what’s in the pipeline?” Clearly, without new cash-generating drugs under development, the company is taking 15% of revenues to pay off what was already purchased. The long-term survival of this company may be in jeopardy.

This may take a long time to play out. Be very careful on this one!

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ryangoldsman