3 Red Flags That Signal it's Time to Sell: Learning From the Past

Description

Heavily indebted balance sheet

A company that is heavily burdened with debt is a red flag, because in hard times, it limits the company's staying power and flexibility greatly.

One glaring example of this is **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX), which continued to leverage itself up in order to continue to make acquisitions. This strategy worked for a while, but it always seemed like a disaster waiting to happen. And then disaster did happen. The company came under fire for its pricing strategy, where it dramatically marked up prices on drugs that were purchased, and the SEC started to investigate the company's accounting practices.

While the price mark-ups, aggressive acquisition strategy, and accounting issues were key to the company's downfall, the fact that the company was so indebted and that it was seemingly too reckless with the balance sheet were warning signs.

Valuation

Another thing that we must keep a close eye on is valuation. When the valuation gets too ahead of itself, we must be confident enough to take profits, as the risk/reward relationship turns negative when a stock is overly valued, no matter how good the fundamentals are.

I'll use **Sierra Wireless, Inc**. (TSX:SW)(NASDAQ:SWIR) as an example here. While I think this is a great company, the stock went through a period where it was grossly overvalued because excessive investor optimism and euphoria bid it up way beyond where it should have traded based on the fundamentals, regardless of how good the fundamentals were.

Back in 2014, the stock was trading at a P/E ratio of 66 times the prior year's earnings and 58 times the expected 2014 earnings; it was pretty much priced for explosive growth that was far beyond the reality. Despite Sierra's strong fundamentals, the valuation was too high. Over the next year, the stock went from a price of over $56 to just over $20 at the end of 2015 for a loss of over 60%.

Expectations too high

Expectations that are too high are related to over valuation of a stock, but it's worth a mention because sometimes investors get caught up in the dream.

The company that comes to mind in this regard is **Ballard Power Systems Inc.** (TSX:BLD)(NASDAQ:BLDP). We could easily say that in the early 2000s, there was blind optimism for the company and its technology, and many investors got burned as the stock got beaten down from its highs of $150 to single-digit territory.

The stock currently sits at $2.22, and the company is still facing much uncertainty. And, understandably, expectations now are extremely low, as it has been a long road for the company. But that is a good thing.

In the company's latest results, revenue increased 51%, and adjusted EBITDA was a positive $1.8 million. The gross margin was 30%, and the company is making headway into China's mass transportation sector.

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