What We Can Learn From Bill Ackman Walking Away From Valeant Pharmaceuticals Intl Inc.

Description

Recently, it was announced that hedge fund manager Bill Ackman sold his firm’s entire stake in **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX). By selling his final position, he has done what many investors hate to do: he locked in losses.

Almost every investor has at least one position in their portfolio that is held at a loss. When an investor enters a position and sees the investment decline in value by say 20%, it is important to understand what needs to happen for the investor to be able to recoup their original investment. Using very simple math, an investment of $100 which declines by 20% to $80 needs to return to $100 for the investor to be even.

Assuming we hit the reset button here, a new investor may purchase the shares at $80 and get a $20 return divided by the initial outlay of $80, which translates to a return of 25%, not 20%!

For investors holding positions that are slightly at a loss, the amount a stock must come back to make up the loss is nothing more than a rounding error. Once it gets beyond 20-25%, however, the numbers are a little more serious.

With a loss of 10% as an example, the return must be 10/90 = 11.1%, meaning a difference of 1.1% — a very minor number.

Valeant shares have declined close to 90% since Ackman made the initial investment, translating to a return of (90/10) = 900% for his firm to get back to even. Although we’ve seen the hedge fund manager do fantastic things in the past, any investor hoping for a return of 900% is dreaming.

The amount of interest expenses as a percentage of revenue is simply too high for this company to survive over the long term, translating to a desperate need to either drastically increase revenue or repay debt.

As it is difficult to increase revenues, the second option is to pay off debt. Debt is close to $30 billion, and that can only mean selling assets or doing a secondary share issue. The challenge with this possibility is that Valeant has $30 billion in debt but a market capitalization of only approximately $5 billion. If the float were to double, the debt would only be reduced by approximately 16.5% or so.

And it seems the company is in for the fight of a lifetime after losing one of the heavyweight members of the board of directors.

Although the company has many excellent products to offer consumers, the reality is, the debt burden is simply too much to carry at this point. Bankruptcy may take months from here, but it’s inevitable — the fat lady will sing!

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