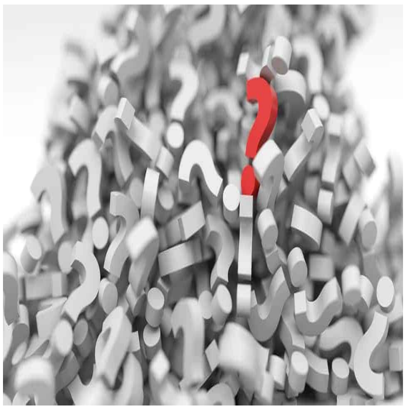

Is Valeant Pharmaceuticals Intl Inc. Canada’s Cheapest Stock?

Description

Most investors are staying a long way away from **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX). It’s easy to see why.

Valeant might be the biggest disaster in recent memory. After being the can’t-miss stock of the previous few years, a determined investigation by a few select analysts determined that Valeant had a secret relationship with Philidor — a pharmacy it was using to push sales of select products.

Philidor was just one symptom of a much bigger issue. Under then-CEO Michael Pearson, Valeant was willing to push the envelope with sales growth. Were there more Philidors out there? What else was the company doing that wasn’t kosher? Investors started to question everything. Pearson ended up in the hospital and was eventually replaced by current CEO Joseph Papa.

After the Philidor scandal, investors started to pay attention to Valeant’s massive debt load. The company owed more than US$30 billion to creditors at the end of 2016. When shares traded at $300 each and the market cap was more than $100 billion, this wasn’t a big deal. These days, shares are under $15 and the market cap is puny in comparison, coming in at $4.9 billion.

Valeant’s debt is a major issue. There’s no getting around that. But with great risk comes great opportunity. If Valeant can fix its current issues, shares could be much higher in a few years.

Incredibly cheap

Valeant recently came out with its 2016 numbers, and the results weren’t terrible. Both revenue and adjusted earnings fell by 7% and 33%, respectively. The top line came in at US$9.7 billion with adjusted earnings of US$5.47 per share. Valeant also had healthy free cash flow with that metric checking in at US$1.8 billion.

Valeant's low valuation becomes obvious when we convert its results back to Canadian currency. Valeant has a market cap of $4.9 billion. Free cash flow in Canadian dollars was $2.4 billion. Thus, shares trade at just two times trailing free cash flow. That might be the cheapest price-to-free cash flow ratio in the Canadian market today.

Now, 2017 is projected to be a little weaker than 2016, but that's primarily because of asset sales. Revenue is projected to be approximately US$9 billion, while adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA) are slated to fall a little more than 10%. Even if free cash flow falls a similar amount, Valeant shares are still unbelievably cheap on a forward price-to-free cash flow basis.

The debt situation

There's a simple reason why Valeant shares are so cheap. With US$30 billion in debt, there are concerns the company may not be able to survive as a going concern.

Management is well aware of this and is currently taking steps to pay down its obligations. The company announced in January that it sold US$2.1 billion worth of assets — cash it will use to pay down debt. The company plans to sell more non-core assets and use existing cash flow to pay off US$5 billion worth of debt by the middle of 2018.

That would be a nice start, but I don't think the company will be out of the woods at that point. Valeant's debt is going to take years to get under control and will require more asset sales.

Once we factor in Valeant's debt, suddenly the stock doesn't look so cheap. It has an enterprise value-to-EBITDA ratio of approximately nine. That's cheap, but not as cheap as some other pharmaceutical companies. As an example, **Gilead Sciences** has an enterprise value-to-EBITDA ratio of under six.

The bottom line

Valeant is incredibly cheap on a price-to-adjusted earnings ratio or a price-to-free cash flow ratio because each ratio doesn't properly measure the impact of the company's debt.

If Valeant manages to get its debt under control, shares will likely shoot much higher. I think that could certainly happen, but it's a risky proposition.

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