1 Beaten-Up Stock With a Potential 50% Upside

Description

Canada-based **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) reported earnings on Tuesday which impressed analysts and investors (though probably not investors who got out earlier this year … such as Bill Ackman).

The pharmaceutical company's surprise profit came as the company was able to pay down debt and take advantage of an income tax benefit, boosting its bottom line into the black for the first time in a while.

Looking at Valeant's existing asset base and its pipeline of new products, the potential exists for the company to continue on its path of debt reduction and modest revenue/earnings growth from current levels (or at least revenue/earnings stability) moving forward.

With that in mind, I'd like to share how I think about Valeant from a high-level standpoint with a (very) long-term perspective.

Here's the logic: a company's enterprise valuation is the combination of the value of the company's debt and the company's equity valuation, or its market capitalization on the stock market. Valeant's equity valuation currently hovers around $7 billion.

The company is reducing its debt load by approximately $1.3 billion per quarter, meaning investors can expect approximately $4 billion of debt to be knocked off the books by December (assuming a stable average payback). Using this simplified math, the potential exists for the equity portion of Valeant's enterprise valuation to increase a little more than 50% ($4 billion/$7 billion) over the course of the year, bringing my stock price target to $25 for December 31. (This will be fun to look back on later in the year.)

By de-levering, Valeant will lose some of its tax shields (which are already enormous), but it will gain profitability as it will have to pay less interest expenses, increasing profitability further.

Currently, the company has just over $28 billion of debt on its books, giving Valeant a debt-to-equity (D/E) ratio of approximately four.

If the company is able to pay down $5 billion in debt per year, the time frame can look achievable for the company to get to a 30-50% D/E within three to four years with a continued payback schedule. The average D/E ratio on the S&P500 has traditionally stabilized around 30%. It may be a long, hard road, but it's an achievable one for investors with a long time horizon.

Maybe Bill Ackman did jump ship too early. At the very least, it is likely that many of the short-sellers will begin to cover their short positions over the coming quarters should Valeant continue to pay back its debt and perform at a breakeven pace or better, as the probability that Valeant's stock price continues to climb increases.

Bottom line

Valeant has done a lot of not so very good things and paid the price. Currently a highly levered, jumbled assortment of pharmaceutical assets, a long-term investor with a vision for how the company could be in three to four years may be tempted to buy in at current levels. Given the fact that this is the first small sliver of light at the end of a potentially very long tunnel, it still may be too early to say.

The potential for impressive returns is there; now it's up to management to make the company's assets and its pipeline of new products work for shareholders.

Stay Foolish, my friends.

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