How Rising Rates May Bankrupt Valeant Pharmaceuticals Intl Inc.

Description

With shares down by almost 50% over the past year, **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) may look like a bargain to many investors, but, in reality, the company may be about to fall further. With a 52-week high of $42.25, there are clearly investors who believed in the turnaround story, but that may have been before the increase in the overnight borrowing rates by the Federal Reserve.

As of the end of fiscal 2016, the company had total debt outstanding of almost US$30 billion, which cost the company close to US$1.7 billion to finance. If we do the math, the average rate of interest works out to approximately 5.6% throughout the year. In the previous fiscal year, the average rate of interest was approximately 4.2%.

Although the risk profile of the company has changed from one year to the next, making debt more expensive to refinance, the company has, in fact, done everything possible to sell non-core assets to make large debt repayments to reduce the interest costs. Clearly, company management knew the ramifications of the increased risk carried by the company in addition to the raising rates.

During fiscal 2016, the company's interest expenses accounted for close to 18% of revenues, which is simply too high to allow the company to turn a profit on an ongoing basis. For comparison purposes, interest expenses accounted for no more than 12% of revenues in the previous year. The company was previously within a "normal" range when compared to other competitors.

In the current fiscal year, the company has reported earnings for the first two quarters. The news is startling. Total revenues have declined by close to 10% on an annualized basis, while the total amount of interest expense has not actually fallen. Taking the total amounts paid in interest expenses throughout the first half of the year and projecting the expenses out, the company will not be saving any substantial money in this category.

The result of selling revenue-generating assets and maintaining the same amount of interest expense may be bankruptcy. Given the higher rates of interest, which are now starting to catch up with the company, investors need to be cautious. Given the current costs of financing the company's debt, a

1% increase in the cost of financing could cost the company an additional US$300 million, or an estimated 3.5% of 2017 revenues.

For those willing to take the risk of investing their money in this company, it is important to note that the most dangerous cost on the income statement may just be the interest expense. Depending on how we project the numbers for the remainder of the year, the interest expense as a function of revenues could reach the 20% mark. Barring a major debt repayment or share issuance, investors may not be able to find their way out of the woods.

As always, invest diligently.

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