VALEANT: DAMAGED GOODS OR DEEPLY DISCOUNTED DRUG COMPANY?

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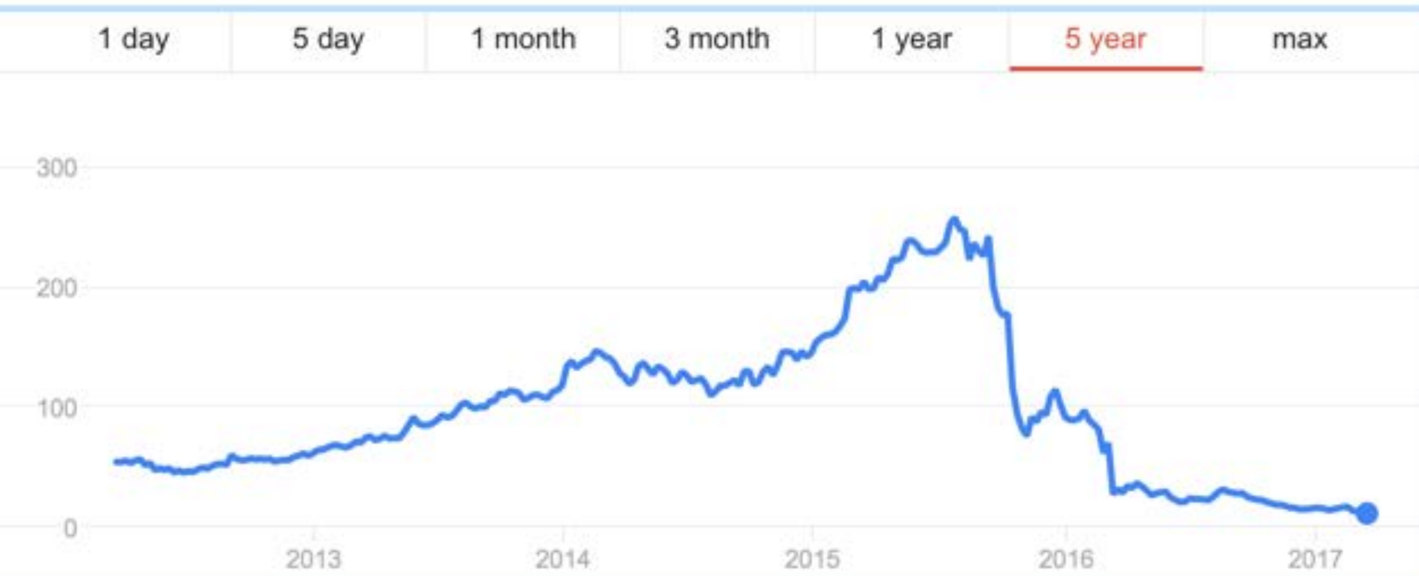
Valeant: The Price History

Valeant Pharmaceuticals Intl Inc

NYSE: VRX - Mar 23, 1:54 PM EDT

10.84 USD ↑0.13 (1.21%)



Open	10.68	Mkt cap	-
High	11.10	P/E ratio	-
Low	10.68	Div yield	-

Valeant: My first try (November 2015)

Valeant settles for mature drug company growth, with a compounded revenue growth of 3% a year for the next 10 years.

	0	1	2	3	4	5	6	7	8	9	10
Revenues	$10,557	$10,874	$11,200	$11,536	$11,882	$12,238	$12,606	$12,984	$13,373	$13,774	$14,188
Operating Margin	43.66%	43.66%	43.66%	43.66%	43.66%	43.66%	43.66%	43.66%	43.66%	43.66%	43.66%
Operating Income	$ 4,609	$ 4,747	$ 4,890	$ 5,037	$ 5,188	$ 5,343	$ 5,504	$ 5,669	$ 5,839	$ 6,014	$ 6,194
After-tax Operating Income		$ 3,798	$ 3,912	$ 4,029	$ 4,150	$ 4,275	$ 4,403	$ 4,535	$ 4,671	$ 4,811	$ 4,955
- Reinvestment	$627	$645	$665	$685	$705	$726	$748	$771	$794	$817	$1,318
FCFF	-$627	$3,153	$3,247	$3,345	$3,445	$3,549	$3,655	$3,765	$3,878	$3,994	$3,638
Terminal Value											$67,227
Value today @7.72%	$56,059										
+ Cash	$ 1,420										
- Debt	$30,883										
Value of Equity	$26,596										
Value per share	**77.11**										

Operating margin drops to 43.66%, as Valeant backs away from drug price increases.

Effective tax rate rises to 20% as acquisition tax shields dissipate.

Valeant maintains its current ROIC of 17.66% as its grows, with reinvestment rate =g/ 17.66%.

Valeant's continues to use debt, albeit with less growth (fewer acquisitions and more R&D). Cost of capital for the firm is 7.52%.

Valeant: A Second Try (in April 2016)

Valeant settles for mature drug company growth, with a compounded revenue growth of 3% a year for the next 10 years. Accounting adjustments reduce base year revenues by 2%.

	0	1	2	3	4	5	6	7	8	9	10
Revenues	$ 10,346	$ 10,656	$ 10,976	$ 11,305	$ 11,645	$ 11,994	$ 12,354	$ 12,724	$ 13,106	$ 13,499	$ 13,904
Operating Margin	40.39%	40.39%	40.39%	40.39%	40.39%	40.39%	40.39%	40.39%	40.39%	40.39%	40.39%
Operating Income	$ 4,179	$ 4,304	$ 4,433	$ 4,566	$ 4,703	$ 4,844	$ 4,990	$ 5,139	$ 5,294	$ 5,452	$ 5,616
After-tax Operating Income		$ 3,443	$ 3,546	$ 3,653	$ 3,762	$ 3,875	$ 3,991	$ 4,111	$ 4,234	$ 4,362	$ 4,492
- Reinvestment	$ 627	$ 645	$ 665	$ 685	$ 705	$ 726	$ 748	$ 771	$ 794	$ 817	$ 976
FCFF	$ (627)	$ 2,798	$ 2,882	$ 2,968	$ 3,057	$ 3,149	$ 3,243	$ 3,341	$ 3,441	$ 3,544	$ 3,516
Terminal Value											$ 55,193
Value today @7.72%	$ 45,051										
Value adjusted for default	$ 44,488										
+ Cash	$ 1,420										
- Debt	$ 30,883										
Value of Equity	$ 15,024										
Value per share	**$ 43.56**										

Operating margin drops to 40.39%, as half of acquisition expenses are moved back to operating expenses.

Effective tax rate rises to 20% as acquisition tax shields dissipate.

Valeant maintains its ROIC of 16.01% as its grows, with reinvestment rate =g/ 16.01%.

Valeant's debt is exposing the company to default risk, as rating drops to below investment grade. Cost of capital for the firm is 8.29%. There is also a 5% chance that the firm will default (and receive only 75% of fair value.)

Valeant: Back again (in November 2016)

Valeant: Valuation on November 9, 2016

Base Year Number
Started with EBITDAR of $4,504 million from LTM but removed acquisition costs & scaled down amortization to reflect R&D expenses

The Acquisition Hangover
Adjustment period of 2 years with flat revenues and depressed margins (matching LTM level).

Slow Growth Drug Company
Valeant will be settle into a low-growth business with R&D driving growth

	Base year	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	Terminal year
Revenue growth rate		0.00%	0.00%	1.00%	2.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	2.25%
Revenues	$ 10,024	$ 10,024	$ 10,024	$ 10,124	$ 10,327	$ 10,637	$ 10,956	$ 11,284	$ 11,623	$ 11,972	$ 12,331	$ 12,608
EBIT (Operating) margin	40.94%	40.94%	40.94%	42.34%	43.74%	45.13%	45.13%	45.13%	45.13%	45.13%	45.13%	45.13%
EBIT (Operating income)	$ 4,104	$ 4,104	$ 4,104	$ 4,286	$ 4,516	$ 4,801	$ 4,945	$ 5,093	$ 5,246	$ 5,403	$ 5,565	$ 5,691
Tax rate	20.83%	20.83%	20.83%	20.83%	20.83%	20.83%	22.66%	24.50%	26.33%	28.17%	30.00%	30.00%
EBIT(1-t)	$ 3,249	$ 3,249	$ 3,249	$ 3,393	$ 3,576	$ 3,801	$ 3,824	$ 3,845	$ 3,865	$ 3,881	$ 3,896	$ 3,983
- Reinvestment		$ -	$ -	$ 100	$ 202	$ 310	$ 319	$ 329	$ 339	$ 349	$ 359	$ 1,120
FCFF		$ 3,249	$ 3,249	$ 3,293	$ 3,373	$ 3,491	$ 3,505	$ 3,517	$ 3,526	$ 3,533	$ 3,537	$ 2,863

EBITDAR margin reverts back to 2011-15 average.

Discounted at Cost of Capital of 9% for 5 years, dropping to 8% in year 10.

Terminal Value
= 2863/(.08-.0225)
= $49,973

PV of CF & Terminal Value =	$ 43,548
Probability of failure =	10.00%
Proceeds if firm fails =	$ 21,774
Distress adjusted Value =	$ 41,371
- Debt	$ 30,714
+ Cash	$ 659
Value of equity	$ 11,315

Value of equity	$ 11,315
- Value of options	$ 20
Value of equity in common stock	$ 11,295
Number of shares	$ 348
Estimated value /share	$ 32.50

Price/Share = $15

The New Numbers (in March 2017)

	2016 10K	2015 10K	% Change
Revenues	$9,674.00	$10,442.00	-7.35%
Operating income or EBIT	$3,105.46	$4,550.38	-31.75%
Interest expense	$1,836.00	$1,563.00	17.47%
Book value of equity	$3,258.00	$6,029.00	-45.96%
Book value of debt	$29,852.00	$31,104.00	-4.03%

Valeant

The Story

Valeant is a tainted company in a business where that taint can be a hindrance in operations, reducing pricing power (because of its past history in pricing) in the near term (leading to negative revenue growth & depressed margins). Transitioning from its past status as an acquisitive company to a more conventional mature drug company, with R&D driving a low growth rate, is feasible but will take time and perserverence. Changes in the US tax code will also push up effective tax rates for teh company.

The Assumptions

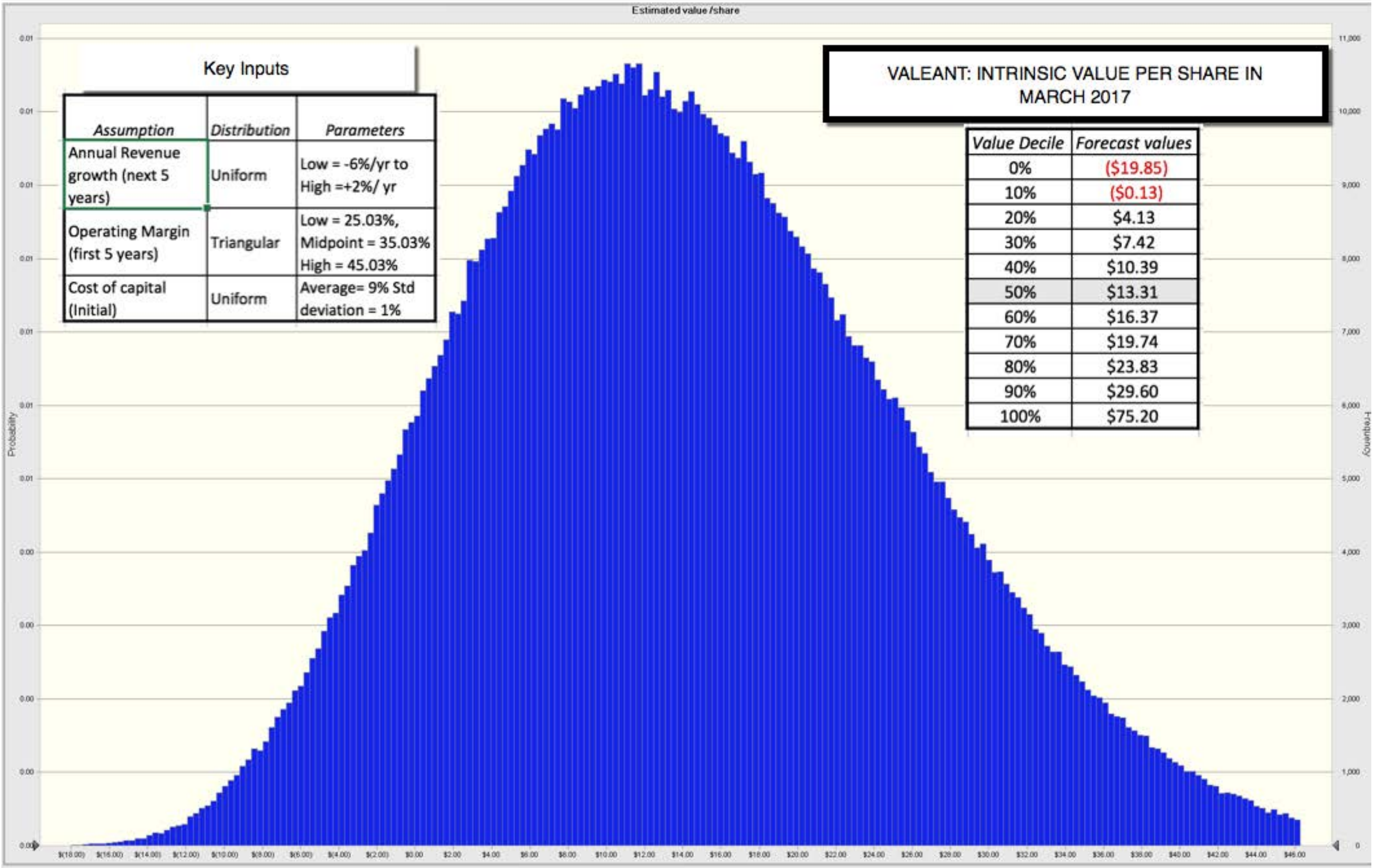
	Base year	*Years 1-5*	*Years 6-10*		*After year 10*	*Link to story*
Revenues (a)	$ 9,674	-2.00%	3.00%		Terminal year	Declining sales as pricing power muted
Operating margin (b)	35.03%	35.03%	40.69%		40.69%	Margins will stay low for same reason.
Tax rate	20.00%	20.00%	30.00%		30.00%	Tax rate rises as US tax code changes
Reinvestment (c)		Sales to capital ratio :	0.70	RIR =	28.99%	Shift from high growth acquisitions to low growth R&D
Return on capital	7.99%	Marginal ROIC =	111.23%		6.90%	Earn cost of capital in steady state
Cost of capital (d)		9.00%	6.90%		6.90%	High risk from debt in near term

The Cash Flows

	Revenues	*Operating Margin*	*EBIT*	*EBIT (1-t)*	*Reinvestment*	*FCFF*
1	$ 9,481	35.03%	$ 3,321	$ 2,657	$ (276)	$ 2,933
2	$ 9,291	35.03%	$ 3,255	$ 2,604	$ (271)	$ 2,875
3	$ 9,105	35.03%	$ 3,190	$ 2,552	$ (265)	$ 2,817
4	$ 8,923	35.84%	$ 3,198	$ 2,559	$ (260)	$ 2,819
5	$ 8,745	36.65%	$ 3,205	$ 2,564	$ (255)	$ 2,819
6	$ 9,007	37.46%	$ 3,374	$ 2,632	$ 375	$ 2,257
7	$ 9,277	38.27%	$ 3,550	$ 2,698	$ 386	$ 2,312
8	$ 9,555	39.08%	$ 3,734	$ 2,763	$ 398	$ 2,366
9	$ 9,842	39.89%	$ 3,926	$ 2,826	$ 410	$ 2,417
10	$ 10,137	40.69%	$ 4,125	$ 2,888	$ 422	$ 2,466
Terminal year	$ 10,340	40.69%	$ 4,208	$ 2,945	$ 854	$ 2,092

The Value

Terminal value	$ 42,688		
PV(Terminal value)	$ 19,113		
PV (CF over next 10 years)	$ 17,222		
Value of operating assets =	$ 36,335		
Adjustment for distress	$ 1,817	Probability of failure =	10.00%
- Debt & Mnority Interests	$ 30,301		
+ Cash & Other Non-operating assets	$ 543		
Value of equity	$ 4,759		
- Value of equity options	$ -		
Number of shares	347.80		
Value per share	$ 13.68	Stock was trading at =	$12.00


Estimated value /share
Key Inputs
Assumption | Distribution | Parameters
Annual Revenue growth (next 5 years) | Uniform | Low = -6%/yr to High =+2%/ yr
Operating Margin (first 5 years) | Triangular | Low = 25.03%, Midpoint = 35.03% High = 45.03%
Cost of capital (Initial) | Uniform | Average= 9% Std deviation = 1%
VALEANT: INTRINSIC VALUE PER SHARE IN MARCH 2017
Value Decile | Forecast values
0% | ($19.85)
10% | ($0.13)
20% | $4.13
30% | $7.42
40% | $10.39
50% | $13.31
60% | $16.37
70% | $19.74
80% | $23.83
90% | $29.60
100% | $75.20
Probability
Frequency

Ackman's Exit: Effects on Investment

- Bill Ackman, long the company's biggest investor and cheerleader and for much of the last two years, a powerful board member, has admitted defeat, selling the shares that Pershing Square (his investment vehicle) has held in Valeant for about $11 per share, representing a staggering loss of almost 90% on his investment.
- As an investor, I have to make my own judgments on whether a stock fits in my portfolio and following others (no matter how much regard I have for them) is me-too-ism, destined for failure.
- It is possible that Ackman's presence in the company and the potential veto power that he might have been exercising over big decisions may have become more of an impediment than a help as the company tries to untangle itself from its past.

Three Paths forward

1. *Going Concern*: By assuming that revenues would continue to drop 2% a year and margins will stay depressed at 2016 levels for the next 5 years and that revenue growth will stay anemic (3% a year) after that, with a moderate improvement in margins, the value per share that I get is $13.68.
2. *Acquisition Target*: I am afraid that the Valeant taint so strong and its structure so opaque and complex that very few acquirers will want to buy the entire company. I see little chance of this bailing me out.
3. *Sum of the liquidated parts*: Now that Ackman is no longer at the company, is for Valeant to open its books to potential acquirers and sell its assets individually to the best possible buyers. Note that this liquidation value will have to exceed $29 billion, the outstanding debt, for equity investors to generate any remaining cash.

My Valeant Decision

- The test: I cannot reverse the consequences of my original sin (of buying Valeant at $32) in April 2017 and the secondary sin (of doubling down, when Valeant was trading at $14) by selling now. The question then becomes a simple one. Would I buy Valeant at today's price? If the answer is yes, I should hold and if the answer is no, I should fold.
- The decision: At today's price, I will hold because the value is higher than the price (though much lower than my average cost per share).
- Self delusion? I am aware that I might be just rationalizing a very common investment mistake: the unwillingness to sell losers. I hope not, but you are always the last person to see your own blind spots!