

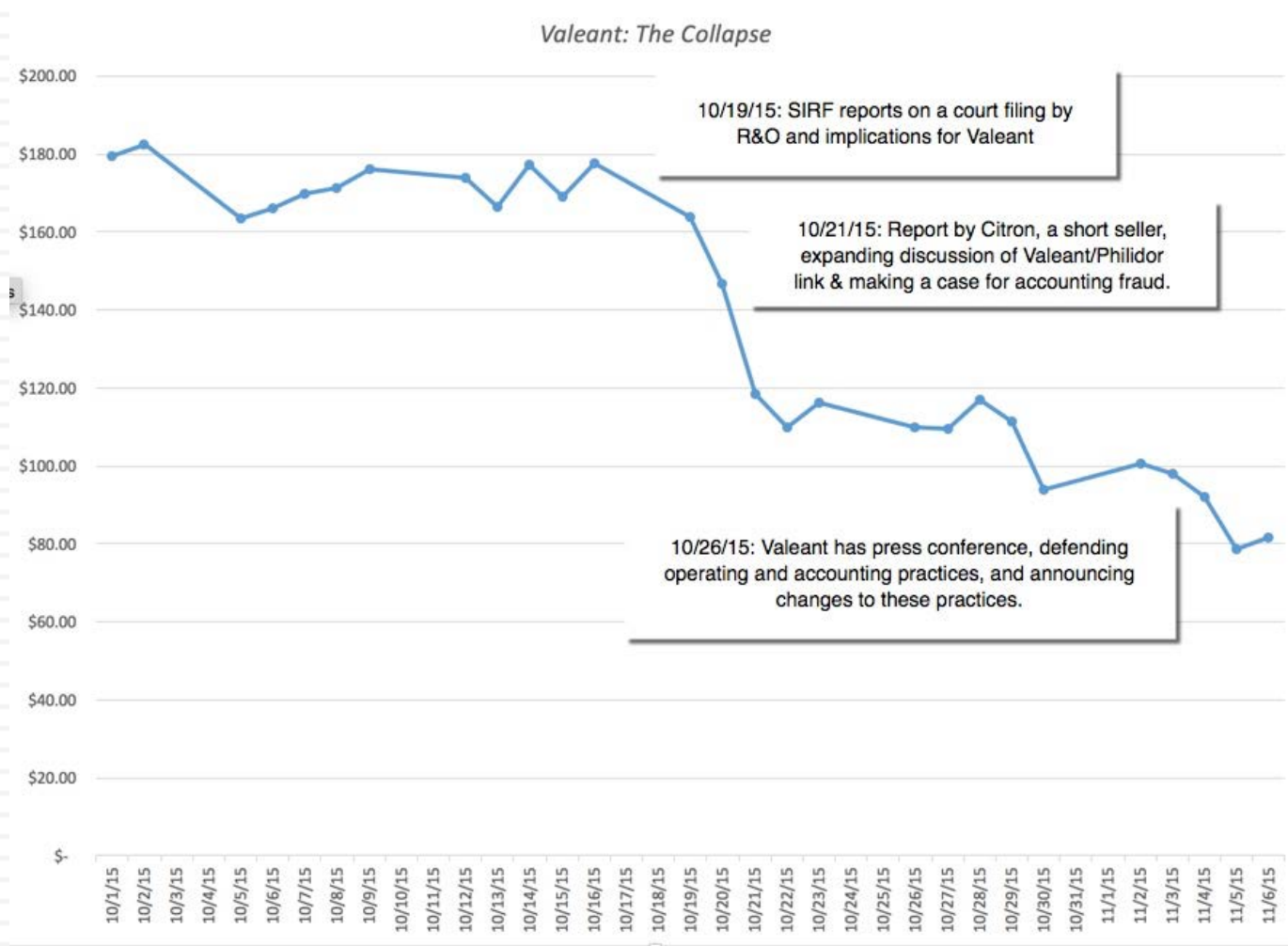


# FAITH, FEAR AND FEEDBACK: VALEANT AS THE ACID TEST

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# Valeant in November 2015: The Price Drop





# My Valeant Valuation (November 2015)

		<b><i>Expected Drop in Operating Income (from Pricing Fix)</i></b>				
		-20%	-15%	-10%	-5%	0%
Expected growth rate in next 10 years	0%	\$ 37.40	\$ 45.08	\$ 52.75	\$ 60.43	\$ 68.11
	1%	\$ 42.18	\$ 50.44	\$ 58.71	\$ 66.97	\$ 75.24
	2%	\$ 47.34	\$ 56.24	\$ 65.14	\$ 74.05	\$ 82.95
	3%	\$ 52.92	\$ 62.51	\$ 72.10	\$ 81.69	\$ 91.28
	4%	\$ 58.94	\$ 69.28	\$ 79.61	\$ 89.94	\$ 100.27
	5%	\$ 65.45	\$ 76.59	\$ 87.72	\$ 98.86	\$ 109.99



# Valeant in May 2016





# Valeant: My Valuation in May 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										

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.)

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: The Pain Continues





# Valeant: The latest earnings report

	2016, Q3	2015, Q3	Change	2016, Q1-3	2015, Q1-3	Change
Revenues	\$2,480	\$2,787	-11.02%	\$7,271	\$7,689	-5.44%
COGS	\$658	\$649	1.39%	\$1,946	\$1,855	4.91%
S,G &A	\$661	\$698	-5.30%	\$2,145	\$1,957	9.61%
R&D	\$101	\$102	-0.98%	\$328	\$239	37.24%
Amort & Impair, finite-lived intangible assets	\$807	\$679	18.85%	\$2,389	\$1,630	46.56%
Goodwill Impairment	\$1,049	\$-	NA	\$1,049	\$-	NA
Acquisiton Costs (all)	\$67	\$213	-63.93%	\$131	\$648	-65.06%
Operating Income	\$(863)	\$448	-292.63%	\$(716)	\$1,366	-152.42%
EBIT pre-acquisition costs	\$(796)	\$661	-220.42%	\$(585)	\$2,014	-129.05%
EBITDA	\$1,060	\$1,340	-20.90%	\$2,853	\$3,644	-21.71%
EBITDAR	\$1,161	\$1,442	-19.49%	\$3,181	\$3,883	-18.08%



# Deconstructing the Earnings Drop

	Effect on operating Income	% Effect
Declining Revenues	\$(317)	15.27%
Change in Gross Margin	\$(192)	9.24%
Change in SG&A	\$(188)	9.05%
Change in R&D	\$(89)	4.29%
Change in Acquisition Costs	\$517	-24.89%
Change in Amortization (Assets + Goodwill)	\$(1,808)	87.05%
Change in Operating Income, , First 3Q 2016 vs First 3Q 2015	\$(2,077)	100.00%



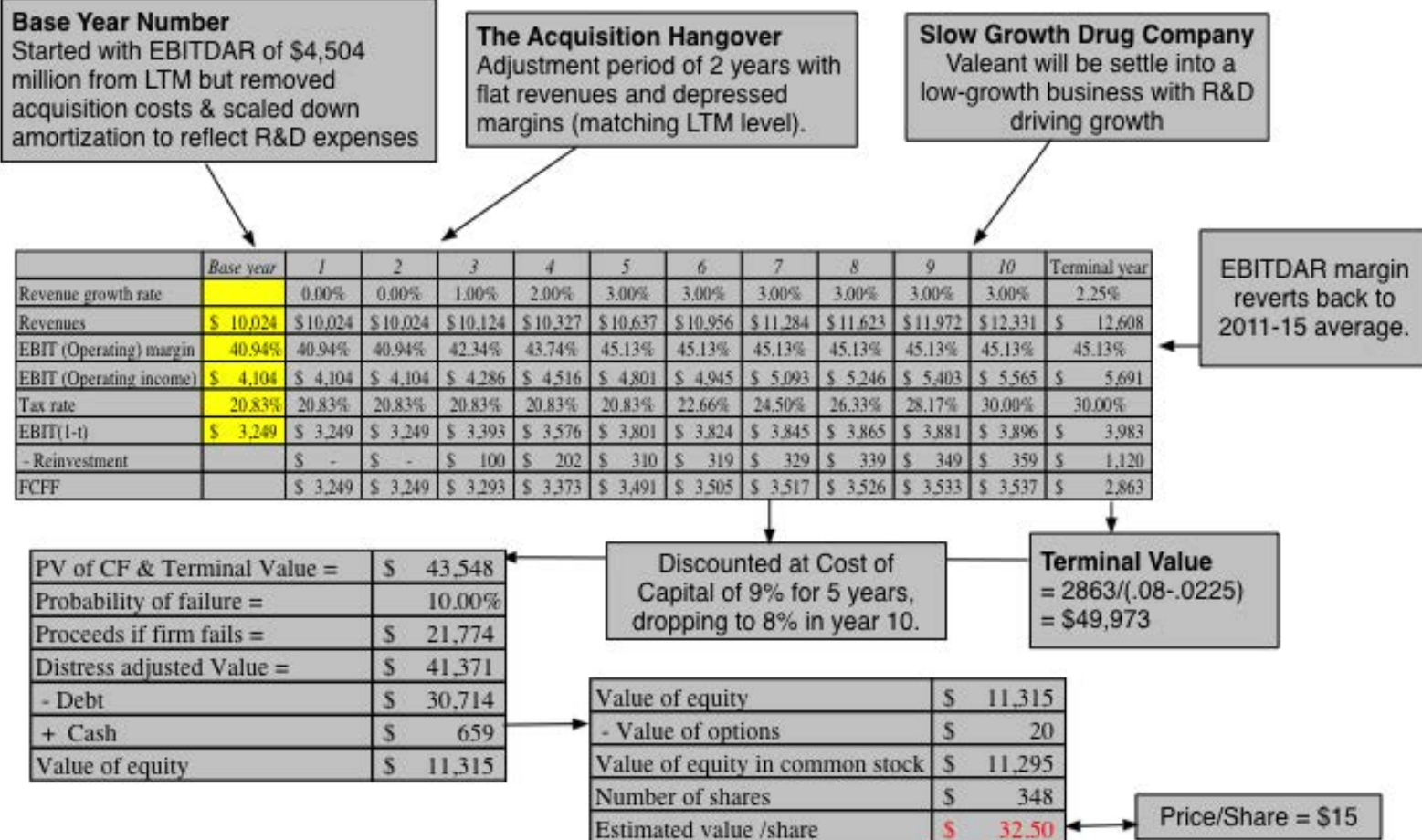
# Cleaning Up Earnings

	2015 10K	First 3 Qtrs, 2016	First 3 Qtrs, 2015	LTM	Cleaned up LTM	Explanation
Revenues	\$10,447	\$7,271	\$7,689	\$10,029	\$10,029	Same at LTM
Gross Income	\$7,915	\$5,354	\$5,877	\$7,392	\$7,392	Same at LTM
SG&A	\$2,700	\$2,145	\$1,957	\$2,888	\$2,888	Same at LTM
EBITDAR	\$5,215	\$3,209	\$3,920	\$4,504	\$4,504	Same at LTM
Amortization (from R&D)	\$2,418	\$2,389	\$1,630	\$3,177	\$187	Reinvestment = R&D - Amortization
R&D	\$334	\$328	\$239	\$423	\$802	! R&D set at 8% of sales, mature pharmaceutical company
EBIT	\$2,463	\$492	\$2,051	\$904	\$3,514	
EBIT (1-t)					\$2,460	Based upon tax rate of 30% (steady state)
Reinvestment needed for 2.25% growth					\$615	Estimated using a return on capital of 9%



# Valeant: My Valuation in November 2016

## Valeant: Valuation on November 9, 2016





# Faith versus Feedback: The Balancing Act

1. Faith: As an investor, you are acting on faith when you invest, faith in your assessment of value and faith that the market price will move towards that value.
  2. Feedback: As an investor, you have to be open to feedback, i.e., accept that your story (and valuation) are wrong and that market movements in the wrong direction are a signal that you should be revisiting your valuation.
- The Balance: You need both faith and feedback in investing and too much of one at the expense of the other can be dangerous.
    - Faith without feedback can lead to doubling down or tripling down on your initial investment bet, blind to both new information and your own oversights, and that righteous pathway can lead to investment hell.
    - Feedback without faith will cause an endless loop where market price changes drive your value and your holding period will be measured in days and weeks instead of months or years.

1.



# The Balancing Act with Valeant

- The Feedback effect: I underestimated how long it would take Valeant to put its past behind it and to revalue the company with my updated story and that is what I tried to do.
- That Faith effect: Since it led me to buy the stock at \$27, when my estimated value was \$43 in May 2016, it should lead me to buy even more at \$15, with my estimated value at \$32.50. So, I doubled my Valeant holdings and some of you will undoubtedly call my attention to this post, especially if the stock continues to slide.