

See the Forest for its Cash



by Henry W. Schacht, CFA

July 27, 2009

The following is an update to my analysis of Forest Labs (FRX) and a compilation of related posts on www.lonelyvalue.com

Forest Labs (FRX) may be the cheapest company I've ever seen. Best known for the anti-depressant Lexipro, the company faces questions about upcoming patent protection losses, pipeline issues, etc. At the current valuation, none of this matters.

Here's why:

Current share price = \$25.80

Share outstanding = 301.7 million

Market capitalization = \$7.8 billion

Total Debt = 0

Defined Benefit Pension Plan: None

Cash and Marketable Securities = \$3.4 billion

Cash and marketable securities of \$3.4 billion? Yes, over \$11 per share. And cash increased \$370 million in the last quarter alone.

Mr. Market says the underlying operating business of FRX is worth just \$4 billion; a business that generated over \$800 million in free cash flow last year. (Note: I made some working capital adjustments. Look at the raw data.) Cash flow from operations (CFO) was over \$1 billion and capital expenditures (CapEx) were just \$40 million.

Even if Lexipro completely disappears in a few years, Forest Labs is ridiculously valued. It's priced for liquidation (or worse). Lexipro will most likely generate more cash than the entire company is worth prior to its patent expiration. You're essentially getting an option on the non-cash, non-Lexipro business for free (or less).

What is the investment community missing? Can they count? Does anyone read financial statements anymore? There is no cleaner balance sheet in Corporate America.

Bruce Berkowitz of the Fairholme Fund gets it. He owns 20 million shares so I'm in good company.

Some of my confidence has to do with great corporate leadership from CEO Howard Solomon to CFO Frank Perier. My award (so far) for the "Best 2009 Letter to

Shareholders” goes to Mr. Solomon. Very rarely is a CEO's letter more than a puff marketing piece. Solomon's letter gives you a window into the company's soul. Read it. A rare shareholder letter; one that is worth your time.

Why is FRX different than other drug companies? He tells you.
What drives the company's decisions? He tells you.
How will value be created for shareholders? He tells you.

I'd love to know what European pharmaceutical company he's talking about. Any ideas?

Here's one particularly good quote on the motivation of many company leaders.

"And that lust for size, the playground of so many executives, and the emoluments of size, which has so often characterized industry in the United States and all over the world, is a significant cause of the worldwide economic disaster we are currently suffering: banks, investment firms, corporations, expanding into uncontrollable dimensions and not knowing what they are acquiring in their expansion; mergers and acquisitions resulting in bloated payrolls and factories and geography. And with it, the misplaced assumptions that management, motivation, competence and employee commitment and performance, on which real value ultimately depends, would just happen as a result of greater and greater size.

In fact, in so many cases just the opposite is true. That kind of growth, that is too rapid, often based on mergers and acquisitions with their inevitable dilution and operational disruption and internal rivalries, and rapid operational expansion at a rate that can't be managed, and all of it often depending on accumulated debt, and overvalued, sometimes grossly overvalued, goodwill which sooner or later has to be adjusted, rarely ultimately benefits either employees or shareholders."

Solomon won't win any awards for syntax, but he's setting the right tone at Forest Labs. The contrast between Forest and its peers could not be clearer. If only more investors realized it. My assumptions about this company are anything but misplaced.

“If a tree falls in the Forest and no one is around to hear it, does it make a sound?”

A lot of trees are falling at Forest Labs. Are you listening?

Disclosure: At the time of publication, the author owned shares of Forest Labs personally and on behalf of clients.

Henry W. Schacht, CFA is the founder of Schacht Value Investors, an investment management firm. He earned his MBA at the University Of Chicago Graduate School of Business and a degree in finance from the University of Notre Dame. Check out his blog @ www.lonelyvalue.com

Contact: Schacht Value Investors, LLC, www.schachtvalue.com