This article by Matthew Haynes is excerpted from a letter of [1949 Value Advisors](), an absolute return-oriented global value investment firm based in Mahwah, New Jersey. Matt is a valued contributor to [The Zurich Project]().

[We initiated] a position in Shire plc following a 43% decline in its share price since August 2015.

We have not owned a pharmaceutical stock in many years. We have looked into several in the last year as almost all have suffered significant share price declines in recent years, but have elected to pass as key elements that we look for were missing.

With Shire plc, we believe that we've found an attractive investment opportunity in a high quality company suffering under a few short term clouds that should dissipate over time and unlock value. Its depressed share price and valuation at the time of our purchase implied very little potential downside, while its longer term prospects could provide meaningful upside. Good things often happen to cheap stocks, but we must first understand the issues.

First, its indebted balance sheet is the by-product of several recent acquisitions, the largest being its $35 billion purchase of Baxalta in 2016. Shire paid a hefty multiple for Baxalta (30X trailing EBIT, according to Bloomberg) and gained key products in hemophilia, but the debt burden has weighed heavily on Shire's share price.

In addition, Baxalta's leading drugs will face competitive pressure from the recent launch of Roche's Hemlibra.

Fortunately, Shire's other businesses generate significant free cash flow and the company allocates much of it toward debt reduction. Consensus estimates for free cash flow imply that Shire's balance sheet could be debt free by year-end 2021. This deleveraging alone, assuming the current (depressed) multiple on EBIT remains constant, and using consensus EBIT estimates for 2021, could drive shares 67% higher over the next four years.

We would argue that post-deleveraging, the current depressed multiples on EBIT and earnings are no longer warranted and Shire shares should re-rate higher reflecting its diminished financial risk, providing additional material upside. Shire's average EV/EBIT multiple over the last seven years has been 14, versus less than 10 at the time of our purchase, implying 100% upside over the next four years if consensus EBIT estimates are near the mark and deleveraging proceeds accordingly.

Lastly, Shire has been the subject of takeover speculation in recent months, following a failed bid by AbbVie in 2014 after the U.S. Treasury Department announced new rules taking aim at tax inversion deals. On January 1st of this year, Shire started accounting for its neuroscience business separately, implying the likelihood of a separation via tax-free spin-off or an outright sale. In either case, we believe that value would be unlocked as this business is worth considerably more than its implied value within Shire.

We would prefer a sale of this business as it would accelerate the company's deleveraging,

which we view as critical to realizing greater equity valuation. At the time of our purchase, we viewed Shire becoming a bid target as remote simply because of its size and the very limited number of global pharmaceutical companies large enough to acquire it.

To our surprise, shortly after building a full position, Takeda Pharmaceutical of Japan announced its interest in acquiring Shire plc. As of this writing, Takeda's fifth offer in as many weeks is being considered by the Shire plc Board of Directors, representing a 50% premium to the undisturbed share price. If Takeda's bid proves unsuccessful, it will have served to highlight the dramatic undervaluation of Shire plc.

We expect that the 50% premium offered by Takeda will have a significant positive impact on investor perceptions of the value of the company's assets and cash flows.

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