Why I'm Considering Selling Magna

Description

Shares of **Magna International** (TSX:MG,NYSE:MGA) have been on fire and the company's recently released quarterly results only fanned the flames. Year-to-date the stock has moved ahead by 31%, with 3.5% or so of this move occurring after results were released on Friday.

Magna is primarily benefitting from a rebound in the North American auto sector. The industry went into a well-documented funk during the 2008/09 recessionary period but has slowly but surely clawed its way out of the hole it was in.

Magna's quarterly results also benefitted from better than expected operating results from its sizeable European division. The European business has acted as a bit of an anchor for Magna's stock. A sign of improvement from this division was warmly received by Magna shareholders, of which I am one.

The investment case

Being a Magna shareholder over the past couple years has been a pretty enjoyable experience. However, this is not a stock that can be trusted. The company does after all participate in one of the most volatile, economically sensitive industries going. Given the industry's dynamics, Magna requires some vigilance to ensure the investment case continues to stick.

Aside from the many positive attributes attached to the Magna story (clean balance sheet, great management, diversification, etc.), I bought Magna primarily because of its valuation.

At the time, shares were trading at a price/sales multiple right around 0.30. Outside of the 2008/09 period, this represented the bottom of the company's historical range for this multiple. The combination of an improving economic environment and rock bottom valuation seemed appealing.

Fast forward to today and Magna's price/sales multiple stands at 0.48. Including the great recession, the 10 year average for this multiple has been 0.37. Relative to its historic mean, Magna's sales multiple looks a tad stretched.

Return drivers

To assume Magna's shares are going to continue higher, we need to believe in some combination of revenue growth, multiple growth, and dividend yield. Given its balance sheet, the dividend is solid. Based on my cost base, that's going to generate a return of about 3.8% per year.

As for revenue growth, the current consensus is for an increase of 6.8% in 2013 and 4.2% in 2014. Call it 5% per year. So, we're up to an expected annual return of almost 9%, at least over the next couple years.

The big issue however is the multiple. Does Magna's revenue multiple remain at a level well above its historic mean, or, do we get a whiff of economic softness at some point in the next couple years that could result in this multiple retreating to say 0.4x? If we apply this more mean like multiple to current 2014 consensus revenues, we get a market price for Magna (assuming current shares) of just $59, 10% lower than the current price.

The Foolish Bottom Line

Magna is a great company but it plays in a tough industry. The stock is cyclical and the way to play it is to buy when it's depressed and walk away when it's not. Personally, I wouldn't buy Magna at today's price, and given the potential for multiple compression, this ride appears to have almost come to a complete stop.

For 3 stock ideas that require far less vigilance than investing in Magna, **click here** and we'll send you our special **FREE** report "**3 U.S. Stocks Every Canadian Should Own**" – **FREE!**

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Fool contributor Iain Butler owns Magna shares. The Motley Fool has no positions in the stocks mentioned above.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:MGA (Magna International Inc.)
2. TSX:MG (Magna International Inc.)

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