Aritzia Inc.: Its Profits Are Lacking

Description

While **Aritzia Inc.** (TSX:ATZ) had a strong first day as a public company closing October 3, trading up 11%, I personally thought it would do much better.

In an article leading up to its IPO, I predicted that Aritzia would open at $22, well above its $16 pricing; it actually opened trading at just under $19, moved up a nickel, and then slid back below $18 by the end of the day. Given how little IPO action there's been in the past year, I was convinced that investors would be sucked in by its "Made in Canada" growth story. I was wrong.

Is it simply that investors loathe retail right now? Or is there something else that keeps people from doubling down on Aritzia stock? I believe it's a little of both.

But for the purposes of this article, let's look at Aritzia's profitability and why that may be causing second thoughts among investors.

Aritzia delivered its second-quarter results October 12; they were generally quite impressive, led by 16.9% same-store sales growth that followed on top of even stronger growth (up 20.8%) a year earlier. Meanwhile, net revenue increased by 30.1% year over year. The top line was certainly buzzing.

Even the bottom line appears to be healthy at first glance with adjusted EBITDA and adjusted net income up 20.4% and 42.5%, respectively. A closer look, however, should cause you to pause.

As Fool.ca contributor Demetris Afxentiou pointed out in his recent article, Aritzia's gross margin in Q2 2016 was 35.9%—160 basis points higher than in Q2 2015. That's the good news. The bad news, as I see it, is they should be higher.

In the past three fiscal years—chronologically from oldest to newest—Aritzia's gross margin has been 40.5%, 37.3%, and 36.6%, respectively. So, even though sales have increased by 44%, or $166 million, gross margins have declined by 390 basis points.

Lululemon Athletica Inc.'s (NASDAQ:LULU) gross margins in the three fiscal years leading up to its IPO in July 2007 were 52.3% (2004), 51.1% (2005) and 51.0% (2006)—a decline of 130 basis points, or about one-third the decline experienced by Aritzia.

Comparing LULU to ATZ is a bit of an apples-to-oranges exercise because Lululemon only sells its own brand, while Aritzia sells clothing made by other popular apparel manufacturers; naturally, its margins are going to be lower.

Fair enough.

So, let's consider **Buckle Inc.** (NYSE:BKE), a Nebraska-based specialty retailer that sells a little of both, just like Aritzia, only at lower price points. Its gross margins are in the mid to low 40s despite double-digit same-store sales declines. Even farther down the income statement, Buckle's operating margin (19%) is double Aritzia's fiscal 2015 operating margin of 9.7%. Despite opening nine stores in fiscal 2015, that's the same number as Aritzia did this past year.

Sure, Aritzia spends more money on its stores than Buckle, not to mention it locates in nicer malls, so the opening costs are a lot higher, but you'd think they could at least get operating margins into the mid teens after 32 years in business.

Aritzia's growth story is a good one. However, it's profits are lacking. For this reason, as Kevin O'Leary would say, I'm out.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NASDAQ:LULU (Lululemon Athletica Inc.)

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