Time to Own the Best Retailer Not Yet in Canada

Description

Over the years many U.S.-based retailers have opened stores in Canada with varying degrees of success. One of the most successful is **Costco Wholesale Corporation** (NASDAQ:COST), which first opened a store in Canada in 1985 and now has 94 warehouse locations across the country generating higher revenue per capita and operating profits than its own domestic market.

Other examples that have done well include **Home Depot Inc.**, **TJX Companies Inc.,** and **L Brands Inc**. Investors have seen these businesses expand across Canada; those who were smart bought stock in these companies and rode their success to investment profits.

Retail is in the doldrums at the moment, so I understand the reluctance on the part of investors to commit funds to anything related to brick-and-mortar retail. However, there is a retailer in the U.S. that operates in 49 states and is growing tremendously fast thanks to a business model that leans on the consumers' preference for experiences, not just buying stuff.

I'm talking about **Ulta Beauty Inc.** (NASDAQ:ULTA), an operator of 974 stores across the U.S. that sell more than 20,000 skincare and beauty products from more than 500 brands in a 10,000 square foot store with 10% set aside for a full-service hair salon.

Think Sephora and more.

Controlling just 4% of the $127 billion U.S. beauty market, Ulta Beauty has got plenty of room to grow. In 2016, Ulta Beauty opened 100 stores; it plans to open the same amount in 2017, all of them in the U.S. While Canada is not yet on Ulta Beauty's radar, it should be, because like Costco, I see Canadians taking to the concept in a big way.

Ulta Beauty is using omni-channel retail the right way to generate top- and bottom-line growth. The average customer who shops in store only spends US$177 annually, while the average customer who shops online only spends US$112 per year. However, the average customer who does both spends US$474 annually — 2.7 times more than the customer who only shops in the store.

Most omni-channel retailers rob Peter to pay Paul. In other words, e-commerce benefits at the expense of brick-and-mortar retail with overall revenues flat-lining.

It's a big reason why Ulta Beauty expects same-store sales and e-commerce sales to grow by at least 8% and 40%, respectively, in 2017. In fiscal 2016, e-commerce sales grew 56.2% to US$345.3 million, accounting for 240 basis points of its 15.8% same-store sales growth.

Bottom line, it had fiscal 2016 operating income of US$224.2 million on revenues of US$1.6 billion for an operating margin of 14.2% — 80 basis points higher than a year earlier. With US$385 million in cash and no debt, it has plenty to finance its future growth.

So, why wouldn't it come to Canada? There are two reasons.

The first is that the average store requires a US$1.4 million investment. With real estate leasing costs more expensive north of the border, it would take longer to recover its initial investment than the typical two-year payback. The second, and probably bigger, argument is that it expects as many as 1,700 stores in the U.S. At its current pace, opening 100 stores per year, it would take seven years to max out its brick-and-mortar footprint.

Bottom line

The best time to invest in any sector is when fear is running rampant. Despite reasonably strong consumer confidence in the U.S., retailers continue to lose customers, putting many famous names into bankruptcy.

While it isn't pretty, I would suggest that Ulta Beauty stock, even at a hefty 3.7 price-to-sales ratio, is better to own than almost every retail stock listed on the TSX with the possible exception of **Dollarama Inc.**

Whether Ulta Beauty comes to Canada or not, I believe you'll make money over the next two to three years.

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