AutoCanada Inc.: An Example of How Unforgiving Rich Valuations Can Be

Description

From the time that I started looking at **AutoCanada Inc.** (TSX:ACQ) back in 2014, the stock has been trading at really rich valuations and almost seemed to be priced for perfection for a while. In the summer of 2014, the stock was trading at over 30 times earnings. Keep in mind, AutoCanada operates in the automotive industry — a highly cyclical industry which is notorious for its volatility. Also, we have enjoyed many years of strength in this industry, so the risk to investing was and is increased.

Missed expectations

At this point, we have seen that in the last four quarters the company has missed expectations, as the growth in the business was not as strong as investors and the company itself expected. The weakness in Alberta when the oil crisis hit and, more recently, weakness in the Canadian auto market overall are to blame. The company's 54 dealerships have pretty much performed below expectations. Same-store revenue declined over 10% in markets such as British Columbia, Ontario, and the Maritimes as auto sales across the country have weakened significantly.

So, what has been happening is that estimates have been ratcheted downwards. The company ended up reporting EPS of $1.45 in 2016 compared to $2.23 in 2014, and the downward trend does not appear to be over yet. The stock declined 74% from its highs in 2014, and we are left with the decision of what to do next. Should we add on weakness, or should we stay on the sidelines?

Well, the market remains fragmented, which leaves AutoCanada in a good position to continue to be the consolidator. But at this point, the balance sheet is very highly levered with a total-debt-to-capitalization ratio of 65%, and the valuation remains questionable.

The P/E ratio on the stock is currently 13.6 times this year's earnings, which is way more reasonable than what it back in 2014, but given the cyclical nature of the company's business, and especially given that we are coming off cyclical highs in the auto industry, it still looks high to me. So, while this valuation is way more compelling than at any time in recent history, earnings are on their way down, and, in my view, that is not a time to add a position in a stock.

This mixed with the company's balance sheet, which getting more and more levered, gives me pause. I would definitely put this stock on my watch list, however, because I like the fact that the company has successfully driven consolidation in the industry. If and when the stock trades at single-digit P/E multiples, which is more in line with its peers, I would give it another look. Patience is key.

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