Red Flag: When Stocks Trade Lower on Strong Results

Description

CCL Industries Inc.'s (TSX:CCL.B) results were strong, no doubt, but is the fact that the stock went lower after these results a red flag, or is it just normal day-to-day short-term movements that mean nothing? Is the stock's valuation reflecting unrealistically high growth rates?

There are many reasons to be bullish on CCL Industries. The company has acted as the consolidator of its industry as well as expanded geographically and into different product markets. The company has grown revenue of $1.2 billion in 2009 to revenue of $3.97 billion in 2016 for a cumulative annual growth rate of almost 20%.

The corresponding increase in free cash flow has been even more impressive. In 2009, the company generated $52.3 million in free cash flow; in 2015, it generated $329 million. And during this period, the stock increased from $30 to its current price of almost $311 per share.

The dividend has been raised regularly throughout the company's history from an annual dividend per share of $0.40 in 2005 to an annual dividend of $2.30 currently for a cumulative average growth rate of 16%.

So, in the first quarter of 2017, CCL reported a 22.5% increase in sales, mostly due to the acquisition of Checkpoint Systems in 2016, but the increase is also a reflection of a 2.1% organic growth rate.

The issue that comes to my mind is that the company has relied on acquisitions to get the kind of growth it has been seeing. Organic growth for its business is much lower 2.1% in this quarter. And the balance sheet is becoming more levered with a debt-to-total-capitalization ratio of almost 50%. Although the company has over $580 million in cash and a net-debt-to-EBITDA ratio of 2.5 times, the $2.7 billion in debt can start to become a problem.

So, valuation-wise, the shares trade at a P/E ratio of 27 times this year's consensus earnings expectation and 24 times next year's earnings. That's reasonable given the growth the company has been able to achieve in recent history, but if acquisitions were to slow down, so would the company's growth rate, meaning that this multiple would be too high, and that we should expect multiple contraction.

So, the fact that the stock declined 1.4% after these results could just be a reflection that the market was somewhat lower yesterday, or it could be a sign that valuations are too high. Time will tell, but one thing that is for sure is that these valuations increase the risk on the stock.

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