



Will the Bears Eat High Liner Foods Inc.?

Description

While I agree that boring businesses often make the best investments, **High Liner Foods Inc.** ([TSX:HLF](#)) just had a quarter that was almost too exciting for my liking. Despite posting earnings results which were less than stellar, along with announcing a product recall for breaded fish and seafood products due to an undeclared allergen, the company's stock price has climbed by 11.5% since its earnings release on May 10 close.

Here's why I believe some of the recent developments in High Liner make this company a speculative play, and one which is likely to see continued volatility moving forward.

Business fundamentals more volatile than long-term investors would like

One thing long-term investors look for is stability, strength, and key long-term fundamentals of staple businesses in sectors such as food and beverage. Fundamentals such as gross and net margins are important in providing investors with a clear picture of how the company has performed over time from an operations standpoint compared to its peers.

A competitive advantage, or "moat," as Warren Buffett frequently cites, is critical in determining how a company will be able to survive and hopefully thrive in the long term; the respective strength (or lack thereof) of margins is typically indicative of the strength of a company's competitive advantage over time.

In High Liner's most recent quarterly earnings, investors can see a deterioration with respect to its gross and net margins; the company's gross margin dropped 240 basis points from 22.5% to 20.1%, and the company's razor-thin net margin decreased from 4.5% to 3.6%. Those are both material drops.

Revenue and earnings were both down materially. A large drop in the company's EBITDA of 28.3% was particularly concerning from the perspective of a long-term investor factoring in EBITDA and free cash flow into a discounted cash flow model.

The company noted that most of the difference in sales and earnings can be attributed to a later lent/Easter season this year over last year; however, the company did note that plant inefficiencies and

an announced product recall are two material factors that have affected these numbers. All indications are that these reduced margins may not rebound to previous levels quickly, as High Liner announced an acquisition during the period which is likely to cause some transitional friction in the short term.

Bottom line

High Liner is operating in a competitive industry with thin margins. After seeing significant margin deterioration this last period and factoring in the likelihood of continued margin deterioration moving forward, I am bearish on the long-term ability of this company to grow its bottom line. I believe the “accretive” nature of the acquisition this past quarter is likely to be more than overshadowed by transitional frictions, and I do not see significant margin improvement or free cash flow improvements moving forward, making this company one I would avoid for the time being.

Stay Foolish, my friends.

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