Did Canada Goose Holdings Inc. Just Lay an Egg?

Description

In recent months, my views regarding **Canada Goose Holdings Inc.** (TSX:GOOS)(NYSE:GOOS) have mellowed considerably to the point where I've gone on record recommending its stock.

That's a far cry from where I stood last October, when I threw out every reason but the kitchen sink as to why investors should stay away from outdoor-wear manufacturer.

"My advice is to tread lightly when and if the Canada Goose prospectus comes out, because if you thought the Aritzia IPO was expensive, Canada Goose is going to be off the charts," I wrote October 19. "In that scenario, the selling shareholders (Bain Capital, company founders) win, while everyone else loses."

I also recommended that investors tread carefully around the **Aritzia Inc.** (TSX:ATZ) IPO, which I thought would open around $22 — six bucks higher than its IPO price, and then head below $16 over the next 12 months.

Aritzia opened trading October 3 at $19, closing the day up 11% from its IPO price. It then proceeded to climb as high as $19.40 later that month; it's been downhill ever since, now trading around $13 with the potential to fall even further.

Meanwhile, Canada Goose went public in March at $17, and it's up 48% in just five months. Boy, did I get that wrong!

Can it go higher?

I wouldn't have thought so last fall, but I've begun to change my tune. One of the things altering my viewpoint, funnily enough, is Canada Goose's money-losing second-quarter report.

Fool.ca contributor David Jagielski recently discussed the many reasons why investors should stay away from the company's stock, the biggest being rising interest rates, which will simultaneously increase the company's interest expense burden while putting a damper on consumer spending.

David has a point that would be stronger if we lived in a linear world, where people's buying patterns are predictable. Unfortunately, that's simply not the case. We might think sales of high-priced items would drop in times of higher interest rates or slow economic activity, but real-world examples, such as luxury retail conglomerate **LVMH**, suggest it's not so clear cut.

Let's consider Canada Goose's Q2 report

The company's operating loss was $17.9 million — the same as a year earlier on 80% more revenue. It delivered $12.5 million in additional revenue with no benefit to the bottom line.

On the surface, it's an alarming situation made worse by the fact its gross margins improved by 17 percentage points to 46.9%. On a trailing 12-month basis, Canada Goose's gross margins are now on par with **Lululemon Athletica Inc.** (NASDAQ:LULU) at about 52%.

Yet it continues to lose money.

But here's where the two companies' stories diverge.

Lululemon is an established brand with a strong retail network, a small wholesale business, and a growing e-commerce operation.

Canada Goose is an established brand with a growing retail network, a strong wholesale business, and a blossoming e-commerce division.

Spending 43% more year over year on operating expenses is necessary to scale its activities. It costs money to open these stores — very little of which has anything to do with gross margins: the profit you make from each piece of clothing.

However, consider that its operating ratio in the second quarter dropped from 115% to 92% — a number to keep watching in subsequent quarters. I think you'll find it will keep declining as revenues continue to climb.

It's all about scale.

As I commented in my latest article about Canada Goose, the company is not looking to build a store network as broad as Lululemon's. It's only looking for busy locations in various world-class cities, where its target customer frequently shops, such as Yorkdale Mall.

As long as its wholesale and e-commerce segments continue to grow at a healthy clip, I don't see the company running into financial difficulties, despite higher levels of debt.

As of the end of June, it had $234 million in long-term debt, which is less than 10% of its market cap. If that number gets to 50%, then maybe I'd start to worry, but right now, it's business is looking good.

Personally, I won't own its stock because of the whole cruelty-to-animals thing, but if you don't have a problem with that, I'd be loading up on it if it ever falls back to its $17 IPO price.

That likely won't happen without a recession.

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