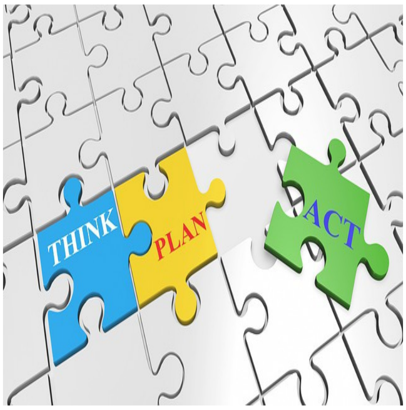

Why Canadian Tire Corporation Limited Is Overvalued and North West Company Inc. Is a Steal

Description

The past five years have sent shares of **Canadian Tire Corporation Limited** (TSX:CTC.A) on a fantastic bull run. It's doubled in price in addition to offering investors an increasing dividend. As there are many ways to analyze a publicly traded security, this retailer is a fantastic example to use when applying the dividend discount model (DDM).

For investors looking exclusively at dividend growth, the track record of this retailer over the past four years has been outstanding. With a current quarterly dividend of $0.65 per share, the compounded annual growth rate (CAGR) of the annual dividend from fiscal 2013 to 2016 was 18%, which has led the company to a higher dividend-payout ratio. Although this is perfectly acceptable over the long term, investors may not be able to use 18% as a growth rate in the DDM, as it is not a sustainable long-term growth rate.

Net earnings have increased over the same period at a rate of 6%, while revenues increased at a rate of 2.5%. Although it would be nice to use 6% as the sustainable long-term growth rate, the reality is that a company like Canadian Tire will not be able to grow at that rate for an extended period of time. Instead, it is much more reasonable to use a growth rate of 4%. Given this growth rate, the DDM calculation that allows us to arrive at a fair value per share will be:

$2.60 (1.04) / 0.06 – 0.04 = $135.20 of share value.

According to the calculation, the current share price of $145 is too high for an investor seeking a 6% rate of return. Let's run through the formula.

The $2.60 is the current dividend paid per share, which is then grown by the long-term growth rate of 4% over the next year. According to the DDM, the current share price is based on next year's dividend. The denominator is the investor's required rate of return of 6% minus the growth rate of the company (or the dividend) which is 4%. The denominator is 2%. In order to arrive at a fair value of $135.20 per share, we divide next year's dividend of $2.704 by 0.02 (or 2%).

When evaluating shares of **North West Company Inc.** (TSX:NWC) in the same way, the result is a little different. Given that the company's dividend grew at a rate of 3.45% from fiscal 2013 to 2016, and the most recent annual dividend was $1.24 annually, we can estimate the value of this company's share price as following (assuming we round the growth rate to 3.5%):

$1.24 (1.035) / 0.06 – 0.035 = $51.34 per share.

North West Company is currently trading at a price of $30 per share. Investors may now be getting a steal, assuming they will be content with a long-term return of 6%.

Investors, of course, must remember the difference between Canadian Tire and North West Company. Canadian Tire is a big-box retailer with a number of gas stations and Mark's Work Warehouse stores under its name, while North West Company is a grocery store which operates mainly in remote regions of Canada and Alaska.

With a simple way to evaluate the share price, investors will gain a lot by beginning with this formula before conducting a deeper dive into each name before buying.

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