3 Reasons You Should Avoid Finning International Inc.

Description

Finning International Inc. (TSX:FTT) is involved in selling, renting, and servicing heavy equipment and other products in many parts of the world. Although the company is diversified in its geography and saw 20% revenue growth in the past quarter, there are still three big reasons I would avoid this stock.

Demand for products is tied to volatile commodity prices

The company's top line saw a big increase this past quarter as mining operations and the oil sands drove demand up as a result of better commodity prices and more stability in oil and gas. Another reason for the improved performance was because the prior year was impacted by the wildfires in Alberta, which led to a decline in sales.

One big problem I see right away is a dependence on a struggling oil and gas industry, where I wouldn't expect a big recovery to happen anytime soon (if at all), and things may even get worse as hedging contracts expire. Finning clearly has a great deal of exposure in a province that is heavily affected by oil and gas prices, and this is a big negative for me.

The other problem is that mining operations are also big drivers of demand for the company's products and services, which are also impacted by commodity prices. As an investor, that's a great deal of exposure to commodities I would prefer to avoid. Right now, commodity prices are on the rise, and so mining is going to see an increase, but next year that could change.

There are too many external factors that could negatively impact the company's performance, and this creates a lot of inherent risk that I would just rather avoid.

Financial performance has not been strong

In the past two years, the company's revenue has dropped by 18%, and last year's sales were down about 10% as well. In addition to struggling sales, the company's bottom line has been very poor with profits of just $65 million in the past year, or 1% of total sales. In 2015, Finning posted a net loss, while in the previous three years, it yielded slightly better profit margins that averaged a little under 5%.

It's perhaps not a surprise that the company has struggled to turn healthy profits with its cost of sales averaging over 70% in the past five years. Although commodity prices will have a big impact on the company's margins, Finning's gross profits have actually been consistently at about 29% and lower. A company that has low gross margins won't have much left over for overhead costs and could struggle to be profitable, which has been the case with Finning.

The stock is expensive and has seen lots of volatility

The company's share price has increased 5% this calendar year and is up over 15% in the past 12 months. However, over the last 10 years, the stock has declined by over 16% and seen many swings in its share price along the way. Finning's stock currently trades at over 31 times its earnings and 2.4 times its book value, and both are high multiples for a company with declining sales and poor profitability.

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Date
2025/07/02
Date Created
2017/09/19
Author
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