
# Is Roots Corp. a Buy After Solid Q3 2017 Earnings?

## Description

Fool.ca contributor Joey Frenette recommended that investors buy a half position in **Roots Corp.** (TSX:ROOT) before announcing its earnings December 5, arguing that the iconic nature of the Roots brand in Canada will keep it from the retail graveyard.



"If you're a believer in the power of the Roots brand, I'd recommend buying half a position before earnings with the intention of buying the other half should earnings come short of expectations," wrote Frenette. "If earnings are a beat, then you may want to wait for a pullback before buying the second half of your position."

Well, Roots earnings were excellent, sending its stock as high as $10.85 in heavy trading — its highest level since falling below $9 in early November.

Frenette is reasonably enthusiastic about the company's future. While I don't have any doubt it will remain a player in Canadian retail for years to come, I was very skeptical about the IPO.

Has Q3 2017 changed my mind? Let's have a look.

**The three main numbers**

Same-store sales grew 10.1% in the quarter over last year, gross margins increased by 180 basis points to 54.9% from Q3 2016, and adjusted EBITDA rose 20.5% to $16.3 million.

Any time you can deliver double-digit growth in all three of these areas, you've done well.

Let's consider how both **Aritzia Inc.** (TSX:ATZ) and **Canada Goose Holdings Inc.** (TSX:GOOS)( NYSE:GOOS) did in their first quarterly reports as public companies.

Aritzia's second quarter of fiscal 2017 saw it grow same-store sales by 16.9%, gross margins increased by 160 basis points to 35.9%, and adjusted EBITDA rose 20.4% to $19.8 million.

Canada Goose's fourth quarter of fiscal 2017 saw revenue increase 21.9% (it only opened its first two retail stores in the fall of 2016, so there were no comparables), gross margins increased by 950 basis points to 54.4%, and its adjusted EBITDA loss increased by 50.0% to -$11.4 million. However, on an annual basis, it had an adjusted EBITDA profit of $81.0 million, 49.2% higher than a year earlier.

So, given the different times of year for all three going public, it's a bit of an apples-to-oranges comparison.

Nonetheless, each of the companies' first reports was reasonably solid, so I don't think one can say too much about Roots that's negative at this point.

It did what it needed to in the third quarter, and its stock is rebounding as a result.

**My two concerns**

As I stated in mid-September before Roots issuing its final prospectus, I was concerned about its debt and its valuation.

At the end of July, its debt was $122 million. At the end of October, it was $112 million or 8.2% lower. That's a good sign, and it's only 20% of its enterprise value, so as long as it continues to grow same-store sales, I'm not quite as concerned as I was before the IPO.



As for valuation, I had a problem with a multiple of 12.1 times its 2019 adjusted EBITDA estimate of $68 million. However, that was based on pre-IPO valuation speculation that put its enterprise value at $823 million.

At an enterprise value of $554 million, the multiple is just 8.1 times its 2019 estimate. That's much more appropriate given its growth.

**Bottom line on Roots stock**

Now that I've had a chance to digest Roots's latest financials, everything Frenette said about the company is 100% on the mark.

My only concern with the company would be its U.S. expansion. Except for **Lululemon Athletica Inc.**, Canadian retailers haven't done a great job south of the border, where there are a lot more retail square feet per capita. That can go sideways in a hurry.

But for now, I'll give Roots stock the thumbs up.

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