



This Cheap TSX Stock Is No Value Trap

Description

Indigo Books & Music Inc. ([TSX:IDG](#)) currently has a forward price-to-earnings ratio of 15.2 — identical to the TSX.

How's that cheap, you ask? Bear with me as I explain.

The usual suspects

If you look at the usual financial valuation metrics, such as the P/E ratio, you're definitely going to find a better value out there. **Canadian Tire Corporation Limited** ([TSX:CTC.A](#)), for example, has a forward P/E of 14.1, which, for some investors, would put an end to any serious consideration of Indigo stock.

However, the P/E ratio, forward or trailing, has become one of the least-valuable metrics in an investors' toolkit in recent years. That's because you're either using data from the past in the case of the P/E ratio, which has little bearing on the future, or you're estimating future earnings in the case of the forward P/E, and that can be equally misleading.

"The forward P/E ratio (a company's market cap divided by its estimated coming year's profit) may also be meaningless," [wrote](#) Fool.com contributor Adam Wiederman in 2012. "That's because for many of these same companies, future earnings can't adequately be estimated. Many companies consistently blow short-term expectations out of the water — so it's a fool's errand to estimate their growth over the long term."

Although it's a relatively old anecdote about the P/E ratio, nothing has changed in subsequent years, except for the fact that stocks as a group have gotten more expensive.

The other problem with P/E ratios is that earnings can be manipulated in a variety of different ways to make an income statement look better than it truly is.

Moving down the list, you've got price to sales, price to book, and price to cash flow. All can be helpful when trying to understand whether a stock is cheap or not.

But for me, free cash flow yield — defined as operating cash flow less capital expenditures required to maintain a business divided by enterprise value — is the best indicator of value.

Here's how Indigo becomes a value play

Canadian Tire, as I mentioned earlier, has a forward P/E that's lower than Indigo's. However, when I calculate its free cash flow yield, I get 2.5%. Inversely, its enterprise value is 40 times free cash flow. Indigo, however, has a free cash flow yield of 2.2%, which is 46 times free cash flow.

Again, Indigo appears to be more expensive than Canadian Tire.

However, when you consider that Indigo has zero debt and \$229 million in cash and short terms investments, which represents almost half its market cap of \$504 million compared to Canadian Tire, which has \$3.1 billion in debt and cash and short-term investments of just \$558 million, or 5% of its \$11.1 billion market cap, 46 times free cash flow doesn't truly reflect its value.

How so?

If you back out Indigo's cash and short-term investments, Indigo stock is trading at a little over eight times forward earnings. Do the same for Canadian Tire, and you get a little over 13 times forward earnings.

The bottom line on Indigo stock

Prior to the Christmas holidays, I'd [suggested](#) Indigo was the one retail stock to buy, believing that if the TSX ever got moving, which it hasn't, Indigo would be at the front of the line of stocks moving higher.

Despite the TSX going sideways over the past five months, Indigo has managed to gain almost 10%, which is great news if you own Indigo stock.

With Indigo's business generating record numbers, including same-store sales, which grew [7.9%](#) over the holidays, Indigo's stock is a lot cheaper than investors realize.

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2. TSX:IDG (Indigo Books & Music)

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