It’s Time to Buy This Back-to-School Stock

Description

If you’re looking for a beaten-down retail stock to put on your back-to-school buy list, **Roots Corp.** (TSX:ROOT) ought to be at the very top of it.

Let me explain.

First-quarter loss

It seems like only yesterday that I wondered if Roots’s stock was headed back to single digits after it announced a first-quarter adjusted loss of $0.11, two cents worse than the same quarter a year earlier.

Although I came to the conclusion that its stock was worth a lot more than $11 at the time of the article in mid-June, just after its first-quarter earnings, investors felt otherwise, sending it on its merry way down to $9 as I write this.

What the heck happened to justify a 21% haircut since announcing earnings? Did many of the Roots IPO shareholders abandon ship for greener pastures, such as **Canada Goose Holdings Inc.** or one of the other hot Canadian apparel brands?

It could be, but still, Roots deserves a better fate.

Its business is reasonably strong with potential opportunities in Asia, online, and possibly even in the U.S., where it’s opening more stores, despite the fact that Canadian brands tend to fail miserably south of the border.

If that pays off, its stock will quickly rebound into the high teens or even the $20s.

Am I missing something?

A margin of safety

As my Fool colleague, Joey Frenette recently stated, the downside for Roots stock if you buy between

$9 and $10 is negligible given the gross margins appear to be getting better and better.

Of course, we'll know more in September when it announces second-quarter earnings, but if you look at its three quarterly reports since going public in October 2017, it's delivered year-over-year gross margin improvements of 180, 100, and 320 basis points, respectively.

That's a sign it's selling a lot of product at full price, while maintaining a disciplined approach to its sourcing of materials.

Forget the money it's spending on stores and e-commerce, and focus on the gross margins, because if it can continue to sell its products at full price, the profits ultimately will come rushing in.

And this is coming from someone who wasn't very positive leading up to its IPO.

However, what it's doing with its online business, not to mention its same-store sales growth at its brick-and-mortar locations, suggests I might have been a bit harsh on one of Canada's most iconic brands.

At this point, I'd be a lot more inclined to invest in Roots than I would Tim Hortons' parent. But I digress.

What's the real issue?

This is only a theory, but the Roots IPO was October 25, 2017. The IPO lock-up would have ended 180 days after that; approximately the end of April.

Roots stock hit an all-time high of $13.55 on May 4, 2018, just days after the lock-up would have expired, freeing Searchlight Capital (20 million shares) and the founders (5.3 million shares) to unload some of their stock at prices above its $12 IPO price.

I wouldn't bet my life on it, but it's not unreasonable to think its largest shareholders would like to cash in some of their chips. That's especially true for Searchlight Capital, whose investors were probably looking for a return on their original investment to buy Roots in the first place.

The lock-up expiry doesn't always hurt a recent IPO, but it can.

The bottom line on Roots stock

Like my colleague, I believe you ought to buy in a big way. If earnings fail to excite, you can always get out at a small loss, but if they impress, which I think they will, your $9 buy is going to look very smart indeed.

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