This Canadian Retail Stock Has 53% Upside!

Description

Canada's retail landscape is a mixed bag. High-growth stocks such as **Canada Goose** and **Aritzia** have dominated industry returns. On the flip side, there have been several laggards such as **Reitmans Canada** and **Hudson's Bay**.

One of the most notable laggards in the space is Canadian icon **Roots** (TSX:ROOT). Since going public in October of last year, the company has lost approximately 19% of its value. Year to date, it has been one of the industry's worst performers as its share price is down 16.84%.

On Wednesday, the company reported second-quarter results. Has this Canadian staple lost its relevance in today's market place?

Second-quarter results

Analysts were expecting the company to post a quarterly loss of $0.02 per share and generate $64.06 million in revenues. Unfortunately, despite beating top-line estimates with $64.2 million in revenues, Roots posted a big miss on earnings per share (EPS). For the quarter, it posted an adjusted loss of $0.06 per share.

Outside the EPS miss, the greatest point of concern is slowing foot traffic. Higher gross margins and a one-time effect of Canada's 150 anniversary offset softer year-over-year store traffic. Don't expect traffic to improve. As per Jim Gabel, president and CEO of Roots, "negative store traffic trends are a concern in Q3."

It wasn't all bad. For starters, gross margins expanded to 55.1%, 180 basis points higher than the second quarter of 2017. This was due in larger part to greater direct-to-consumer (DTC) sales. Likewise, the company expanded its retail footprint with additional stores in Canada, the U.S., Taiwan, and China.

Despite negative traffic, the company re-affirmed guidance. At the mid-range of fiscal 2019 targets, Roots expects to grow sales to $430 million and net income to $37.5 million. This would result in a compound annual growth rate (CAGR) of 15% and 54% over fiscal 2017. The company is undergoing some significant operational changes with the aim of improving efficiencies. It's new Integrated Distribution Centre is expected to be up and running by mid-2019.

Valuation

Roots is currently trading at 23.1 times earnings and two times book value. In comparison, the industry averages are 64.3 and 3.2. It is important to keep in mind that these averages are inflated by some of the industry's high flyers. Canada Goose, as an example, is trading at almost 100 times earnings.

Where it gets interesting is, when you look at expected growth rates, the company appears cheap. On a forward basis, the company is trading at only 9.82 times earnings. Likewise, its P/E-to-growth (PEG) ratio is 0.98. A PEG below one indicates that its share price is not keeping up with expected growth rates. As such, it is considered to be undervalued.

Analysts have a one-year average price target of $14.32. This implies 53% upside from today's share price! Six rate the company a buy, three a hold, and there isn't a single sell call among them.

Roots has done a solid job of expanding its brand in Asia and DTC sales will continue to drive margin expansion. Assuming it reaches the expected 20% in operational savings from its new distribution facility, increased profitability will follow. The negative foot traffic is a real concern and worth monitoring, but I believe the sell-off to be overdone. Roots is still a top 10 brand in the country and its expected growth rates are in the top half of the industry.

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