Don’t Close the Book Completely on This Retail Stock

Description

Earlier this year, I asked a question about **Indigo Books & Music** (TSX:IDG), one of Canada’s best-known retailers.

The headline shouted, “How High Can Indigo Books & Music Inc. Fly?” In hindsight, the answer should have been “not very.” I explained to readers the things Indigo needed to do for IDG stock to revisit its all-time high of $35.50 set in May 1999.

Wow, was I off the mark. Currently trading at a 52-week low of $11.70 as I write this, IDG stock has lost 37% of its value year to date with only a handful of days left on the calendar.

Clearly, investors have turned the page on Indigo, but before you close the book on its stock, let’s consider the pros and cons of doing so.

The pros of closing the book

I’m not a technical analyst by any means, but a quick look at its stock chart shows how badly Indigo’s stock has broken down. It is trading well below its 50-day and 200-day moving averages for 2018; its 50-day moving average crossed below the 200-day moving average in late June. It’s been downhill ever since.

If I were a technical analyst, I probably would have shorted the stock, but I’m not, so I kept on recommending IDG into late summer, despite the fact it had lost 26% of its value between my March call and my August 25 reaffirmation of its business model.

Is it stubbornness on my part? Perhaps.

But on my recent visit back to Toronto at the end of October — I moved to Halifax in February — I checked out the renovations completed on its flagship store at Bay & Bloor; I was blown away by the look of it. It was a total upgrade to the old store. It was like night and day.

Renovations are welcome, I can hear the naysayers, but they don't pay the bills. Good, old-fashioned cash flow does, and Indigo doesn't have much of it.

Through the first six months of 2018, Indigo had negative cash flow of $47.2 million, 14% higher than a year earlier. In fiscal 2017, Indigo had cash flow of just $28 million. Unless it pulls a rabbit out of its hat in the second half, it's going to have less than that from a billion dollars in revenue.

When you look at Indigo's business from this perspective, it's hard not to be skeptical.

The cons of closing the book

It's always darkest before the dawn goes the expression. Indigo's stock has got to move higher. It's just got to. There's a bit of wishful thinking.

However, both analysts covering IDG have a "buy" rating on its stock. That's got to count for something. Wishful thinking … again.

However, the analysts believe that it's too early into the company's renovations — it's renovated 18 stores since 2016, including 12 in the latest quarter and another eight by the beginning of April — to close the book on the company.

The analysts estimate that renovations will increase sales at the affected stores by 20%, providing an excellent return on investment. However, there's more work to be done by CEO Heather Reisman before the efforts are declared a victory.

Coremark Securities analyst believes the sales hiccup due to renovations is a "short-term issue" and has a 12-month price target of $22. PI Financial analyst Bob Gibson has a $24.50 target price, believing its efforts in the kids and babies market could bear fruit; the same is true for its expansion into the U.S.

I continue to believe, like the analysts, that a reasonably well-run operation like Indigo deserves a share price in the $20s.

The final chapter

Most investors are laying off its stock until there's irrefutable evidence that the renovations are translating into growth. Until then, it's likely stuck in the low double digits.

Therefore, unless you absolutely can afford to lose money on Indigo, I'd wait until the evidence suggests the renovations are ringing up the cash registers. That's especially true in a volatile market like the one we're in at the moment.

While I believe in Indigo as a company, there's not enough of a margin of safety for my liking.

CATEGORY

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