Caution: This Stock May Be More at Risk From a Recession Than You Realize

Description

Canada is more than likely going to be in rough shape at some point. The Canadian government and citizens are engaging in record levels of borrowing. History generally indicates that periods of low interest rates are often accompanied by large amounts of debt. Large debt loads lead to high asset prices. Unfortunately, inflated asset prices can deflate rather quickly when prices begin to turn lower and debt begins to become unsustainable.

While it is impossible to determine the timing of a debt collapse and a potential recession, it is possible to see if there is a high likelihood of its occurrence. Some companies are closely linked to economic strength. Restaurants, movie theatres, and other recipients of discretionary spending will likely be hit hard if there is a recession in Canada.

Companies that sell food are often thought to be more resistant to recessions. Although this is generally true, **MTY Food Group** (TSX:MTY) operates in a relatively riskier arena. The restaurants it owns, such as Baton Rouge, Mr. Sub, and Thai Express, are more often the recipient of discretionary income. This makes them potentially more at risk than a food retailer like a grocery store may be.

MTY may suffer in the event of a Canadian recession. At the moment, everything is going well for the company, so it is hard to imagine the impact that a recession may have on it in the future. In the third quarter of 2018, revenues increased 26% year over year. Net income increased by 86% — a remarkable growth rate from this owner of restaurant brands.

Its dividend is also growing, supported by its earnings growth. Just a few weeks ago, the company reported a 10% increase in the dividend. While it currently yields less than 1%, the rapid increase should keep investors satisfied.

The problem with the stock is not whether the company is profitable, well run, or currently growing. MTY is executing well and has benefited from its strategy. The decision investors should make is whether the stock will retain or even expand its valuation in the face of growing unemployment and reduced spending power that often accompanies a recession.

While MTY is a positive growth story, there are some potential pitfalls that warrant a degree of caution. With its lofty trailing price-to-earnings ratio of around 30 times, MTY is arguably already quite expensive. If earnings contract as consumers have less disposable income, investors will likely begin to lose faith in its growth prospects. They might then begin to sell its shares, leading to a decrease in the share price.

The company is also a growth-by-acquisition story, which adds to the downside risk. Acquiring companies frequently requires a significant amount of debt, and MTY has taken on a fair amount. At the moment, the acquisitions have been accretive, adding value to the company. Nevertheless, large debt loads can become an issue if growth ceases or income falls.

MTY is experiencing significant growth in its earnings and revenues that are very tempting for growth investors. While its valuation is high at the moment, the company’s strong business should be able to support that valuation for the foreseeable future. But the real challenge for the company is the potential risk of weakness in the Canadian economy. Overleveraged Canadian consumers and a highly indebted government may lead to a recession, which could greatly impact a company like MTY.

If you believe that the Canadian economy is poised for a recession, do not buy MTY. Wait for a better entry point after an economic downturn drives down the share price. If you happen to own it at the moment, however, you need to decide whether you should sell or hold it through the bad times. Just be aware that if you choose to hold this company, you may have to weather a recession-related storm sometime in the near future.

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Date
2025/07/21

Date Created
2019/01/30
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