The Best $5 Stock You're Afraid to Own

Description

What a difference a year makes.

Roots (TSX:ROOT) stock is up 43% year to date through April 9. That's a big turnaround from the 72% loss it delivered in 2018. Heading into its Q4 2018 earnings release April 3, Roots was on a roll.

Did it deliver enough to maintain momentum? No, not really. It was as high as $4.70 in late February, about 6% higher than where it's currently trading.

If you're investing in an RRSP or TFSA, Roots isn't the stock for you. However, if you're in a taxable account, here's why I believe it could be the best $5 stock on the TSX you're afraid to own.

The positives in 2018

Three things jump out at me from 2018.

The first is the retailer's gross margins. These increased by 150 basis points in 2018 to 57.3%. By comparison, **Aritzia's** were 39.8% in fiscal 2018 while **Lululemon's** were 55%, both well below Roots.

The second factor that speaks to the value buy at play here is the company's partner stores in Taiwan (117) and China (37). In 2018, its partner stores opened a total of 12 net new stores in the two countries compared to just two net new stores in Canada and the U.S. In terms of sales, Roots's partner stores grew them by 7.7% year over year to $45.2 million. They now contribute 13.7% of the company's overall sales, 60 basis points higher than a year earlier.

Founders Don Green and Michael Budman made a great call years ago when they got into business with its overseas partners. That relationship continues to blossom.

Finally, Roots's target for its e-commerce business in fiscal 2019, is to continue to grow it internationally. By the end of the year, it expects e-commerce to account for 17-19% of its non-partner revenue. That's approximately $57 million, or 16% overall.

A good retailer generates 20% or more from its e-commerce. Roots is heading in that direction, which is excellent news.

The negatives in 2018

Fool contributor Amy Legate-Wolf believes Roots did little in the fourth quarter to keep its stock rolling. She sees a tired brand that can't expand beyond the company's domestic market. Yes, it's going to have a difficult time making inroads in the U.S., where the competition is cutthroat.

Here's what I had to say about the company earlier in the year: "My biggest concern with Roots is its U.S. expansion," I wrote February 3. "Very few Americans know about the brand except for movie stars and athletes who come to Toronto and Vancouver and are exposed to it. … Unless you're prepared to lose your entire investment, I wouldn't buy Roots stock at this point."

At the time, it was trading around $4.19. Not much has changed since.

Roots is trying to go slow and steady when it comes to expansion — one or two new stores for both Canada and the U.S. — and it's hard to know if it will ever reignite its store expansion plans.

So, if you're a growth-stock type of investor, Roots is not for you.

The risk/reward in 2019

Roots's key assumptions are that it will grow sales by 9-14% with adjusted net income flat to 19% growth in 2019.

An interesting fifth goal that many investors probably missed was that it plans to deepen the company's offering in leather and footwear in 2019. I own a beautiful leather bag that I've had for several years. It never lets me down when I'm travelling.

Roots's heritage is in leather, not sweatpants. The fact it's doubling down on its past is an excellent sign.

For my money, the odds of it getting to $10 are a lot better than it going to zero. I'm not sure I would have said that after the first two quarters of 2018.

If you can afford to lose your investment, I wouldn't be afraid of placing a bet on the beaver.

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