Warning: A Correction May Be on the Horizon for This Industry

Description

Waste Connections (TSX:WCN)(NYSE:WCN) and **Waste Management** are two companies that have made a killing for investors over the years. Turning trash into cash is indeed a very profitable and robust business. If you've been following the trend of "smart beta," a popular strategy which aims to construct portfolios with lower-volatility, fundamentally sound stocks at low price points, you'll know that trash companies are ideal candidates.

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They're defensive (trash happens, even in times of recession), and they tend to also benefit from a stronger economy (more consumption comes with more trash packaging, recyclables, and foodstuffs). What's even more compelling than the lower correlation of trash companies to the broader markets is the incredible capital gains they're clocked in over time.

Who says you can't have cake and eat it too?

Waste Connections, the Canadian way to play the trash space is up around 40% for the year, and although the wide-moat, fundamentally pristine company that can't seem to do things wrong looks to be worth a premium multiple, I think the valuation has become a bit extended given today's growth expectations.

Upon first glance, the 46.7 trailing P/E is enough to make value investors like myself cringe, and although the stock rightfully deserves a premium, it is possible for a wonderful company to command too much of a premium.

You could have the greatest stock on the planet, but if it's overvalued, you could still stand to lose money.

I'm not against buying shares of growth companies at high multiples if the growth opportunity and existence of near- to medium-term catalysts is there. But if shares trade at overly frothy multiples solely because of a rotation in capital across sectors at the broader market level, I think investors should think twice about the price they'll pay.

Waste Connections has been doing really well, and it'll continue to do so even when economic conditions become harsh, but at this juncture, it's hard to justify the multiple expansion given no recent developments have really impressed me.

The stock trades at 27 times forward earnings, 5.1 times sales, 3.9 times book, and 17.4 times cash flow — all of which are considerably higher than the stock's five-year historical average multiples.

That's just too much of a premium to pay for the premium company, and I think a pullback to more reasonable valuations is justified. So, when it comes to the trash industry, expect a correction. The rising popularity of the "smart beta" strategy and the fact that the name is a big holding in many ETFs based on the strategy leads me to believe the name is overdue for a big move lower.

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