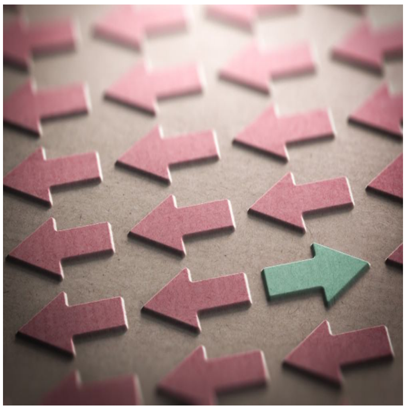

Contrarians: Is Gildan Activewear (TSX:GIL) a Buy?

Description

I had a big drop on my U.S. dividend portfolio last week after **Gildan Activewear** (TSX:GIL)(NYSE:GIL) shares took a nosedive. The 25% drop in those shares brought down the value of that account by over $1,000 per 100 shares owned. After any drop of that magnitude, I always need to take stock of my position and ask myself a simple question: Do I buy more or do I sell?

The first place I tend to look at is the simple fact of why I bought the stock in the first place. If all the original assumptions remain in place, the lower price will represent a great buy point to purchase more shares. If those assumptions have changed, then it is time to eat my losses, sell the stock, and look elsewhere for a new opportunity.

The main reason I have for buying this stock is to receive U.S. dollar dividends from my Canadian ownership stake. Gildan pays its dividend in U.S. dollars, which means that we can get “free” U.S. dollars if you use a process called “journaling” your shares to the U.S. side of your account. Call your broker to see if this is possible since not all brokers do this.

Gildan sports a yield of around 2.09% at this new, lower price. For me, all else being equal, this means I can now buy Gildan shares cheaper to get more income per price being paid for its shares. The company has also raised its dividend each year recently, frequently by double digits. Since 2012, Gildan has raised its dividend by 20% annually.

While lower earnings may cause these increases to slow, it is highly likely that the company would prefer to continue increasing its yield over time.

Let’s be clear: this company is not presently forecasting losses. It is simply stated that “weaker-than-expected demand in North America and ongoing softness in international markets negatively impact third-quarter results and full-year outlook” leading to a slight reduction in third-quarter earnings and sales. The expected decreases are projected to be in the single digits at 7% and 2%, respectively.

These numbers, while disappointing, are not earth-shattering. The company is still profitable, and it maintains a very low payout ratio of much less than 50% of earnings. Even if there is a small, hopefully temporary, earnings contraction of around 7%, this will make next to no impact on its dividend or its dividend-growth prospects.

There are two major risks for would-be investors. The first major concern is the company's balance sheet, and the other is its competitive advantage and business moat.

In order to fund its growth, Gildan has taken on a considerable amount of debt. That amount is approaching US$1 billion as of the Q2 quarterly report. Of course, that is offset against current assets of US$1.6 billion. The problem is, though, US$1 billion of those current assets are in the form of inventories, with only US$50 billion in cash. If those inventories can't move, that could be an issue.

While underwear is a staple for many people (I'm assuming), Gildan's products are very exposed to competition. Many people can make and sell underwear, so market share may be somewhat hard to defend in the long run. They are very commodity-like in some respects, so there may be potential weaknesses if competition heats up.

Should you buy Gildan today?

While am definitely continuing to hold my position, I am fairly certain I will be adding more in the next couple of weeks. Let's face it; Gildan was an expensive stock and expensive stocks are always susceptible to sharp drops on any semblance of negative news.

This appears to be a case of the market being a short-term trading vehicle reacting to the news of one quarter. As far as I know, everyone still needs to wear underwear, so there will probably continue to be demand for Gildan's products.

If the trend of earnings contraction continues over time (like years, not a couple of quarters), my opinion may change. But for now, Gildan looks to be a buy after this pullback for my U.S. dividend-building portfolio.

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