TFSA Investors: 1 Canadian Stock I Would Avoid in a Recession

Description

There are some industries that do very well when the global economy is booming. When this happens, missed earnings estimates and other red flags are overlooked because the stock is on a run. This translates to only focusing on the growth potential and turning a blind eye to the downfall.

Morneau Shepell (TSX:MSI) is currently a stock that's going through this phenomenon. The company has missed earnings estimates for the last four consecutive quarters, but the stock has gone up from $25.79 on December 5, 2018, to $33.65 on December 6, 2019.

Most recently in the numbers reported for the third quarter of 2019, earnings per share came in at $0.02 per share, 82% from the estimated earnings of $0.11 per share. And the stock has still gone up by around 5%.

To be fair, Morneau is a company with a good history. It has been a leading provider of human resources consulting and outsourcing services for 50 years. Almost 6,000 employees at Morneau work with some 24,000 client organizations that use their services in 162 countries.

Focus on inorganic growth

In 2019, Morneau made two acquisitions. It acquired MorningStar Health. The larger, more important acquisition was Mercer's standalone, large market, health, and defined benefit pension plan administration business in the United States.

The company reported its numbers for the third quarter of 2019, and on the face of it, they seem great. For the three months ended September 30, 2019, the company reported $224.0 million in revenue — an increase of 22.5%, or $41.2 million, from the same period last year, primarily due to Mercer and LifeWorks acquisition-related revenue.

However, the numbers don't hide the fact that free cash flow for the company declined in the last 12 months. Free cash flow clocked in at $60 million in the last 12 months compared to $75 million at the end of 2018. When a research analyst pointed this out on the analyst conference call, Morneau

Shepell asked if they could take the conversation offline.

Another point to note is Morneau's dividend payout. Morneau's dividend yield is 2.35% at $0.065 per share per month. This is a dividend-payout ratio of 260%, which doesn't seem healthy at all.

In fact, Fool contributor Karen Thomas suggested as much in her May 30, 2019 report when she cautioned investors about the earnings mismatch in Morneau. However, the stock has since gained 10.87%.

From the looks of it, it seems that Morneau's stock is overheated. If the prophesied recession does occur in 2020, the first thing that companies will freeze will be hiring additional people. Morneau stock will be badly hit, and your investment in it could whittle down very quickly.

Analysts have given Morneau stock a price target of between $36 and $38 for the next 12 months. Is a 10% upside worth the risk? I don't think so. There are plenty of other stocks in the market that we can look at. We can always revisit this stock if there are clear indicators that fears of a recession are overblown and will not come to pass.

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