Is Canadian Tire (TSX:CTC.A) Really Going to Fall 50%?

Description

A renowned short-seller has issued a dire warning for one of Canada's most well-known retailers. Ben Axler of Spruce Point Capital Management recently opened a short bet against **Canadian Tire** (TSX:CTC.A). Axler says the company is grossly overvalued and could shed half its valuation in an imminent correction.

Is he right? Axler was right with his last major Canadian short bet. **Maxar Technologies** stock is down an astonishing 74% since his hedge fund released a bearish report on the stock. So, to find out if history is likely to repeat itself, investors need to take a closer look at Axler's thesis and Canadian Tire's underlying fundamentals.

The bearish thesis

The bearish call hinges on the management team's apparent complacency. Axler argues that Canadian Tire is "falling behind" other major retailers that are much more competitive than it.

Meanwhile, management has channeled the company's cash towards dividends and buybacks instead of investing in bolstering their competitive advantage. The stock's dividend yield currently stands at 3%. The highest rate in the retailer's recent history.

Another reason the company risks being left behind is its massive physical footprint and lack of online strategy. The corporation owns and manages over 1,700 retail outlets, which could increase its costs and lower margins while competitors have been deploying digital strategies to be price competitive.

All these reasons seem valid. Canadian Tire could join the list of countless other retailers that have failed in recent years due to similar reasons. Which is why investors need to take a closer look at the fundamentals to judge the risk.

Tire's fundamentals

Falling behind the competition is a legitimate concern. However, this concern could be magnified by leverage. In other words, a heavy debt burden may have some role to play if the stock dips dramatically over the short term.

Canadian Tire currently holds $10.14 billion in debt, which is nearly *twice* the value of its equity. Spruce Point estimates that the company generates $200 million in free cash flow, which may be inadequate to reduce the debt enough to avoid a ratings downgrade.

The company's current debt ratings are BBB by DBRS and BBB+ by S&P, which means any downgrade would push the company's bonds from investment grade to junk. It doesn't seem like the company can cope with higher interest rates payments in this hypothetical scenario, especially not if the current dividend payout is maintained.

All these factors could mean that Canadian Tire is closer to the retail graveyard than investors expect. Management will need to switch the company's strategy, sell some non-core assets to raise funds, or cut the dividend to manage its debt burden if sales come in below expectations.

Bottom line

Like several other retailers, Canadian Tire faces enormous competitive pressures from digital giants and foreign multinationals alike. These issues are amplified by the company's heavy debt burden and massive outlet network.

Management could still turn things around and use the physical storefronts, and its financial services arm to gain an edge over competitors. However, at the moment, the risks for investors are simply too great to ignore. A 50% drop looks genuinely possible, especially if the debt is downgraded by ratings agencies.

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