Can Investors Profit from Canada's Grocery Wars?

Description

Competition is fierce in the grocery business. Margins are thin, weather affects sales and grocers must stay on top of the latest trends.

The Canadian grocery space is an all-out war. The winner will be the company that offers sought-after products at fair prices, takes care of core customers and maintains profit margins — while not overspending to acquire new customers. Piece of cake, right?

The most recent development in the Canadian grocery space is the **Sobey's**, a subsidiary of **Empire Co.** (TSX: EMP.A), acquisition of **Safeway's** (NYSE: SWY) western Canadian assets for $5.8 billion.

Empire, with $16.3 billion in sales, arguably paid a premium for Safeway's assets, but they give the company prime locations throughout Western Canada. The Alberta properties are especially appealing given the retail sales growth experienced in the province over the past year. Alberta's retail sales in March were up 4.7% from the same month a year ago, according to Statistics Canada.

Competition Under Review

Canada's Competition Bureau will review Empire's acquisition. It's possible Empire may have to sell some assets, which may present opportunities for **Loblaw** (TSX: L), the largest Canadian grocer, and **Metro Inc.** (TSX: MRU). It's more likely Loblaw would pick up the leftovers since Metro concentrates on Ontario and Quebec.

The Canadian grocery market is a high-priced market, but prices of goods may drop as a result of increased competition. **Wal-Mart Stores Inc**. (NYSE: WMT) plans to spend $450 million this year to open several new stores and expand its distribution network, and **Target Corp.** plans to open 124 stores by year's end.

Margin Squeeze

In the face of this increased competition, maintaining margins in this sector, which already has tight margins, is going to be difficult.

Wal-Mart's net profit margin of 3.8% was lower than Metro's 6.5%, but better than Empire's 2.2% margin. But Wal-Mart's scale is huge at $469.1 billion in annual sales, so it can handle a price-cut strategy in specific markets facing increasing competition.

Empire's net profit margin of 2.2% will likely be compressed unless it implements cost savings in its new Safeway stores. Empire said it expects to find cost synergies of about $200 million over three years by integrating the distribution, information technology and procurement divisions of both Sobeys and Canada Safeway.

Metro and Loblaw surely had an opportunity to buy Safeway's Canadian assets, but probably decided they were too expensive. Metro recently spent $50 million to build a new distribution system in Laval, Quebec, and is buying back shares.

Loblaw recently opened a new 10,000-square-foot store called The Box by No Frills in Calgary. This is an alternative way to grow the company without having to shell out major capital for acquisitions.

Empire's stock climbed 18% from June 12, when news of its Safeway Canada acquisition was announced, to June 27, compared with no gain for Loblaw and a gain of 3.5% for Metro.

Conclusion

Shares in Canadian grocers Empire, Metro and Loblaw have all made gains in recent years. Going forward, their performance may be choppy due to increasing competition and pressure against their margins.

There appears to be a "honeymoon" premium baked into Empire's stock since news of its Safeway Canada acquisition was announced. The acquisition will take several months to complete. Investors may want to wait until then to decide whether to buy this stock.

Canada's grocery companies are solid, but it's a tough industry that's getting tougher. In the Motley Fool's special **FREE** report "**3 U.S. Stocks Every Canadian Should Own**" we've profiled 3 companies that are so out in front of their industries, a competitive war is out of the question. To download this report at no charge, simply **click here now**.

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This post was created by Fool contributor Michael Hooper.

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CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:EMP.A (Empire Company Limited)
2. TSX:L (Loblaw Companies Limited)
3. TSX:MRU (Metro Inc.)

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