Food & Drugs: A Recipe for Success

Description

By: Eamonn O'Keeffe

It's been a busy couple of months in the Canadian grocery space. The way we shop is undergoing some pretty dramatic changes. And just in case you've been trekking through the Yukon or canoe tripping in Newfoundland for the past month and missed the details of one of the biggest announcements to hit the Canadian retail/grocery space in some time, we're here to help.

The $12.4 billion acquisition of **Shoppers Drug Mart** (TSX: SC) by **Loblaw** (TSX: L) is a game-changer for the Canadian economy. This deal, announced on July 15, unites Canada's biggest pharmacy company with the nation's largest supermarket chain. The Shoppers business and brand will be retained as a subsidiary of Loblaw. Pending final approval, this merger will create a retail behemoth with over 2,300 stores nationwide and a combined $42 billion in sales.

What drives investor confidence in this transformational deal? Here are four key benefits of the merger:

1. Cost savings

Loblaw and Shoppers expect this deal to result in $300 million in savings annually by year three which according to their news release (see here) is not "dependent on any store closings". They will likely cut costs by trimming management teams to avoid overstaffing and duplication. Moreover, combining shared expenses such as IT and marketing may lead to further savings. The merger will also allow the companies to put their more profitable private-label (company-owned) brands–Life and President's Choice–into more stores nationwide. This wider distribution will allow research and development costs to be spread over many more customers. But the combined company's biggest savings will likely come from the ability to leverage its increased buying power and negotiate for lower prices from suppliers.

2. Access to urban markets

Selling Loblaw brand President's Choice (PC) products in Shoppers' network of smaller-format urban locations will give Loblaw access to convenience-oriented customers who do not live near big-box grocery stores. Indeed, as recent controversy over a proposed Wal-Mart near Toronto's Kensington

Market suggests, large-format stores are increasingly unwelcome in Canada's downtown cores. Small-format urban locations have been very successful at increasing grocery sales in other markets, especially in the UK with Sainsbury's, Tesco and Marks & Spencer. Loblaw could replicate this success in Canadian city centres.

3. Mutual growth opportunities

Shoppers' sales are evenly split between pharmaceutical products and general merchandise, proving that consumers looking for convenience will buy more than medication at their local drugstore. The introduction of the Loblaw's President's Choice brand into Shoppers stores will allow the drug-store chain to increase its annual $1 billion worth of food sales and draw in new customers.

By acquiring the market-leading drug-store chain, Loblaw is able to dramatically expand its small share of the pharmaceuticals business. Moreover, Loblaw will benefit from Shopper's big stake in one of the most lucrative markets in retail: high-end cosmetics products.

4. Loyalty programs & consumer data

Nearly 30% of the Canadian population–ten million people–-is registered with Shoppers' Optimum rewards program, the largest retail loyalty program in the country. Loblaw can use this massive database, in conjunction with information from the PC Plus program, to better understand the needs of Canadian consumers–especially in urban markets.

Potential challenges

Although Loblaw's acquisition of Shoppers is a sound decision that has significant upside, challenges still loom for Canada's No. 1 grocer. The food retail business is very competitive; Loblaw cannot rest on its laurels. In June, **Empire Company**, the parent firm of Sobeys, bought the 214-store Canada Safeway chain for $5.8 billion, consolidating their position as the second-largest grocery chain in Canada. In addition, Longo's and Whole Foods are intent on grabbing market share in urban areas.

Moreover, Shoppers faces strong regional competition from London Drugs in Western Canada and Lawtons in the Maritimes.

Wal-Mart and **Target** are aggressively trying to increase their Canadian market share in both the grocery and pharmaceutical businesses. Likewise, **Costco** has plans to build up to 25 new big-box stores to cater to its 10 million Canadian members.

Finally, cash-strapped governments are trying to curtail ballooning healthcare budgets by implementing reforms to lower drug prices, hurting Shoppers' bottom line.

However, this deal will help the combined company overcome these obstacles. For example, Shoppers can compensate for flagging drug revenues through increased food sales. Moreover, with a combined 65 million square feet of selling space, Loblaw has the scale and buying power to compete with Target and Wal-Mart.

As the Financial Post recently revealed, major US pharmaceutical chain **Walgreens** had considered acquiring Shoppers. By merging with the market-leading drug store chain, Loblaw has made entry into the Canadian market much more difficult for foreign companies such as Walgreens or CVS.

Foolish Final Thought

Though the move may appear to be a bold one, it's not hard to see why Loblaw made this move. As a result of the acquisition of Shoppers Drug Mart, Loblaw is well positioned for continued growth in a competitive market.

Canadian grocers are doing their best to deal with an increasingly competitive environment. The barriers to entry in their business have been toppled by the big U.S. chains. If you're looking for companies that have their barriers to entry firmly intact, **click here now** and we'll send you our special **FREE** report "**3 U.S. Companies That Every Canadian Should Own**".

The Motley Fool's purpose is to help the world invest, better. ***Click here now*** *for your free subscription to* ***Take Stock****, The Motley Fool Canada's free investing newsletter. Packed with stock ideas and investing advice, it is essential reading for anyone looking to build and grow their wealth in the years ahead.*

Follow us on Twitter and Facebook for the latest in Foolish investing.

Fool contributor Eamonn O'Keeffe does not own shares in any of the companies mentioned at this time. The Motley Fool owns shares of Costco.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:L (Loblaw Companies Limited)

Category

1. Investing

Date
2025/08/27
Date Created
2013/08/15
Author
motley-fool-staff