Did Empire Company Ltd. Bite Off More Than It Can Chew?

Description

After Sobeys parent **Empire Co. Ltd.** (TSX:EMP.A) completed its $5.8 billion acquisition of Safeway Canada, the company demanded that its suppliers provide 1% price cuts and apply them retroactively to November 3. As it turns out, those cuts were needed more than first thought.

On late Wednesday, Empire reported results for the third quarter, and the numbers were very disappointing. Profit tumbled to 0 cents per share, or 84 cents per share on an adjusted basis. The average analyst estimate was $1.23 per share. Same store sales decreased 0.2% year-over-year. The shares are down about 3% as a result.

This is certainly a very critical juncture for Empire. The company will have to digest both a management change and a major acquisition in the upcoming year, and meanwhile Empire faces some stiff headwinds.

Recent challenges

First of all, the company had to deal with terrible weather in Canada, especially Ontario. Certainly that did not help Empire's results in the quarter. Competition has also gotten more intense, especially with the expansion of **Target** (NYSE:TGT) and **Walmart** (NYSE:WMT) in Canada.

More recently, Empire has had to deal with a slumping Canadian dollar, which will force the company to pay higher prices for imported goods. If Empire cannot get price concessions from foreign suppliers, or pass on the cost to its customers, then margins will suffer.

Furthermore, Empire's suppliers are not going to capitulate without a fight. Industry food groups such as the Food & Consumer Products of Canada are trying to put pressure on Ottawa to write a grocery code of conduct. Ideally such a code would prevent the kinds of demands that Empire made late last year.

Safeway will be a challenge too

The Safeway acquisition brings back memories of Sobeys' $1.5 billion takeout of Oshawa group in

1998, which is what made the grocery chain a national player. The merger led to an IT nightmare when the two companies were unable to integrate their systems. Eventually the new system crashed during a holiday season and had to be scrapped, leading to a $50 million write-off.

While the Safeway integration should be much cleaner, the events 15 years ago serve as a reminder that these types of integrations are very difficult. It's something that investors should be concerned with as Empire deals with its many other challenges.

Foolish bottom line

The Oshawa acquisition was still very successful by any standard, and most people are confident that the Safeway merger will be too. And despite the recent headwinds, Empire still has a fantastic track record, delivering 13.5% annual returns to shareholders since the Oshawa merger. Meanwhile **Loblaw Companies** (TSX:L) has returned less than 4% per year over the same time period.

And with all the consolidation going on in Canadian grocery, Empire will be part of an industry with high barriers to entry and excellent bargaining power over suppliers and customers. The company remains an excellent option for investors looking for a low-risk holding.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:TGT (Target Corporation)
2. NYSE:WMT (Wal-Mart Stores Inc.)
3. TSX:EMP.A (Empire Company Limited)
4. TSX:L (Loblaw Companies Limited)

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