Top 3 Canadian Grocers for 2014

Description

Legendary investor Peter Lynch said it best: “Visiting stores and testing products is one of the critical elements of the analyst’s job”. With that in mind, what is the one thing we all do every week? We head over to the nearest grocery store and load our shopping cart with the essentials for the coming days. Day in day out, these stores take in a meaningful percentage of our hard-earned cash, so why not try and get some income from this essential service?

Loblaw

Third place goes to **Loblaw Companies** (TSX: L).

A subsidiary of **George Weston** (TSX: WN), Loblaw is present nationwide through its divisions Maxi&Cie, Provigo and Loblaw to name a few. Grocers should be valued predominantly on return on invested capital and free cash flow from operations — that is, the amount of money left after all expenses have been paid.

Loblaw managed to generate $614 million in free cash flow last year on revenues of $32 billion. Its return on invested capital stood at 6.89% for fiscal year 2013 lower than the average for the past three years. While positive, a diminishing return on invested capital is a yellow flag concerning management’s allocation of capital.

Any significant development in recent years could bring that return on invested capital higher. In 2013, Loblaw acquired Shopper Drug Martfor $12.4 billion. According to management, after this transaction, Loblaw should have around 20% of the lucrative drug prescription market in Canada. It also created the **Choice Properties Real Estate Investment Trust** (TSX: CHP.UN) to whom Loblaw sold 20 of its real estate properties to effectively lower its debt burden.

So while there are catalysts that could propel this stock higher in the coming years, the low return on invested capital means we should tread lightly considering the capital allocation record of management.

Empire Company

Our runner-up is **Empire Co.** (TSX: EMP.A) owner of the Sobeys chain. Like Loblaw, Sobeys is present nationwide with more than 1500 retail stores across Canada along with 46 movie theatres. Its return on invested capital is at 7.32% in 2013 on par with its three-year average. Its free cash flow though, is standing at $66 million on revenues of $5.7 billion — much lower than the competition and its own three-year average of $200 million.

Significant developments in 2013 included the buyout of all the Canadian Safeway stores in 2013 which, if executed correctly could add significant revenue for the company. Still, Safeway failed with those stores, so the odds of Empire succeeding are not in our favour.

And our grand winner is… Metro

Metro (TSX: MRU) is our grand winner of the grocer wars. It's the smallest of the three, but a quick glance at our metrics shows that it is by far the most profitable and best capital allocator.

With return on invested capital of 35% last year, and average of 32% in the last three years, we can easily see that Metro's management is the best capital allocator of our group. Add to that the $250 million in free cash flow generated out of $5.3 billion in sales for 2013. That's from only 358 supermarkets and 184 pharmacies. It's obvious that Metro knows how to execute.

Metro is the clear winner of the grocer war, but is the price worth it? Looking at the price-to-earnings ratio of each company, Metro is currently standing at 15 while Loblaw and Empire are at 24 and 18 respectively. So not only is Metro the best operator, it is also the cheapest on a P/E ratio.

CATEGORY

1. Investing

TICKERS GLOBAL

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

Category

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