Why You Should Be a Picky Eater When Investing in Canada's Grocers

Description

On Thursday, **Empire Company** (TSX: EMP.A), the parent of Sobeys, announced that the chain would be closing 50 stores across the country in an attempt to streamline operations after its $5.8 billion acquisition of Safeway's Canadian stores in the fall of 2013.

Essentially, after years of competing with each other in the western part of Canada, Sobeys and Safeway stores overlapped geographically in certain locations. One of the locations in Calgary that is closing is Sobeys' London Town, which I've visited several times. It's located almost directly across the street from a Safeway that's bigger and consistently busier. London Town was also underperforming in the first place, so this is a good excuse to get rid of it. This same sort of situation is happening across the western part of country, which is why Sobeys took the initiative to review all its stores.

In the short term, store closures always hurt. Not only will sales decrease, but the company has set aside $200 million for closing related costs. These weak results filtered down to the bottom line, as the company also announced Thursday that it essentially broke even during the last quarter, after restructuring costs.

It's not all bad news for investors, though, as Empire did announce it was boosting its quarterly dividend by a penny to $0.27 per share. The stock now yields 1.6%.

What does this mean for retail in general?

It's hard to be bullish on Canada's grocery sector these days.

Basically, the Canadian consumer is tapped out. Canadians are sitting on a record amount of personal debt, housing costs more than ever, and even gasoline is expensive. Inflation is starting to become something the Bank of Canada is keeping its eye on.

This doesn't really affect the average Canadian's trip to the grocery store — after all, we need to eat — but it does make the consumer think twice about buying impulse items, which generally have higher margins than bread and milk.

Thanks to **Target** entering the Canadian market in 2013, competition is more fierce than ever. Even though Target's Canadian results have been weak thus far, the chain is still taking business away from somebody. Target isn't a great operator at this point, but it will improve.

Wamart is also beefing up its presence in Canada, as it continues to convert more of its stores into supercentres, which are approximately double the square footage of their traditional stores and carry a full grocery section. Canadian consumers love one-stop shopping, so these stores should continue to be popular.

Should investors avoid the sector?

Because of these headwinds, there are some cheap stocks in the sector.

Metro (TSX: MRU) looks surprisingly cheap these days, trading at just 14 times trailing earnings, and 12 times estimated 2014 earnings. It is expanding in a somewhat different direction, announcing recently that it had acquired a 75% stake in Quebec bakery Premiere Moisson.

On the surface, it seems like a reasonably priced stock. However, its main market is Quebec, where the provincial economy is sluggish. Investors can expect tepid same-store sales growth at best, and possibly regression. No wonder the stock is cheap.

Loblaw (TSX: L) made news last year when it agreed to buy Shoppers Drug Mart, beefing up in the two areas where it was noticeably weak: pharmacy and urban locations. Unlike Sobeys' acquisition of Safeway, Loblaw and Shoppers don't have a lot of overlapping stores.

However, investors are paying a premium for the company. The stock trades at 24 times trailing earnings, and is forecast to drop to only 17 times next year, as Shoppers adds to the company's bottom line. Considering Canada's challenging retail environment, it's difficult to justify buying Loblaw shares at this level.

Of course, often the best time to buy is when things look bleak. Empire's shares are flirting with 52-week lows, and closing underperforming stores should help profitability over the long term. Both Sobeys and Safeway are terrific brands, since they cater to customers who aren't quite as price sensitive. If investors buy Empire shares and tuck them away for a few years, there's little doubt they'll be higher than today.

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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Date
2025/07/19
Date Created
2014/06/27
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