A Strong Quarter for Loblaw Companies Ltd Means it’s Time to Buy George Weston Ltd

Description

George Weston Limited (TSX: WN) is the parent company of **Loblaw Companies Limited** (TSX: L), the leading food and drug retailer in Canada that operates under well-known banners such as Superstore and Shoppers Drug Mart. George Weston also owns valuable food manufacturing operations in Canada and the U.S., reporting as Weston Foods. This fact seems to be almost forgotten by investors, creating an attractive investment opportunity.

Solid third-quarter results for Loblaw

Loblaw recently announced adjusted earnings per share of $0.90 for the third quarter, which represented an increase of 23% over the same period last year, beating the market consensus handily. Both the food retail division as well as the recently acquired Shoppers Drug Mart performed well, with some synergistic cost savings already evident.

A valuable portfolio of assets

George Weston owns a valuable portfolio of assets, and the 46% interest in Loblaw is the dominant asset. In addition, it also owns 100% of Weston Foods and 5.4% of the listed **Choice Properties Real Estate Investment Trust** (TSX: CHX.UN).

Weston Foods is a leading fresh and frozen baking company in Canada and operates a frozen baking manufacturing business in the U.S. and a North American biscuit manufacturing business.

Weston Foods generated sales of $1.8 billion in 2013 and adjusted EBITDA of $330 million, contributing 5% of the total revenue of George Weston and 13% of the adjusted EBITDA. The balance was contributed by Loblaw, by far the dominant holding in the overall portfolio. Although Weston Foods is a considerably smaller operation than Loblaw, it produces consistently higher profit margins and returns on assets than Loblaw.

Weston Foods has been struggling in 2014, with adjusted EBITDA 10% lower in the first six months compared to 2013. Management ascribes the decline to increases in commodity and other input costs, plant start-up and investment costs, and lower fresh bakery sales volumes. The results for the second half of the year are expected to improve as input cost pressure eases.

Investors get Weston Foods at a very low valuation

The value of the Loblaw and Choice REIT shares held by George Weston, adjusted for the net debt in the holding company, amounts to just over $11 billion. The market value of George Weston is currently just over $12 billion, leaving an implied equity value of $963 million for the food business. That should generate an EBITDA of around $300 million in 2014. The estimated EV/EBITDA valuation is just over four times — considerably lower than a selection of listed North American peers.

Over time, the share prices of George Weston and Loblaw tracked each other closely, but over the past two years, the Loblaw share price outperformed the price of George Weston by 20%. This has now resulted in an extremely cheap implied valuation placed on Weston Foods.

The discounted valuation could partly be ascribed to the holding company status, as well as the tightly controlled share structure with Galen Weston, the current executive chairman, holding 63% of the issued shares. However, the current valuation seems too low. It offers, at the very minimum, a cheap entry into the well-performing Loblaw. In addition, investors will receive the added bonus of a quality food manufacturing business of which the value could be unlocked at some point in the future.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:L (Loblaw Companies Limited)
2. TSX:WN (George Weston Limited)

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