The Real Reason Why Loblaw Companies Ltd. Shares Could Get Crushed

Description

Canadian newspapers love talking about the "grocery wars", in which companies like **Loblaw Companies Ltd.** (TSX: L) and **Empire Company Limited** (TSX: EMP.A) are supposedly cutting prices at will. As the story goes, they are competing for customers so fiercely that profitability is getting crushed.

Fortunately for shareholders, these stories are greatly exaggerated. While there is some price competition, the industry is still dominated by just a few small players, each of whom knows how to act rationally. And certain initiatives by these retailers are helping to protect margin. For example, grocers are selling more prepared foods, which come with much higher price points.

Loblaw itself provides a perfect example. Its recent acquisition of Shoppers Drug Mart helps tighten its grip on the market, and the company just reported Q3 earnings of $0.90 per share, a 23% increase over last year.

But there's another headwind which should seriously concern Loblaw and its shareholders.

Abusive practices

Here's a good rule of thumb: if you want to enjoy your life, don't sell anything to Loblaw. The company is known to treat its suppliers very poorly, even worse than a company like **Walmart**. Some of its more abusive practices were highlighted when it bought Shoppers. And others have come to light more recently.

For example, Loblaw has routinely asked suppliers to help pay for store improvements. The company also demanded that suppliers not increase prices during 2013, citing its adoption of a new SAP system. If a supplier refuses, it could risk losing significant shelf space. Empire has also employed some dirty tricks. After acquiring Safeway's Canadian stores, it demanded retroactive price cuts from suppliers.

Here come the regulators

Response from the regulators has been painfully slow. But more recently, the Competition Bureau is intensifying its efforts, even demanding that some suppliers hand over confidential records. The regulator is looking for “restrictive trade practices.”

Suppliers are pressuring the regulator to introduce a “code of conduct”. There is already a code in place in the United Kingdom, and it restricts some of the practices that Loblaw and Sobeys currently employ.

For example, UK grocery retailers “must not vary any supply agreement retrospectively, and must not request or require that a supplier consent to retrospective variations of any supply agreement.” They also cannot “require a supplier to make any payment towards that retailer’s costs of the opening or refurbishing of a store.”

So what effect will this have?

Shareholders of Loblaw and Empire should be nervous. The leading grocers in the UK have been struggling, thanks to the emergence of hard-line discounters. And if similar regulations were adopted in Canada, then smaller grocers could compete more effectively too. Your best bet is to stay away from the grocery stocks.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:EMP.A (Empire Company Limited)
2. TSX:L (Loblaw Companies Limited)

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Date
2025/07/23
Date Created
2014/11/19
Author
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