Loblaw Companies Limited and Metro, Inc. Are Dominating U.S. Competitors

Description

Consolidated industries usually mean outsized profits for the biggest players. Not only is there limited competition, but competitors usually have carved out niche segments, whether it's by geography, price point, or product category.

While it's not often pointed out, the Canadian grocery market is one of the most consolidated markets in the country. Roughly 80% of the entire market is controlled by only five companies. Compare this to the U.S. market, where over 20 firms comprise the top 80%.

This consolidation has led to some real benefits for Canada's biggest grocers.

Fewer competitors means higher profits

It's no wonder why Canadian supermarkets command higher profit margins than their U.S. peers. **Loblaw Companies Limited** (TSX:L) and **Metro, Inc.** (TSX:MRU), the largest publicly traded grocers in Canada that both have operating margins between 5% and 7%. Their biggest U.S. peers, however, all have margins under 3%, including **The Kroger Co**, **Safeway Inc.**, and **SUPERVALU INC**.

While limited competition has led to higher profits, the unique characteristics of the Canadian market helps keep it that way. For example, the U.S. market is dominated by large-format supermarkets such as **Wal-Mart Stores, Inc.**

While this strategy has worked in the U.S., companies have had a hard time adapting to smaller-format stores. This month, Wal-Mart pulled the plug on its small-store format Wal-Mart Express, closing 269 locations due to high costs and disappointing international results.

While major U.S. competitors have struggled with this concept, small-format discount stores have met big demand in Canada. Loblaw operates 500 discount stores, nearly half of its store base. Metro's small-format Food Basics and Super C brands represent more than 40% of its network.

In all, Canadian grocers command higher profit margins, while operating in an environment that outside competitors find difficult to traverse.

Will food inflation eat into profits?

If you live in Canada, you've probably noticed an uptick in the amount you spend on food. After four years of stable prices, food-cost inflation reached multi-level highs last year. Fruit and vegetable prices rose 9% in 2015, while meat prices rose 5%. A weak loonie is largely to blame. Many worry that consumers will eventually cut back on spending, perhaps switching to lower-cost items or foregoing discretionary items.

For now, it doesn't look like that's happening. For example, food prices have been up in every one of the last six quarters. Meanwhile, Metro's same-store sales have outpaced food inflation over five of those quarters. What this means is that Metro has been able to sell more food for higher prices in spite of record inflation levels.

While persistent inflation may eventually eat into profits, Canadian grocery stores haven't noticed. Both Loblaw and Metro have seen their shares advance higher this year, despite a TSX decline of over 5%. Due to favourable industry conditions, don't be surprised to see this outperformance continue.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:L (Loblaw Companies Limited)
2. TSX:MRU (Metro Inc.)

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