



## Loblaw Companies Limited's Recent Earnings Beat: Not Sustainable Long Term

### Description

**Loblaw Companies Limited** ([TSX:L](#)) is Canada's largest retailer with a market capitalization of approximately \$29 billion. The company has recently released its earnings for the last quarter, which beat analyst expectations, resulting in a share-price increase of nearly 7% over the past three trading days.

I'll be taking a look at what these numbers mean for the long-term investor.

### Shoppers Drug Mart acquisition helping top line, hurting bottom line

Last year's acquisition of Shoppers Drug Mart has helped Loblaw's boost top-line earnings. The company has experienced revenue growth of 36% overall since 2015 with a quarter of the revenue increase coming from the Shoppers acquisition last year. The same-store front sales grew 2.5% in Q3 2016 at Shoppers Drug Mart—higher than the overall revenue growth rate of Loblaw of 1.6% across all company-owned stores.

That said, the company experienced restructuring costs and reorganization costs amounting to \$46 million as a result of the merger, hampering earnings, which fell to \$142 million from \$150 million a year earlier, although still beating analyst expectations.

### Long-term profitability uncertain

It is important to note that two key factors that drive the profitability of large retail concerns, like those of Loblaw: gross margin and sales volume.

Loblaw is a company in an industry with very tight margins attempting to grow through acquisitions. With borrowing costs currently at all-time lows, large acquisitions such as the Shoppers Drug Mart acquisition may increase revenues and profits for some time, but they add additional interest rate risk to the company's future cash flows.

The company is able to tweak its sales volume in the short term by cutting margins in an attempt to snatch market share from competitors, but, in the long run, this deflationary pressure may result in the

“tide lowering” for all companies, cutting into retail margins permanently via price wars and other retaliatory measures taken by the company’s competition.

### **Debt concerns**

The reality is that debt-financed acquisitions mean the company will be left with a large debt burden and interest payments on that debt.

In the second quarter of this year, the company noted that, while revenues increased substantially more than expected, the company’s profitability was indeed affected by interest expense and financing charges.

Long-term investors will need to keep an eye on the company’s debt portfolio to ensure that future free cash flows from operations will not be encumbered by so much debt that it goes solely to paying down debt, leaving equity holders in the dark.

### **CATEGORY**

1. Investing

### **TICKERS GLOBAL**

1. TSX:L (Loblaw Companies Limited)

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### **Category**

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### **Author**

chrismacdonald

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