Loblaw Companies Limited Reports Strong Results, But Are Shares Overvalued?

Description

Loblaw Companies Limited (TSX:L) continues to impress with its performance and its domination of the grocery market. But with first-quarter results demonstrating just how tough the grocery market is right now, we are left to consider if the stock's valuation has gotten ahead of itself.

Loblaw reiterated what other grocers, like **Metro, Inc.** (TSX:MRU), have described: a highly competitive market that is still hurting from deflationary pressures. On the earnings call, management noted that they do not believe that these pressures will ease in 2017, and they believe that promotional activity will remain aggressive.

So, it is their intent to continue to work on efficiencies, cost cutting, and effectively targeting the consumer through the use of analytics and customer data. Loblaw's size and the fact that Shoppers Drug Mart is part of the company serves to mitigate the risks the company is facing.

As for the first quarter of 2017, revenue was pretty much flat, as was same-store sales growth. Let's break down the numbers. Same-store-sales growth in food retail was negative 2.1%, and drug retail same-store-sales growth was 2.5%. Adjusted net earnings increased 7.7% as margins increased (the EBITDA margin increased to 8.3% from 8% in the same quarter last year). Earnings per share increased 9.8%, as the company continued its share repurchases.

Loblaw is trading at 17.4 times this year's expected earnings with an 8.4% expected growth rate and 15.8 times next year's earnings with a 10% expected growth rate. For comparison purposes, Metro trades at 17.9 times this year's earnings with an expected 8.4% growth rate and 16.4 times next year's earnings with an expected 8.9% growth rate.

All in all, it seems to me like the shares of Loblaw, and Metro, for that matter, appear fairly valued. Both stocks have increased dramatically over the last three years with Loblaw's shares increasing 61.5% and Metro's shares increasing 108%. The dividend yields on both stocks are respectable and increasing; Loblaw increased its dividend by 3.8%, and Metro increased its dividend by 16% in the latest quarter.

This sector is defensive and stable, which is a good thing, but competition remains intense. Also, a real risk to the stock’s valuation is that as investors feel more comfortable investing in other sectors such as the oil and gas sector again, the money will have to come from somewhere, and we might see a sector rotation out of the consumer staples sector given its rich valuations. This would drive valuations down in the sector as a whole.

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