Empire Company Limited Turnaround Looks to Keep it Simple

Description

Empire Company Limited (TSX:EMP.A) CEO Michael Medline has been in the position for less than four months, but he’s certainly moving fast to alter the trajectory of Empire stock, which had lost 50% of its value over an 18-month period until bottoming out in mid-December.

Since then, its stock has gained back about 40% of those losses due, in large part, to the January appointment of Medline, the former **Canadian Tire Corporation Limited** chief executive.

Medline’s latest move to turn around its flagging grocery business is to make the job cuts and structural changes necessary to create a leaner and more proactive Sobeys.

Under the three-year plan, which will see Empire save $500 million annually by 2020, Sobeys will become a national organization operated along functional lines, eliminating a regional structure which has led to a duplication in decision making and a more cumbersome operation.

The announcement made sure to reassure its front-line employees in its stores and distribution centres that they would not be affected by the cuts. According to Medline, the moves are more about fixing an organizational structure that is hopelessly bureaucratic, rather than blowing it up.

“We are a $24 billion dollar retailer and we act more like a number of $5 billion dollar companies,” Medline said May 4 while discussing what’s been dubbed “Project Sunrise.”

“I have talked with some of the biggest brands in the country and the world and we are probably the most difficult company for them to do business with, and not because of our people — the structure was holding us back.”

From a business perspective, he’s making complete sense. Sobeys is losing market share because it’s a high-cost competitor in a low-cost industry.

Morningstar data shows that Empire’s best year over the past decade regarding margins was fiscal 2011, when gross margins and operating margins were 25.3% and 3.3%, respectively.

Over at **Loblaw Companies Ltd.** (TSX:L), its best year was this past year, when gross margins were 28.4% and operating margins were 4.5%. Finally, **Metro, Inc.'s** (TSX:MRU) best year was also in 2016 with gross margins of 19.7% and operating margins of 5.9%.

What do you notice about these numbers? I see two things.

First, Empire's best isn't nearly enough against its two rivals. Second, and a big part of why Medline is overhauling Sobeys's operating structure, is the 22-percentage-point spread between gross margins and operating margins. A lot of money is being left on the table from the time the product is bought to when it is sold.

Loblaw also hasn't done a great job delivering to the bottom line, but it is excellent at generating free cash flow, so it's not a problem for the company. Metro, however, gets the most out of the least from its stores; it's a big reason why its stock has performed so well over the years compared to Loblaw and Empire.

As Medline says, this is an initiative undertaken for Sobeys to compete in a very competitive marketplace. It's going to take time, so investors buying or holding Empire stock are taking a leap of faith that Medline and the board are correct in their assessment of what's holding Sobeys back.

Empire stock might get a bit of a pop from this, but it's going to take several quarters before there are any indications the plan is working. Many analysts are skeptical about the size of the cost savings targeted, and I would tend to agree. In my experience, very few companies hit their cost-cutting targets promptly.

Is Project Sunrise enough to turnaround Sobeys? Who knows? But Empire had to do it given the dysfunctional state of its business.

For the next 12 months, Empire stock looks like dead money to me. For now, I'd be buying Metro or Loblaw instead.

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