Considering Loblaw Companies Ltd.

Description

Over the past year, shareholders of **Loblaw Companies Ltd.** (TSX:L) have received a very adequate return in addition to a dividend yield which is close to 1.5%. While the dividend is nothing spectacular, shares have increased by 8% over the past 52 weeks. On a year-to-date basis, shares are up approximately 7%.

Loblaw currently trades close to 30 times trailing earnings. Investors need to ask themselves why they are purchasing shares at these multiples. Shares, which are currently priced near $76, make up the company's market capitalization of approximately $30 billion, which includes both grocery stores and pharmacy (Shoppers Drug Mart).

While the grocery stores and pharmacy businesses are both very defensive, investors may not be getting a bargain when making this investment. Revenues were $42.6 billion in 2014 and grew to $45.4 billion in 2015 and then to $46.4 billion in fiscal 2016. Looking at fiscal 2015 and 2016, total revenues increased no more than 2.2%, which is arguably the cost of food inflation over the same time period. During the first quarter of 2017, the increase was no better than 0.2% in comparison to the year earlier.

Clearly, consumers are looking for less expensive alternatives. And while investors may enjoy consistency, the share price may not continue its upward momentum should the tide begin to recede.

Looking at the bottom line of the company, the situation is a little different. The earnings per share (EPS) increased from $1.42 in 2015 to $2.37 in 2016, showing the company has been successful in cost cutting. The challenge that management will face is going to be repeating the process year after year.

While expenses may be cut in the second part of the income statement (selling, general & administrative), those who have looked at the gross margin in relation to revenues may be surprised by the numbers. During the fiscal year of 2014, the gross profit was 24.7%, which increased to 27.6% in 2015. In 2016, the percentage increased again to 28.4%, and investors seemed to be satisfied.

Although the EPS is a very important metric for investors to consider prior to making an investment, the top line of the income statement (the revenues number) is oftentimes even more important. The reason revenue is so important is an increase or decrease in the number can be a leading indicator of things to come. Assuming a mature company is continuing to add customers at a sustainable rate, the revenue number will most often increase in tandem.

From past experience, however, investors have noticed that a stagnant or declining revenue number can often lead to further problems down the road. While the expenses are usually committed to for a number of years (rent, salaries, interest expense), it remains very difficult to hide the challenge of a declining customer base. In a low-margin business such as this one, investors may need to be very careful before buying.

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2. Investing

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ryangoldsman