Is Loblaw Companies Ltd. Speculative or Safe at Current Levels?

Description

The jury is still out on **Loblaw Companies Ltd.** (TSX:L) with respect to how the company is expected to perform long term.

Many bullish investors choosing to add defensive stocks such as Loblaw to their portfolios note that strength within the pharmacy business (in Loblaw's case, its Shoppers Drug Mart subsidiary) is likely to shine through in the long term. The pharmacy sector is likely to give Loblaw a boost compared to other large Canadian grocery retailers such as **Metro, Inc.** (TSX:MRU) or **Empire Company Limited** (TSX:EMP.A). Specifically, new cannabis legalization regulations which have not yet been finalized point to the possibility that large pharmacy chains such as Shoppers will be able to apply for licences to sell marijuana to consumers across Canada.

Those bearish on the long-term prospects of Loblaw point to the fact that this company is still primarily a grocery retailer in a highly competitive space with competition and price wars having impacted margins for some time now. Price deflation with respect to specific food categories has also been a headwind that many long-term investors have pointed to with respect to Loblaw; while Loblaw still maintains a dominant market position in the Canadian grocery retail space, it should be noted that this growth has come at a massive cost to the business — namely, the current debt load carried by this retailer has continued to increase over time.

Loblaw's string of acquisitions and growth-related activities in recent years has led the company to incur a total debt load of $11.7 billion, which is a meaningful sum when compared to Metro and Empire, which have debt loads of $1.5 billion and $2 billion, respectively. Loblaw is still a much larger company than Metro and Empire (approximately three times larger than Metro and six times larger than Empire); however, its debt-to-market capitalization ratio is much higher. Higher levels of leverage in an environment where razor-thin margins are likely to continue into the future is a risk investors must weigh.

From a valuation perspective, Loblaw is not cheap, but it's not expensive either, trading around the 15 times forward earnings level, similar to that of Metro. Empire lags behind its peers with a forward price earnings ratio of 26.

Bottom line

When comparing Loblaw to its peers, investors see a divergence among the major players in the Canadian grocery industry with Loblaw clearly taking the title as the highly levered growth play in the sector. I personally prefer Metro over Loblaw; the underlying fundamentals of Metro's business model provide a larger margin of safety over the long term for investors. Empire remains on the outside looking in — in my opinion, Empire's fundamentals lag way behind Metro and Loblaw, making Empire and Loblaw more speculative plays in the long term than Metro.

Stay Foolish, my friends.

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Date
2025/08/26
Date Created
2017/05/30
Author
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