Loblaw Companies Ltd. Posts Good Q2 Results, but There Is a Fly in the Ointment

Description

Loblaw Companies Ltd. (TSX:L) is a food and pharmacy company that operates under different banners. Loblaws, No Frills, Real Canadian Superstore, Maxi, Provigo, Shoppers Drug Mart, and Joe Fresh stores are all subsidiaries of Loblaw.

Canada's largest operator of grocery and pharmacy stores reported its 2017 second-quarter results on July 26, which were better than expected, given a context of price deflation.

Revenue for the quarter ended June 17 rose to nearly $11.1 billion — up 3.7% from revenue of $10.7 billion earned in the same quarter last year.

Loblaw showed a strong rise in profit, driven by a strong customer spending during the Easter period. Thus, its second-quarter profit more than doubled to $358 million, or $0.89 a share, from $158 million, or $0.39 per share, a year earlier.

Big challenges ahead

On the day Loblaw's quarterly results were announced, its share price dropped by 5%. This drop can be explained by another announcement made by the company, which could dampen its profit in the next quarters.

Indeed, Loblaw announced that the rise in minimum wage is going to increase its labour costs by about $190 million next year.

A few days earlier, the Ontario government announced that the province's minimum wage would be raised from $11.40 per hour to $14 per hour on January 1, 2018, and to $15 per hour on January 1, 2019.

In Alberta, the minimum wage is going to raise from $12.20 per hour to $13.60 per hour on October 1 this year, followed by an increase to $15 per hour on October 1, 2018.

The expected $190 million rise in labour costs is forcing Loblaw to find ways to cut costs, such as cutting jobs. The company is planning to do this by increasingly digitizing manual invoice jobs and by installing more self-checkouts in its Shoppers Drug Mart stores.

In simple words, Loblaw is going to replace human workers by machines. This trend already began a few years ago, but the raise in minimum wage is going to accelerate it.

However, there is another solution that doesn't require replacement of employees by machines. According to CIBC World Markets, the company could offset the rise of $190 million in labour costs by increasing its sales prices by 0.4%.

For this solution to work, consumers must be willing to pay more. If they buy less items, this will not work. It's also possible that consumers won't notice a rise of 0.4% in prices, which is very small. But with the fierce competition coming from **Wal-Mart** and **Costco**, Loblaw could be hesitant to rise its prices, even slightly.

Loblaw is facing another financial headwind due to the healthcare reform in Quebec.

The expected cut in generic drug prices by Quebec's government will negatively impact Loblaw's pharmacy business in the coming quarters in 2018, both in the province as well as in the rest of the country.

With all the threats Loblaw is facing, and given the uncertainties surrounding its operations, I don't think this company's stock is a buy right now. It's a great defensive stock to hold for the long term, but if you don't already own it, I would suggest waiting for a better time to buy it.

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