Empire Company Limited: Is the Recovery Real?

Description

Any time a stock jumps more than 10% in a single day's trading, it's only natural for investors to consider why it happened and, more importantly, if it's a sign of things to come.

Empire Company Limited (TSX:EMP.A) jumped almost 14% September 14 on better-than-expected Q1 2018 earnings. That's good news for a stock that's delivered very little for shareholders over the past 30 months; therefore, it's not a bad idea to consider whether this latest move is the beginning of a real recovery in its stock price or a temporary blip leading to further pain and misery.

Here's my take on both sides of the argument.

The real deal

Empire's stock finished 2016 at $15.46 on an adjusted basis including dividends. Rising steadily in the first six months of 2017, it hit the skids over the summer, trading in a tight, up-and-down range between $18.50 and $22.75.

It's been below $20 on two occasions, and now, after the 14% pop, it's twice been above $22. It's hard to know which direction it will head next.

In mid-June, all of the Canadian grocery stocks took a hit on the announcement that **Amazon.com, Inc.** was buying Whole Foods. Empire recovered nicely, trading above $22 in nine days' trading. The next drop came leading up to the latest earnings announcement, and we all know how that turned out.

I'm not a technical analyst, but this would seem to suggest Empire's stock is forming a floor around $20.

"We are encouraged by our first-quarter results. Stabilizing margins, good cost control, and an increase in same-store sales combined with our important transformational work of Project Sunrise gives us a level of optimism not seen in the business for some time," said Michael Medline, president and CEO.

As Medline went on to state in the company's press release, it's still got a lot of work to do to get back to where it was in fiscal 2015, when Empire's operating cash flow was $1.2 billion, or almost double where it is today.

That said, you can't help but think things are looking up for Sobeys.

Nothing more than a head fake

Back in early May, I suggested that investors steer clear of Empire stock for a while.

"Is Project Sunrise enough to turn around Sobeys? Who knows? But Empire had to do it given the dysfunctional state of its business," I wrote. "For the next 12 months, Empire stock looks like dead money to me. For now, I'd be buying **Metro, Inc.** (TSX:MRU) or **Loblaw Companies Ltd.** (TSX:L) instead."

Empire has easily outperformed both its rivals year to date — it's up 40% compared to 0.6% for Metro and 7.5% for Loblaw — so there's no question which stock has the momentum.

The problem for Empire, as I see it, is that it's trying to get its act together at a time when the grocery business in North America is as competitive as it's ever been.

Sobeys could lose serious market share if Amazon starts expanding Whole Foods here in Canada. While I'm not sold on that happening, if it does, you can bet there are going to be casualties, with Sobeys the most likely to take a hit.

Medline has a lot on his plate.

First, he's got to fix the company's Western Canada operations, so the entire business operates as one big unit from coast to coast and not as a bunch of regional fiefdoms. Second, he's got to worry about the minimum wage increase eating into profits gained as a result of Project Sunrise. Lastly, he's got to figure out how to compete with Whole Foods, which is dropping its prices by 30% or more.

That's asking a lot of any management team, especially one that's recently been overhauled with many changes to its executive roster.

Bottom line on Empire's stock price

While I don't see Sobeys being out of the woods by a long shot, I do think that Empire Company *is* a $20 stock.

To get a $30 share price, Empire has to do a lot more than growing its same-store sales by 0.5% and increasing its adjusted EBITDA by 14.6%.

A successful turnaround only comes with higher operating margins and taking market share from its competitors — both of which aren't yet a reality.

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