Why Loblaw Companies Ltd. Might Have a Horrible 2018

Description

Loblaw Companies Ltd. (TSX:L) could be in store for a rough 2018. Not only will rising minimum wages add nearly $200 million in costs to the company's financials, but it estimates that it will incur another $100 million as a result of the gift cards that it is issuing for its role in a price-fixing scheme that lasted more than a decade.

However, Loblaw could be saddled with an even bigger expense, as it is in the middle of a tax dispute with the Canadian Revenue Agency (CRA) that could cost the grocer as much as $404 million in interest and penalties. The trial is set for April 23; the CRA alleges that Loblaw used an off-shore bank account in Barbados to circumvent rules and avoid paying taxes.

In total, Loblaw could see an extra $700 million in costs added this year that would not add any benefit to its operations. That could be a big hit in an industry where we're seeing many retailers struggle, and growing competition from **Amazon.com, Inc.** with its recent acquisition of Whole Foods certainly doesn't help.

Recent performance doesn't generate much optimism

In its most recent quarter, Loblaw's sales were flat, and in 2016 its top line grew by just 2%. Although the company's profits doubled last quarter, a $700 million hit to the bottom line could have a devastating impact on a company that has struggled to find much growth. With a profit margin averaging just 3% in the last five quarters, Loblaw doesn't have a lot of margin for error, and adding non-operational costs to its books will only make it more challenging for it to stay out of the red.

Could pot be the key?

Recently, Shoppers Drug Mart, which is owned by Loblaw, struck a deal with two big-name pot stocks. In early December, the drugstore announced a deal with **Aphria Inc.** (TSX:APH) to sell pot online, and that could possibly open the door to marijuana eventually being sold in store. If successful, it may only be a matter of time before Loblaw decides to add pot to its retail stores (where it is legal to do so).

We've already heard that **Alimentation Couche-Tard Inc.** (TSX:ATD.B) was interested in adding cannabis to its convenience stores, and with the way pot stocks have been soaring in the past year, jumping on the bandwagon might be an easy way to grow sales.

Is Loblaw too risky to buy?

In the past six months, Loblaw's stock has declined more than 3%, and adding a tax dispute to its growing number of issues isn't going to make investors more inclined to buy the stock. At an earnings-per-share ratio of more than 16, the stock is a little high given the struggles it has had in growing sales. However, the stock has still not seen the sell-off that I would have expected given all the issues Loblaw has faced recently, and investors might be better off waiting for a dip before buying the stock.

With limited growth and a dividend of barely 1.5%, Loblaw can only be a viable investment as a value buy, but that is only if it comes down in price.

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