Look Out Below! 1 Troubled Canadian Stock to Be Wary of

Description

Empire Company Limited (TSX:EMP.A) was one of my top contrarian picks for 2017, but after surging nearly 60% in just over a year's time, I think the stock has gone from undervalued to dangerously overvalued in spite of the operational improvements brought forth by the new management team with Michael Medline at the helm. Not only has the stock run up too high, too fast, but there are ominous long-term headwinds that I believe will cause the company a substantial amount of pain over the next three years.

The recent earnings-induced rally may be short-lived

Empire recently released its Q3 2018 fiscal results, which saw an adjusted EPS of $0.33, up +250% on a year-over-year basis and crushing analyst expectations of $0.25. The seemingly impressive bottom-line beat was thanks in part to real estate and asset sale gains. With the exclusion of fuel, same-store sales were up a modest 1.1%, but the most remarkable takeaway is the fact that cost controls have begun to materially impact the financial results, with SG&A expenses that were down 2.1%, slightly lower than what many analysts were expecting.

Empire's cost-cutting program, Project Sunrise, stands to eventually realize $500 million in annual savings, and it's definitely encouraging to see subtle improvements to the financials; however, with one problem solved, another more insidious one is on the horizon.

Industry disruptors could hit Empire where it hurts

Although it appears that the company is almost out of the woods, Medline and company still face an uphill battle. The Canadian grocery scene is slated to become a "bloodbath" over the next five years, as digital grocers move in on select Canadian markets. As you probably have guessed, I'm mostly referring to **Amazon.com, Inc.** (NASDAQ:AMZN) and its planned entry into the Canadian grocery market, which will be a huge gut-punch to all physical grocers.

There's a huge storm coming, and Empire doesn't appear to be well prepared. In fact, it's still trying to retain the customers it lost in the past from its own mismanagement. As a result, the company is in much worse shape versus its peers, which I believe are better equipped to deal with the impending disruption. In order to adapt, Empire is going to need to spend a great deal on e-commerce initiatives, while simultaneously moving forward with Project Sunrise, two time-consuming endeavours which will present a massive challenge for Medline and company.

Bottom line

Shares of Empire are on the right track, but the industry is in major trouble with Amazon looking to prey on existing Canadian grocers. That said, I'd treat the recent rally as an opportunity to exit your position before impending disruption sends shares back into the red. Although there are signs of internal improvements, it will be the external forces that'll ultimately hurt shares over the long term.

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