Empire Company Beats Expectations, but It's Not Good Enough for Investors

Description

Coming fresh off its divestiture of Empire Theaters to become a nearly pure play on the Canadian national grocery market, **Empire Company Limited** (TSX: EMP.A) reported earnings that beat analyst's estimates only to see shares fall after the announcement. So what did investors see that made them sour on the stock? Let's dig in and take a closer look.

The top and bottom line

For the company's fiscal second quarter ended November 2, the company saw adjusted earnings from continuing operations come in at $1.15 per diluted share. This number easily beat the average estimate of $1.09 per diluted share and nearly met the high analyst estimate of $1.16 per diluted share. However, the number was short of the $1.21 per diluted share produced during the second quarter of the prior year.

As far as revenue is concerned, Empire could not have come closer to the analyst estimate producing sales of $4.43 billion which is the exact number the pros were expecting. This number beat the same period in the prior year by 1.8% or $79.7 million.

Digging deeper

As we all know, investors need look beyond just the top and bottom line to not only understand where the company has been for the last quarter, but where it may be headed in future quarters. In retail, one number that draws intense scrutiny from investors is same-store sales.

For Empire's grocery subsidiary Sobeys, same-store sales inched up a mere 0.2%. Management blamed the modest performance on a highly competitive environment which is the nature of this industry. However, the company was outdone by its largest competitor, **Loblaw Companies Limited** (TSX: L) which reported same store sales of 0.4% for its most recently reported quarter which ended on October 5. In addition, Loblaw believed performance may have been hindered by as much as 0.5 to 0.7% due to the Thanksgiving shopping week falling later in the month after the quarter ended.

Another important measure investors can use to assist in the evaluation process is earnings before income taxes, depreciation and amortization (EBITDA). Empire produced an adjusted EBITDA of $214.8 million compared to $213.2 million during the same quarter in the prior year. Of the $214.8 million, the food retailing segment supplied $203.8 million while the remaining $11.0 million came primarily from the company's real estate operations.

So what spooked investors?

Margins, Margins, Margins… The Canadian grocery business is becoming ever more competitive as invaders from the South, **Wal-Mart Stores Inc.** and **Target Corp.**, vie for the almighty consumer dollar. The battle between the two U.S. based retailing giants has forced the grocery retailers to rely on aggressive promotional activity in order to maintain foot traffic.

Adjusted EBITDA edged less than 1% higher during the quarter despite success by the company in controlling costs. The primary culprit was a 51 basis point decline in gross margins. Wal-Mart will most likely continue its efforts to add food to store shelves in order to stay ahead of a more recent entry by Target. This will continue to force grocery retailers such as Sobeys to remain on the offensive with promotions in order to steer customers away from the competition keeping margins under pressure.

Increased focus and expansion

As Wal-Mart and Target look to expand their footprint within the Canadian borders, Empire has made its own moves to broaden the focus on retailing. To that end, the company closed a few major transactions just last month. In an effort to focus its resources more squarely on the retail business, the company closed on the sale of Empire Theaters in two separate transactions for approximately $248 million.

The company also looked to strengthen its presence in Western Canada with the acquisition of Canada Safeway Limited for $5.8 billion in cash which also closed in November. The acquisition will help the company keep pace with competitor **Loblaw** which announced in July it would acquire **Shoppers Drug Mart Corporation** for $12.4 billion.

Final thoughts

The near-term success of Empire and more specifically its food retailing unit Sobeys will lie in management's ability to control and cut the cost structure of the company as the highly competitive environment is here to stay.

The current quarter will be the first full quarter without the theater business and will contain a nearly complete quarter of results from the newly acquired Canada Safeway. The acquisition of Canada Safeway presents both opportunities and risks for the stock. If management is able to leverage the potential synergies created by the acquisition it has the ability to positively impact margins. However, all acquisitions carry a certain amount of integration risks which can negatively impact margins and add to the cost structure.

Currently, I am in no rush to buy into the Canadian retail game and would much rather take a wait-and-see approach to Empire. The third quarter results should give investors an indication on how the integration of Canada Safeway is proceeding and to what degree synergies have been leveraged.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:EMP.A (Empire Company Limited)

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