Why Loblaw stock may finally have hit bottom. Really

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Shareholders of **Loblaw Cos. Ltd.** must feel like they've been run over by a grocery cart. They've endured supply-chain nightmares, nasty earnings surprises, executive shuffles and - worst of all - the growing shadow giant Wal-Mart is casting over the Canadian grocery business.

In short, the outlook for Canada's biggest grocer has never been bleaker. Which is precisely why investors such as Norman Levine find Loblaw's battered stock - down 60 per cent in the past three years - so attractive.

"We like it at these levels because all the bad news is known," says the managing director of Portfolio Management Corp., which bought the shares when they were trading at $32 a few months ago.

They've since dropped to $29.95, but Mr. Levine isn't fazed: He expects Loblaw to soar at the first sign its turnaround is bearing fruit. That could take a year or two, he admits, but he's prepared to wait, because when it happens, "there will be a rush to get into this thing."

Buying at the point of maximum pessimism is a time-honoured investing strategy, and there's certainly no shortage of pessimism swirling around Loblaw. Of the 12 analysts who cover the stock, nine rate it a "hold" or "sell."

But for all the gloom enveloping the company, there are also several reasons to believe the shares have finally hit bottom.

The stock, which is near a 10-year low, trades for slightly more than the value of Loblaw's extensive real estate portfolio, which analysts estimate is worth $23 to $31 a share. Theoretically, that provides a floor to the share price.

Loblaw insiders have been net buyers of 34,000 shares in the public market over the past 12 months, according to INK Research. Insider buying is often a bullish sign because it suggests officers and directors think the stock is undervalued.

Loblaw's retail price reductions to compete with Wal-Mart and other grocers will be largely completed this year, which, combined with layoffs and other cost-cutting measures, should allow Loblaw's depressed profit margins to recover.

The stock is showing short-term momentum, rising in eight of the past nine sessions.

Peter Holden, an analyst with ***Veritas Investment Research*** who rates Loblaw "outperform," points out that having Wal-Mart in your backyard isn't necessarily a death sentence. In the United States, supermarket operator **Kroger Co.** has been gaining share against Wal-Mart in most major markets where the two stores compete head to head.

Kroger succeeded by opening larger stores, improving its technology infrastructure and lowering costs - many of the things Loblaw is doing now. Investors who bought Kroger shares at the depth of its woes in 2002 aren't complaining: The stock has nearly tripled.

There are no guarantees the same thing will happen with Loblaw, of course, and some shareholders aren't sticking around to find out.

"The competition is so ruthless," says Chris Damas, a former Bay Street money manager who is now an independent stock analyst in Barrie, Ont. He recently dumped his Loblaw shares. "I really think this thing is going to the low 20s before it has a resurrection."

But Loblaw fans note that, in addition to the company's extensive real estate holdings, the stock has another layer of downside protection: The Weston family could decide to sell Loblaw or take it private, just as Empire Co. Ltd. did when it acquired the Sobeys chain last year.

For Loblaw, the key to a successful turnaround is to improve its profit margins, which have been decimated by restructuring-related costs and a move to lower prices across its banners. In 2004, Loblaw's EBITDA margin - earnings before interest, taxes, depreciation and amortization as a percentage of revenue - topped 8 per cent. It has fallen every year since, tumbling to 5.5 per cent last year.

Given the increasingly competitive grocery landscape, nobody expects margins to recover to 2004 levels. But many analysts think a bottom is near, and modest margin improvement lies ahead.

"The swoon is almost over, with the floor being hit," Desjardins Securities analyst Keith Howlett said in a recent report.

Shareholders who have suffered one disappointment after another can only hope he is right.