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Three Canadian grocery stocks well worth checking out

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It's been less than a year, but it seems much longer since Target Corp. threw in the towel on its Canadian expansion. It's seemed longer still that Target was poised to be a massive competitive threat to the Canadian grocers, rather than the fabulous disaster it became.

Despite Target's departure, however, some analysts are still warning that the Canadian grocery market is becoming more competitive, given the growing influence of Wal-Mart Stores Inc., Costco Wholesale Corp. and independent grocers. Citing her own price survey, ***Veritas Investment Research*** analyst ***Kathleen Wong*** titled her recent report "Grocery Competition Intensifying." Morningstar analyst Ken Perkins says "competition is increasing in Canada."

A funny thing has happened, however, amid this intensifying competition: Canadian grocers are showing few signs of the profit erosion that has occurred at their peers in the United States. Loblaw Cos. Ltd. is posting some of its highest margins of EBITDA, or earnings before interest, taxes, depreciation and amortization, in years. Metro Inc. has maintained its high margins. Empire Co. Ltd. is also keeping its numbers steady, despite difficulties in integrating Safeway Canada into its operations.

This suggests a couple of things: One, the view, expressed in this space, by this author, in each of the past two years – that Canadian grocers were in for a long-term decline in profits at the hands of major U.S. foes – may end up being just plain wrong. And two, the multiples the grocers have attained this year, higher than at any time since the Great Recession, may finally be justified.

"So far, 2015 has been excellent, and it looks like 2016 will be another great year for grocers," says Perry Caicco of CIBC World Markets Inc. Here's his list of reasons: the Canadian consumer is resilient; grocery square footage growth has moderated; the Canadian dollar will be less of a problem; the space Target abandoned will mostly not be used for food retailing; and a recovering Ontario should add to grocers' profits.

Mr. Caicco acknowledges that "Wal-Mart is becoming a better grocer and is adding square footage quickly; Costco continues to add boxes; and independent grocers (both ethnic and non-ethnic) are thriving." The arrival of a European discount grocer such as Aldi or Lidl could put a dent in his gung-ho thesis, he says. But, "in the meantime, 2015, 2016 and probably 2017 might one day be remembered as the glory days of Canadian supermarkets."

The three major grocers, then, offer a choice for investors. Loblaw, busily integrating Shoppers Drug Mart as it continues its stellar performance, is the top pick of analysts, with 12 of 16 rating it a "buy," according to Bloomberg. Metro offers high performance, a track record of dividend increases, and a scintillating piece – of top-performing convenience-store company Alimentation Couche-Tard – but, priced at an unusually high level compared to its past history, it gives some analysts pause. And Empire, the grocery stock trading closest to its 52-week low, is a turnaround play, appropriate for investors who are willing to wait for it to straighten out its Safeway problems.

At Loblaw, the company's second-quarter results, released in August, "tick all the right boxes," said RBC Dominion Securities analyst Irene Nattal. Ms. Nattal, who has an "outperform" rating and $77 target price on Loblaw (versus Friday's close of $66.27) says the company's sales growth in the quarter proved the company passed along the inflation in food costs directly to the consumer, and then added more revenue through higher traffic and bigger "baskets" as a result of customers buying more. The company also announced the closing of 52 underperforming stores, demonstrating a "greater focus" on return on capital, Ms. Nattal says. (The Competition Bureau has been investigating Loblaw about its pricing practices with suppliers; the resolution will likely impact future profitability.)

David Hartley of Credit Suisse, who has a $79 target price, says he expects strong free cash flow at Loblaw – which has the highest debt load of the three grocers, owing to its Shoppers Drug Mart purchase – to result in an announcement of a dividend increase or a share buyback sometime in the next three to six months. (CIBC's Mr. Caicco, it should be noted, raised his Loblaw target price to $89 in August as part of his "glory days" thesis.)

Ms. Nattal is also bullish on Metro, saying its August results continued to support her thesis that Metro's "relentless focus on solid execution of strategies" to drive sales growth while also boosting profit will deliver strong returns to shareholders. She has a $41 target price, versus Friday's close of $36.06. She's one of eight analysts with "buy" ratings, according to Bloomberg, versus five "holds" and two "sells."

The quirk in Metro's valuation is that it holds roughly $2-billion – about a 6-per-cent stake – worth of stock in convenience store operator Couche-Tard, one of the top-performing consumer stocks on the Toronto Stock Exchange. That's helped spike Metro's share price, so much so that a number of analysts say the current levels can't be supported by Metro's actual grocery performance. "Valuation remains our issue," says Credit Suisse's Mr. Hartley, who has an "underperform" rating and $33 target price on the shares. While he says Metro "continues to manage the business well," the stock is trading well above its 10-year average on a price-to-cash-flow basis. "We are concerned with the potential of a reversion to the mean."

Empire presents no such worries about trading above historical multiples. The company has deeply troubled investors this year with its progress reports on Sobey's acquisition of Safeway Canada. Barclays Capital analyst Jim Durran reflected that with his September notes titled "An integration gone wrong" and "No quick fix: Recovery to take time."

Empire's explanation is that while the integration of information-technology systems went smoothly from a technical standpoint, Safeway employees were slow to adapt to the new computers, leading to excessive "shrinkage," or inventory that went bad, and, as Mr. Durran describes it, "suboptimal" management of the stores' sales and promotions. Mr. Durran believes the problems will be fixed and the merger cost savings will be achieved, but the current problems keep his rating at an "equal weight" and $29 target price.