

Warren Buffett's school of thought says now's the time to buy Loblaw

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The problem with stock analysts is that they're too polite. Jim Durran, National Bank Financial's man on the retail beat, fell into the trap yesterday after Loblaw said *sayonara* to its president, John Lederer.

"Aside from the normal course of succession planning, was there any other catalyst that resulted in today's announcement?" the analyst asked Galen Weston, Loblaw's controlling shareholder.

"No."

That was good enough for Mr. Durran, who graciously dropped the line of questioning. But the idea that Loblaw replaced its top executive in a "normal" succession is, of course, hogwash. Mr. Lederer is young -- 51 this year. He had worked for Canada's largest grocer since he was in short pants. He had been president for less than six years at a company that believes in long-term management. (The previous boss, Richard Currie, held the job for almost 25.)

Even if the analysts bought the explanation, investors did not. No sooner had the lunchtime conference call ended when Loblaw shares began to dive -- again. At \$49.50, they've now fallen 29 per cent in a year and are almost back to where they were five years ago.

That alone does not make them a bargain. But the investment case is intriguing. At a little more than 15 times this year's projected profits, Loblaw is now about as cheap as it's been since the early 1990s. What's Warren Buffett always telling us to do? Buy a good business when it's out of favour because of temporary problems.

No one disputes that Loblaw is a good company, maybe even a great one. It's certainly out of favour. So the only question is, are its problems temporary? It can't seem to get its supply chain right. Stuff is going out of stock much too often. One Loblaw shareholder we know does checks of the aisles; in three visits to his local outlet this summer, he hasn't been able to find Diet Coke. Wal-Mart is building its first Canadian supercentres, which will include a full grocery selection. Loblaw's Real Canadian Superstores are nice but they cannibalize sales in its traditional food outlets. Et cetera.

These headaches are known and well-documented. Unless the new management proves to be incompetent, which is unlikely, the supply chain will get better. The Wal-Mart threat, while serious, may be overblown. Perry Caicco, CIBC's top-ranked retail analyst, figures there won't be much damage to profits at incumbent grocery chains for three or four years because the Beast of Bentonville is expanding slowly at first.

But then, there really hasn't been that much damage to Loblaw's bottom line from *any* of its problems so far, which is the point. The stock isn't down because this is a broken business; it's down because it simply isn't going to grow as quickly as investors were counting on when they were paying 25 times earnings for the stock.

True, profits have not yet returned to their 2004 peak, when Loblaw earned about \$3.50 a share. The massive investment on the Real Canadian banner -- Loblaw's total capital spending has averaged \$1.2-billion a year since 2003 -- is going to produce a few underachieving stores. But the company is earning a 13-per-cent return on equity, which is still decent. Debt? High, but manageable.

Underlying the whole business is a nice portfolio of property. Peter Holden of Veritas Investment Research estimates the land and buildings are worth at least \$40 a Loblaw share (an educated guess, because it's impossible to tell from the company's disclosure). A quick way of lifting the share price would be to spin off the property as a real estate trust, as Empire did with its Sobeys stores this year.

Don't count on it. Short-term financial engineering is not the Westons' style. It's more likely that they'll focus on doing a better job with what they've got. From 1994 to 2004, Loblaw's share profit grew by more than 20 per cent a year. Those days are gone, but expectations are a lot more reasonable, too. In fact, investors seem to be counting on very little growth at all. The P/E ratio suggests they believe Loblaw can grow at just 4 or 5 per cent a year, based on a formula that value-investing guru Ben Graham invented for calculating embedded growth rates.

That seems too pessimistic -- no matter who is running the company.