LOBLAW IN FREE FALL

42% profit drop sparks worst rout in 20 years

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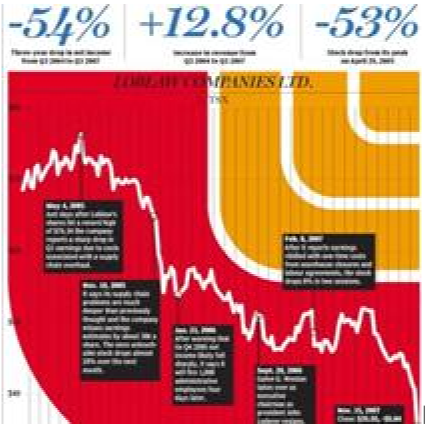

FP DataGroup, Andrew Barr, National Post(See hardcopy for Graphic)

Shares of Loblaw Cos. Ltd. fell the most in 20 years yesterday after the grocery giant widely missed analyst predictions with a 42% drop in third-quarter net earnings and ongoing cost cuts to fight a price war with competitors Wal-Mart Canada Corp. and Sobeys Inc.

"We characterize this period of our turnaround as a period of maximum risk," with continued cost-cutting and increased employee turnover, executive chairman Galen G. Weston told analysts during a conference call. "We expect continued margin pressure and risk to earnings," he added, noting the retailer is about halfway through the risk period.

While Canada's biggest grocery chain stuck to its timeline of a three-to five-year period to return to solid ground, continued downward pressure on margins surprised industry analysts, who had not predicted the toll that ongoing restructuring and price competition would take on the business. The shares closed down 12% yesterday at $35.55.

"[Loblaw] expects margin deterioration in the fourth quarter, and that was a surprise, and further margin deterioration next year even after cost savings," said one retailing analyst. "If [annual earnings] consensus estimates were at $2.80 [for fiscal 2008] that is probably too high by 60¢ or 80¢ -- materially lower than what was out there before. Loblaw also confirmed that it will be late 2008 or 2009 before any significant growth."

Net income fell to $117-million, or 43¢ a share, in the period ended Sept. 30 compared with a profit of $203-million (74¢) last year.

The retailer, which has been shaving prices on 1,000 items a week for the past three months, said price cuts at its stores contributed to a gross margin decline of about $60-million compared with the quarter last year. Operating margin fell to 2.7% from 4.4% and operating profit fell 37% to $250-million. Adjusted for one-time items, Loblaw earned $287-million, or 56¢ a share, compared with $434-million (90¢), widely missing the average prediction of 76¢ a share among analysts polled by Thomson First Call. Revenue at Loblaw climbed 1.4% to $9.14-billion and sales at stores open a year or more rose 1.6%.

"A lot of investors who have been struggling through with this for a number of quarters just said I'm not going to hold this anymore," said ***Peter Holden***, analyst at ***Veritas Investment Research***.

"Loblaw is halfway through a three-part restructuring, there is enormous complexity going on and a lot of extra costs in the system," ***Mr. Holden*** said. "The margins keep going down and the question is can they improve to a reasonable level? These are just bad results, and nobody should try to sugarcoat that."

A $23-million charge in the quarter, or 5¢ a share, was due to severance and consulting fees stemming from the retailer's ongoing restructuring program, a plan to cut 1,000 head office jobs. Costs under the plan, dubbed 'Project Simplify,' are anticipated to be $185-million. An additional charge of $3-million, or 1¢ a share, was booked for liquidating excess inventory.

While it is slashing prices and jobs, Loblaw is also trying to fix its supply chain and attempting to improve general merchandise sales at its large superstores. It expects to spend between $700- and $800-million next year to reconfigure existing stores in a bid to boost sales. A bright spot for the retailer is the potential for its Joe Fresh clothing brand, which Loblaw hopes to grow to $1-billion in sales by the end of 2009. But while sales of Joe Fresh are robust, supply chain problems -- an Achilles' heel for Loblaw over the past two years --delayed the launch of the Joe Fresh hosiery and kids lines by one month, hurting sales in the quarter.