Why Loblaw's recent rally may be overdone

By David Milstead, Globe and Mail
January 30, 2013

Analyst suggests the stock has benefited too much from the company's plans to spin real estate into a REIT

The market loved Loblaw's December announcement that it planned to split off the bulk of its real estate into a REIT; the shares are up 40 per cent, to more than $40, in the six weeks since.

This is perhaps too much, suggest Kevin Chu and Mark Rosen at Accountability Research Corp. They've rated Loblaw a "sell," with a $36 target price.

Mr. Chu and Mr. Rosen estimate the enterprise value – market capitalization plus net debt – of a Loblaw REIT spinoff at $6.6-billion, below what they say is the Bay Street estimate of $7-billion.

The two look at Crombie REIT, the 2006 spinoff of real estate from Sobey's parent Empire Co. At the time, they say, Crombie had just 15 per cent tenant exposure to Sobey's, with the balance coming from a variety of retail tenants. By contrast, the Loblaw REIT will have 83 per cent exposure to the grocer, they say.

Also: Empire Co. kept a minority stake of 49.5 per cent in Crosbie; Loblaw, by contrast, intends to be a controlling shareholder of its REIT, with at least an 80 per cent ownership.

Crombie currently trades at an enterprise value of about 14.5 times its EBITDA, or earnings before interest, taxes, depreciation and amortization, the Accountability Research analysts say. That's roughly two full percentage points below Canadian retail REITS.

Given those circumstances, their estimate for the Loblaw REIT uses a generous 15.5 multiple – and still ends up at $6.6-billion, short of what others see.

"We question the market's appetite for a minority interest in a REIT that has an over-exposure to one tenant," they say.

Still, it isn't the Accountability Research analysts' skepticism about the REIT that's really driving the "sell" rating – it's their pessimism about the grocery business.

To see this, it's helpful to contrast their estimates with those of ***Kathleen Wong***, an analyst at ***Veritas Research Corp.***, another independent firm with a reputation for accounting-driven research. ***Ms. Wong*** has a "buy" rating and $46 fair value estimate on Loblaw.

Ms. Wong values the REIT at $8 per Loblaw share; Accountability Research puts a $7.23 price on it. The big difference is that ***Ms. Wong*** values Loblaw's grocery and financial businesses at $38, while Accountability Research values the company's operations and its remaining real estate at just under $29.

Ms. Wong estimates average EBITDA of $1.85-billion over the next two years and places a multiple of 6 on it. That produces an equity value for the company of nearly $11-billion, or close to $38 per share.

The Accountability Research analysts see $1.66-billion in EBITDA, and place a 4.9 enterprise-value multiple on it. They also estimate Loblaw will have about $500-million more in net debt than ***Ms. Wong*** forecasts, which drives down the equity value they derive. All told, they see the company with a market capitalization of about $7.4-billion, or $26 per share. The real estate that remains with the company, not in the REIT, adds about $2.50 more per share, they estimate.

The two pick the 4.9 multiple because it is in-line, they say, with U.S. grocery giants Kroger Co. and Safeway Inc. "On the grocery side, our valuation for Loblaw reflects continuing intense competitive pressures for the company, particularly from the expansion plans of Target and Walmart in 2013 and beyond," they say.