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L.TO - Q2 2018 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

L reported 2Q18 adjusted net earnings available to common shareholders of CAD421m.



JULY 25, 2018 / 2:00PM, L.TO - Q2 2018 Loblaw Companies Ltd Earnings Call

CORPORATE PARTICIPANTS

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Vishal Shreedhar *National Bank Financial, Inc., Research Division - Analyst*

PRESENTATION

Operator

Good morning. My name is Tiffany, and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited Second Quarter Results Conference Call. (Operator Instructions) Roy MacDonald, you may begin your conference.

Roy MacDonald - Loblaw Companies Limited - VP, IR

Great. Thanks very much, Tiffany, and good morning, everybody. Welcome to Loblaw Companies Limited Second Quarter 2018 Results Conference Call. I'm joined this morning by Galen Weston, our Chairman and Chief Executive Officer; Darren Myers, our Chief Financial Officer; and our President, Sarah Davis.

Before we begin today's call, I want to remind you that today's discussion will include forward-looking statements, such as the company's beliefs and expectations regarding certain aspects of its financial performance in 2018 and future years. These statements are based on assumptions and reflect management's current expectations and are subject to a number of risks and uncertainties that could actual results or events to differ materially from our expectations. These risks and uncertainties are discussed in the company's materials filed with the Canadian regulators.

Any forward-looking statements speak only as of the date they are made. The company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than what is required by law.

Also, certain non-GAAP financial measures may be discussed or referred to today. Please refer to our annual report and other materials filed with the Canadian securities regulators for a reconciliation of each of these measures to the most directly comparable GAAP financial measure. And with that, I will turn the call over to Darren.



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Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Thank you, Roy, and good morning, everyone. We delivered solid financial results in the second quarter. This quarter saw the full impact of changes to minimum wage rates, and the Incremental Health Care reform came into effect on April 1. Overall, we were pleased with our performance against these headwinds.

On May 4, Choice Properties completed the acquisition of Canadian Real Estate Investment Trust, or CREIT, to create Canada's largest real estate investment trust. The financial impact of CREIT is reflected in our Choice Properties segment. On a consolidated basis, revenue increased by \$69 million, adjusted EBITDA by \$48 million and net interest expense and other financing charges of \$48 million in the second quarter of 2018. As a result, the acquisition had a nominal impact on adjusted net earnings in the quarter.

Looking at Q2 on an adjusted consolidated basis, and normalized for the disposition of the gas bar business and the acquisition of CREIT, our revenue grew 1.4%. We delivered growth in EBITDA of 1.3%. Net earnings declined by 2.8% and fully diluted earnings per share grew by 3.7%.

We continued to drive positive same-store sales with growth of 0.8% in food retail and 1.7% in drug retail. Drug retail same-store sales growth had front-store growth of 0.3%, largely attributable to strength in HBA and cosmetic categories. In pharmacy, we saw same-store sales growth of 0.3%, on strong prescription growth performance. Our pharmacy same-store sales were negatively impacted by drug reform.

Looking at food retail. Our internal inflation was marginally lower than CPI of 0.1%. Against another quarter of intense promotional activity, we were pleased with our performance. We delivered growth in tonnage, traffic, volume and basket.

Retail gross margin was 29.5%, up 140 basis points from last year.

Our retail gross margin improved 20 basis points year-over-year after excluding a favorable 70 basis points from the impact of the gas bar business and a favorable 50 basis points from the impact of the consolidation of franchises. Food retail margin was up slightly in the quarter, while drug retail was relatively flat despite the healthcare reform headwinds.

Retail SG&A as a percentage of sales as reported was 20.9% or 140 basis points worse than the prior year. Our SG&A rate decreased by 30 basis points year-over-year after excluding an unfavorable 60 basis points from the impact of the gas bar business and 50 basis points from the impact of the consolidation of franchises.

SG&A was negatively impacted by higher labor rates and foreign exchange losses in the quarter. Against the headwinds, we benefited from higher supply chain fees and previously announced cost-saving initiatives.

On an adjusted basis, net earnings available to common shareholders were \$421 million, a decrease of \$25 million compared to last year.

Normalized for the disposition of the gas bar business, net earnings decreased by \$12 million in the quarter and \$7 million year-to-date.

In the quarter, redemptions against the Loblaw Card program represented \$36 million or \$53 million year-to-date. We saw rent redemptions averaging less than \$3 million per week in the quarter, down from \$4 million per week at the end of Q1. As we stated last quarter, the sales and corresponding profit did not benefit the company's financial performance.

Free cash flow was \$248 million in the quarter, and we continued to return capital to our shareholders buying back 4.6 million common shares at a cost of \$300 million. Overall, we were pleased with our financial performance in the quarter.

On July 1, new Canadian tariffs were imposed on \$16.6 billion of U.S. imports. It is difficult to estimate the ultimate financial impact of these tariffs as it will depend on how suppliers respond and how Canadians ultimately choose to trade.

In addition to the tariffs, we also see continued cost pressures going forward from higher transportation costs and a lower Canadian dollar. We remain focused on overcoming these incremental headwinds. The intensely competitive market in the second quarter meant that inflation was



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more muted than we might have expected. Looking forward, we would not be surprised to see upward pressure in prices given the underlying cost pressures and incremental headwinds noted.

Stepping back, we're executing well against our 2018 plan. We remain committed to our long-term financial framework and are continuing to focus on stable trading, promotional effectiveness, process improvements, and efficiencies, while we invest for the future. I will now turn the call over to Sarah to provide additional color.

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Thank you, Darren, and good morning, everyone. Our long-term strategy relies heavily on a commitment to stable trading in our core businesses. This steadiness supports shareholder value and allows us to invest in new and exciting areas. In this respect, we were successful in Q2.

Two key elements to our strategy are operational efficiencies and making the most out of our data. In terms of efficiencies, during Q2, we added self-checkout kiosks to 58 more Shoppers stores, bringing the total to over 350 nationwide now covering all provinces. We will complete the year with more than 400 sites. Where the kiosks are available, more than 25% of our customers are using them.

In our food business, we are upgrading our self-checkout technology, which is improving scan rates and customer satisfaction. With our latest upgrades, interventions have declined more than 50% and penetration rates are improving. This tells us that customers like the convenience.

On our use of data, customers remain at the forefront of all we do, particularly in promotional and marketing activities. Our campaigns are meant to excite customers, while maximizing our investments. As we give customers clearer promotions, we are getting credit for value. We feel good about the balance we have struck across our promotional mix in store, in flyer and through our loyalty program.

Our confidence is particularly strong in loyalty. Less than 6 months since the launch of PC Optimum, 13.5 million Canadians are now active members, and they are swiping, earning and burning points at a remarkable clip. Penetration rates or the per transaction use of loyalty has surpassed 70% in important categories of our business.

These are not only world-class usage levels; we're seeing year-over-year comp increases in the high single digits. Add that to our customer satisfaction scores of 85%, and it's clear that Canadians are loving PC Optimum. Soon members will have more to love when we go live in Esso stations nationwide, offering points for fuel and bringing us to a total of 4,500 locations where PC points are available. This is the kind of convenience we promised.

Taking a quick look at our pharmacy operations, we continue to seek and find efficiencies. In our Shoppers business we've seen good growth in our C-Pack or Compliance Pack business. Automating complex prescription fills and providing patients that simplifies packaging that provides convenience, safety and adherence. It also frees our pharmacist to focus on higher value patient service and care. Throughout our Shoppers stores we are improving our service offer. We added 20 new enhanced food sections this quarter, bringing the total to 68 on track for nearly 100 by year-end, and in the stores where the enhanced food offering is established, we are seeing a fresh item in more than 25% of customer baskets.

We also opened 2 next-generation beautyBOUTIQUE formats in the quarter. For those of you in the Toronto market, you can see a creative application of both enhanced food and enhanced beauty in our new Yonge and Dundas location where we took over the former Hard Rock Café with an inventive take on a modern urban Shoppers store.

Across the enterprise we delivered on our promise for the quarter with a strong core performance. This is part of our recipe for success allowing us to invest for our growth. With that, I'll turn it over to Galen.



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Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Thank you, Sarah. Good morning, everyone. As Darren and Sarah have outlined, the retail market is challenging. Competitive pressures remain intense and anticipated headwinds remain significant. In this environment we delivered value to customers, grew same-store sales, improved share and controlled cost. It was a good quarter.

Looking forward, in addition to anticipated headwinds, we see incremental FX and transportation costs and the impact of tariff cost pressures. As a result, we expect some acceleration in retail price inflation in the back half. We are executing our strategy, improving processes, reducing cost and expanding our digital presence to deliver the best in food, health and beauty for Canadians. We are doing this right across the enterprise. For instance, as PC Bank has concentrated its focus on payments, they continue to post strong performance and set the stage for future innovation.

In our retail businesses, we are enhancing our e-commerce services through PC Express and home delivery options. The recent launch of our mass beauty assortment online and serving a rapidly growing number of patients and caregivers through our e-pharmacy. And 6 months after the launch of PC Optimum, our loyalty scan rates are higher than ever establishing a powerful platform that will play an increasingly fundamental role in our relationship with customers.

Year-to-date, across our retail divisions, we are drawing most customers in discount and market grocery, at Shoppers Drug Mart and online. Best of all, we are serving customers smarter with consistently improving customer satisfaction scores that tell us we're firmly pointed in the right direction. Our strategy is working.

Roy MacDonald - *Loblaw Companies Limited - VP, IR*

Thank you, Galen. Tiffany, could I ask you to introduce the Q&A process, please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Irene Nattel with RBC Capital Markets.

Irene Ora Nattel - *RBC Capital Markets, LLC, Research Division - MD of Global Equity Research*

Couple of questions, if I may. We heard the word accelerating inflation in the back half of the year a couple of times in the prepared commentary. Can you talk about what you're seeing already, whether you're seeing cost push inflation, what the tone has been, and I guess, it's -- we're about 4 or 5 weeks into Q3, so is it already starting or is it more still to come?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, so, look, the market remains intensely competitive, and that has kept a lid on inflation over the first 6 months of the year. But what we're seeing now is such a significant incremental over and above set of costs that have begun to impact us like transportation and the costs that are going to impact us in the future like the impact of tariffs.

And so when you take the planned headwinds that the industry faced in 2018, add these incremental headwinds, we see a very strong possibility of an accelerating retail price inflation in the market. And are we seeing it, yet? Yes, we are seeing some indications of it across certain categories and as those pressures continue to land on the desks of the merchants from the suppliers, we expect that we will see some more.



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Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

That's very helpful. Also, on the subject of the tariffs, I mean, the whole thing is very complicated. Can you walk us through in terms of the products that you actually have listed in store where you see the impacts of the tariffs and what the plans are in terms of adjusting for these?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Irene, it's Darren. I mean, as you say, it's very complicated and as much as I'd love just to give you some numbers and some estimates, it's very difficult to do so because what we have to figure out is how suppliers are going to react, what actions did they take.

And ultimately, it's going to be up to the customers and what they choose to do and there will be alternatives for them. So it's a little bit difficult to say, but we're certainly closely monitoring it and actively managing it.

Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

Okay. Understood. And then just one final one from me, if I may. In terms of the e-commerce rollout, where are we in terms of store count and are we on track with regard to the announcements you made at Q1?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

So we are absolutely on track. Very pleased with the progress both in terms of the rollout of PC Express, our click-and-collect proposition and then also our home delivery relationship with Instacart. I wasn't going to say the number that we are at this point, but we're just over 500 click-and-collect locations. And we're on track to deliver the numbers we expect for the year.

Operator

Your next question comes from the line of Kenric Tyghe with Raymond James.

Kenric Saen Tyghe - Raymond James Ltd., Research Division - SVP

Galen, to drive tonnage traffic volume and basket out as highlighted in the context of the market takes some doing. Could you speak to some of that strength and perhaps also just even directionally, how much of those wins were PC Optimum tractions sort of driven as Sarah highlighted?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Okay, I think I'll take that. It's Sarah. So, I would say some of it definitely comes from the new loyalty program. Our customers do seem to really like it, and we are seeing the high penetration rates that I mentioned.

Another piece to it would be just we are working on our promotional effectiveness, which I think I talked about at the last call, which is really finding the -- as perfect a mix as you can between your promotions in the flyer versus in-store promotions as well as combining it with loyalty and finding that great mix, which allows you to have incremental sales that cost you as little as you can, while at the same time exciting your customers. So that's really the work that we are currently working on.

We started in one of our food divisions. It was something that Shoppers did quite a bit of before. So they're now adjusting to the new PC Optimum program, but continuing that work. And then we've started it in one of our food divisions, and we are basically going methodically through categories and then, also starting to bring that into one of the other -- our other food division.



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So I would say, it's trying to be a little more analytical. We've sort of ramped up in that kind of core strength within our business as well and that would be part of what we are -- what you are seeing.

Kenric Saen Tyghe - *Raymond James Ltd., Research Division - SVP*

That's great. Thanks very much, Sarah. If I could quickly just switch gears on the gross margin and drug and healthcare reform. You highlighted not much impact or modest impact in core to there.

Could you just share with us was that broadly in line with your expectations? Are there increased margin pressures expected in terms of healthcare reform in the back half or are the pressures sort of tracking as expected or your mitigating actions proving as effective as you expect, or however you care to answer the question?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Yes, sure. So, we were definitely pleased with the performance, I would say, it was as expected. A couple things I would note to you. First is that, we had 11 of 12 weeks of reform in the quarter. We were also -- were helped by our focus on stable trading as well as a supply chain handling fee and we did get some benefits from shrink as we have a number of initiatives around inventory and we are seeing some of the benefits of that in the quarter.

As we look forward, although we're not giving guidance, I would say that we would expect to see some pressure with the full impact of reforms as we go into the second half.

Operator

Your next question comes from the line of Jim Durran with Barclays.

James Durran - *Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst*

So on -- just going on the drug reform side. The 0.3% RX comp store sales number. Should we then be expecting like if volume stays at sort of the 3% level, that drug reform brings us back close to 0% comp store sales for the rest of the year until we lap in April?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Yes, I don't want to give guidance on the number going forward. We certainly had good script growth this quarter, and we had some favorable mix that we would expect to continue in the back half, but there will also be some additional pressure with full reform in the back half. So there'll be a little bit of downward pressure, I would say, as a directional comment.

James Durran - *Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst*

Okay, appreciate that. On e-commerce, just on Instacart. Is there anything you can give us in terms of observations about how that business is performing and some idea about the rollout plans from here?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

I think not much more than what we said in the last quarter other than to affirm our conviction. We continue to roll Instacart out across the country in multiple incremental markets. We're very pleased with the response that we see. There's a high level of interest.



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We see it predominantly incremental to the click-and-collect business. It seems to be continuing to trend as a different shopping need or shopping experience that quick 1 hour to 2 hour turnaround, very attractive to customers. The baskets are not quite as big, suggesting that they are, again, more convenience-oriented shops as opposed to full stock-up shops. But none of that is different to what we talked about in Q1. We would expect to continue to drive that strategy through the balance of the year.

James Durran - *Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst*

And how are you finding the competition for that e-commerce customer? Is it placing any incremental pressure on the pricing that Instacart is trying to bring into the market? And how much they're trying to charge for handling fees or full-year membership?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

No.

Operator

Your next question comes from the line of Mark Petrie with CIBC.

Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

Thanks for the color on the food retail gross margin performance, but I did just want to come back to it and just understand it a little bit more clearly. Is essentially the positive result is really the payoff from loyalty and your work on data analytics and refinements in promotional strategy and tactics or are there other factors driving that number?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Yes, it's certainly those items that Sarah talked, I mean, that's overall how we are managing and driving margin improvements. But in addition to that, I would say, in the quarter, we are seeing the benefits of the spike in handling fee and as well in food and in drug we saw benefits from food shrink. So the teams did a very good job particularly in the face of the headwinds that we've seen in managing the stable trading.

Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

Okay. And I've heard -- made comments in the past about sort of tolerating tonnage softness in the first half of 2018 or through the course of 2018 as you've kind of learned processes for those adjustments in terms of merchandising and promotional weights and tactics, but the tonnage performance has been quite strong.

Wonder if you could just talk a little bit about how you're feeling about the performance and what your outlook is for the balance of the year?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Okay, so I think it's true. We did say maybe last call or the call before, that we are focused on good tonnage, and not doing things just to drive tonnage that may not be in the best interest of our customers. And so really, that's still what we're doing. We are pleased with the tonnage that we are seeing. We do feel like the business has been performing well.



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It's always hard to predict how you're going to perform in the back half of the year, but we don't have any plans to change anything. So we're still -- we'll continue competing as we do focused on the areas that we've talked about being a little more analytical and focusing on the customer and hopefully that will mean that our tonnage continues the way that we've seen it in the past.

Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

Okay. And then just last. Sarah, could you just clarify your comment in the script with regards to the Optimum program and the year-over-year comp increases in the high single digits? What's that referring to exactly?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Yes, it's a focus, and so basically we have many different types of customers, and we group them into different levels. And what we're seeing is in some of our most engaged customers, which are, of course, are the ones that we love to have. We're looking at -- and those that were involved in both programs in the prior year, we are seeing that they are -- there is even more cross-shop.

They are loving the program more and for those customers we are seeing a high single digit improvement, which is great. We want our very loyal customers to love the program and that's what we're seeing.

Operator

Your next question comes from the line of Patricia Baker with Scotiabank.

Patricia A. Baker - *Scotiabank Global Banking and Markets, Research Division - Analyst*

I think this question is for you, Galen. If we go back to the initial announcements that the minimum wage is going to increase and we had the healthcare reforms. And at that time, there was a lot of people were talking and speculating that what would happen is that you would try to pass through and mitigate that -- some of those costs by increasing prices.

And then if we go back to your commentary in I think the month of March, you were quite adamant in stating that the last thing that you really wanted to do was just to take prices higher. And at that time, we were aware of the minimum wage, we were aware of the drug reform and the higher transportation costs.

So looking at what you're saying today and that you have an expectation that we will see higher prices -- the likelihood of higher prices in the back half, I'm wondering if that statement is primarily be -- coming from the impact of the proposed tariffs?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, I mean, look I think transportation in addition to tariffs is impacting us in an increasingly meaningful way, and we see that continuing for some period of time. Look, you know my view. My view is that inflation over the long term -- too much inflation over the long term is not good for our competitive position. We're committed to delivering value to our customers as often as possible with our pricing strategies.

And, but there are limits. We are trying to manage a financial plan. And as the costs continue to pile up, we are changing our view a little bit and see that these structural changes are going to put pressure on retail pricing across the industry. We don't think it's going to be meaningful, super significant, but it certainly will be higher than what it is today.



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Patricia A. Baker - Scotiabank Global Banking and Markets, Research Division - Analyst

Okay. And if I may, I'd like to ask a question about Shoppers. We look at the script count growth was 2.9% this quarter. We're seeing a decline in the trend there. It's been decelerating. Is there anything particular happening in the market and do you know where the market was overall in the period?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

When you say do I know where the market was, which market do you mean?

Patricia A. Baker - Scotiabank Global Banking and Markets, Research Division - Analyst

The script count -- overall script volume in Canada.

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Oh, I see. Yes. So, look we're quite pleased with the performance of our script volume. Obviously there's deflationary pressure on the top line. That is a concern that we have to actively manage. But relative performance in the market is very satisfactory.

Patricia A. Baker - Scotiabank Global Banking and Markets, Research Division - Analyst

Okay, and one final question. Sarah, you gave us the penetration of self-checkout in the Shoppers side of the business, and referenced that, you are seeing an increased penetration in food, but can you give us what that number is?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Yes, so, in food it has always been in the low 20s. And now since we've made some adjustments to the software to make it a little bit more customer-friendly, we're seeing it above 25, so 26 that type of range.

Operator

Your next question comes from the line of Michael Van Aelst with TD Securities.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

You covered pretty much all my questions other than just maybe you could just give us an update though on some of your technology initiatives, including timeframe of when you'll be adding SAP into the drug side?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Okay, I can take that. So basically, most of our technology upgrades have been -- the [concept] of the back office is pretty done with SAP in Loblaw and then JDA, we use for our supply chain. And we do in both businesses have that back office.

In terms of SAP, we've sort of got a bit of a phased approach going where SAP -- and JDA is already in the distribution. So bringing SAP specifically to stores, we don't actually have a timeframe. It's not happening in the next couple of years, but having the back office and all of the financials and supply chain all on the same systems, we are on track to have that done in the next year or so.



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But purely in the stores, we don't have a plan to bring it -- roll out SAP to the Shoppers network in the next couple of years. Maybe I'll just add that ultimately we do want them on the same systems, but because their systems are working fine, we don't feel like we need to make the investment until it's time to make an investment in the store systems and then we will bring them on to the same systems.

Operator

Your next question comes from the line of Peter Sklar with BMO Capital Markets.

Unidentified Analyst

This is Jennifer filling in for Peter. I just have one quick question. I noticed that the square footage growth in the quarter was pretty minimal. So how do you see that playing out for the rest of the year and going into next year?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Jennifer, it's Darren. That's as expected. I mean, our strategy has not been to add significant square footage each year. So it's consistent with what we have stated before and that's where you should expect us to be maintained.

Operator

Your next question comes from the line of Vishal Shreedhar with National Bank.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

On RX script count growth, do you see any benefit to the actual count growth when prices go down, maybe in the cash-pay business?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

It's not meaningful. No.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

Okay. Once upon a time, Shoppers used to say that they would focus on professional services in pharmacy in part to offset the pressure from reforms. Is this still a focus for Loblaw? And if so, is it a material benefit? And how big is the professional services business?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

So professional services continue to be an important part of the strategy, and we've been growing that business steadily consistently across the country for the last 3 or 4 years. It's slow going because it's dependent upon the regulatory frameworks in each of the provinces in terms of what they allow and as you probably know they're quite different across the country.

At this stage, it's not an enormous business. I wouldn't describe it as material. But we do see it continuing to grow, and ultimately, it will become a meaningful part of how we generate revenue inside our pharmacy business. And then the other place that we are focused is on specialty pharmacy. And that's an important area of strategic growth for us, and we have some good results in the second quarter there too.



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Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay. Galen, I think, in the script, you said that this was a good quarter, but looking, let's say, taking a few steps back, looking at the course of the year, what metrics, if you can simplify it for us, and pick a few, what metrics do you use to define what constitutes a good quarter or a good year actually? Is it return on invested capital, tonnage growth? What would be the ones that you'd point out for the investment community?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Well, we have a financial framework and that financial framework is the starting point for how we measure our success. That financial framework translates into a budget, and then we provide our perspective on the year based on that budget. And so that's how we judge our performance.

It includes all the things that we've talked about, it includes stable trading, it includes stable margin, it includes making sure that we have stable-to-positive share. It includes SG&A leverage, and it includes returning capital to shareholders and improving our return on capital. So it would be all the metrics that you would expect us to look at, and in that context, of a more difficult year than in past years, we feel this was a good quarter.

Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay, I think I may have tried to ask in the past, but it seems from quarter-to-quarter, Loblaw says they are successful in -- more often than not, in achieving stable trading. And I have gotten to the point where I don't really know what that means.

Is there any help you can give me, maybe, like is there a gross margin range that management looks at? Is it quantitative, when you're saying stable trading? Maybe some help there would be appreciated.

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Stable trading for us is we don't want to have big swings in the top line or gross margin performance in the business in between quarters. And so, that's really ultimately what we mean.

We measure it in terms of share, relative share performance. We don't need to overshoot in a given period of time with share and we also don't want to give up a significant amount of ground.

And the same thing, we have a band in terms of what we think our gross margin should ultimately look like because if you do see your gross margin in a particular quarter, that delivers good earnings, but it creates volatility in future quarters, and if you overinvest in your gross margin in a particular quarter, the exact same things happen. So this is about managing within consistent bands in sales and margin and share from quarter-to-quarter and year-to-year.

Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

So this is a quantitative measure? So it's not qualitative when you say we've achieved stable trading?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Oh, it's both. But it has quantitative bands that we guide ourselves to internally.



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Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay, and those bands are internal, and you can't share those with the investment community? Or any help that you can provide there?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Nope.

Operator

Your next question comes from the line of Chris Li with Macquarie.

Christopher Li - *Macquarie Research - Research Analyst*

I think Sarah, last quarter, you highlighted some initiatives had begun to reduce the costs that -- to reduce the goods not for resale. Just wanted to see if you can give us an update in terms of where are you on that initiative and what is the size of the opportunity there?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Okay. For sure, goods not for resale would always be one of the areas we would go to for whenever we're looking for cost savings. There is a lot of money that we spend in that area. In terms of a target, I don't think I want to give out a target of exactly what we're looking for. But we would always look for improvements from year-to-year in that area, and I think that's about all I can say on that.

Christopher Li - *Macquarie Research - Research Analyst*

And will you see the benefits manifested being in the cost of sales line or in operating expenses?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

It would be in operating expenses, SG&A.

Christopher Li - *Macquarie Research - Research Analyst*

OpEx. Perfect. Okay. And then, Galen, wanted maybe to get your high-level thoughts on the prospect of national pharmacare being implemented and how do you think that could potentially impact the pharmacy business over the longer term?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, so look this is an important subject of discussion across at the federal level, at the provincial level and clearly for those of us who are in the industry. Our perspective, we support a pharmacare system that provides coverage for Canadians who don't currently have access. We also support a consultative approach and we look forward to and are actively working with the government to develop an effective policy that serves Canadians' needs.

At this stage, it's hard to say ultimately, which way it's going to go. Suffice to say I think everybody's working together to make sure that we have the right coverage for Canadians and we need to make sure that we do that in a cost-effective way. As we get more clarity on how that policy is unfolding as we get more certainty, we'll certainly share it with the analyst community.



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Christopher Li - *Macquarie Research - Research Analyst*

And is it your understanding that the recent 5-year agreement between the provinces and the [maturing] drug manufacturers, that agreement will not be affected even if Canada does go to a full national pharmacare system within, say, the next couple of years?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

You'll have to ask the Federal Government that. At this stage we can't comment, but suffice to say we don't know ultimately what this is likely to look like, but we are actively participating in conversations.

Christopher Li - *Macquarie Research - Research Analyst*

Okay, and my last question is, as the industry continues to evolve being in e-commerce or healthcare, can you share with us your latest thoughts on M&A and potential opportunities there to strengthen the company in certain areas?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, so, clearly, like everybody when asked this question, we don't comment on our M&A activities. It's also important I think to mention. We believe we have a very, very strong set of assets, and that we can compete effectively both in the present and in the future with those assets.

Would we ever consider supplemental M&As to help us execute that strategy? Sure, every -- I think, every good company would. But in terms of large acquisitions, that you might contemplate, that really doesn't fit into our strategic outlook at this time.

Operator

Your next question comes from the line of Keith Howlett with Desjardins Securities.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

Yes, I had a question on the front end of Shoppers Drug Mart, which I guess, has a high/low strategy, much like, I guess, grocers. But I'm wondering whether what your plans are to take that business online, and whether it will pose any specific problems relating to its front-end pricing strategy?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

So I think, a little premature for us to comment on that. You can see in the last couple of weeks, we launched our mass beauty proposition from Shoppers Drug Mart online. That's very exciting for us. Beauty is obviously a huge area of growth and it's got attractive online economics.

Ultimately, it's fair to imagine that there will be an online proposition available to customers in other parts of the center of the store, but it's too early for me to comment on how exactly that would look or what the economics are likely to be.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

And then I was just wondering on the -- if you can give a bit of a recap of the supplier and handling fees as to how well it was implemented across the supplier base and, whether it's where at the level you anticipated and whether it was sufficient to offset some of the headwinds that you had forecast?



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Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Yes, Keith, the supplier -- the supply chain handling fee has gone as expected certainly, and it's being rolled out and accepted by the supply base. So I would say, everything is on track from that end and it has certainly -- that plus the other cost-reduction initiatives we put in place are certainly on track, which is part of the reason we're getting the good performance that we're getting in the current environment. So I would say everything is going as it should be.

Operator

(Operator Instructions) Your next question comes from the line of Jim Durran with Barclays.

James Durran - *Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst*

I've just been hearing from some U.S. sources that perhaps the China-U. S. tariffs could result in excess supply of produce in the United States and therefore, potentially provide a deflationary opportunity for Canadian grocers importing product from the United States.

In your comments about increasing inflation as you look out, is that incorporated? Or are you seeing the possibility of any deflation in the imported products?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Oh goodness. I mean, there is so much speculation at this point about the cross-border impacts, the global impacts of the trade wars that are taking place.

We're trying not to speculate on the future. We are trying to focus on the policies that are firm. The ones that we can understand and the ones that we can make day-to-day decisions on. And so that's what we're doing.

And the tariffs we know about are the ones that the Canadian government has put on U.S. imports and that's where we are focused today. Consequential impacts at this stage are purely speculative. If they become clear and they become meaningful, we will certainly have a point of view.

Operator

Your next question comes from the line of Keith Howlett with Desjardins Securities.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

I wonder if you could just comment on what you're seeing from the consumer in terms of their choice of channel and how they're spending on goods across the grocery store? Whether they look pinched or whether they look confident, that sort of thing?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes. No notable changes in trend from past quarters or even in past years. I wouldn't say that the consumer anywhere is feeling particularly flush in the way that they are spending. You can see the competitive intensity that's out there.



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They are particularly focused at the discount end where people are aggressively looking for the value shopper, but that is not a big change. That's been the case in this country for many years. And it continues to be the primary battleground for customers and we are actively engaged on that front. So that would be it.

Operator

Your next question comes from the line of Chris Li with Macquarie.

Christopher Li - Macquarie Research - Research Analyst

Just a -- one quick one on click-and-collect. Galen, I believe you now have some stores that are offering click-and-collect for 3-plus years now. And just wondering for those stores, are they generating enough volume now that you're breaking even in terms of covering the labor expenses required to pick the goods?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Yes, so we see positive contribution in our click-and-collect business. And obviously, that contribution is more significantly positive in the locations that have been open for a longer period of time. And it's a reflection of volume and the efficiency with which those stores are able to process that volume, both improve over time.

Christopher Li - Macquarie Research - Research Analyst

Okay. And just overall for your click-and-collect business, what would you say the average substitution rate is so far on average?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

So I don't think we are publicly disclosing that, but we would say that our service levels, which we measure very closely in PC Express and click-and-collect, are not wildly different from the service levels that people would experience in store.

And we have an active program of working with customers to make sure that we are making attractive substitutions available to them. And there's always opportunity to improve those service levels both at store level and with click-and-collect and we are actively working on that too.

Operator

There are no further questions in queue at this time. I turn the conference back over to our presenters.

Roy MacDonald - Loblaw Companies Limited - VP, IR

Great. Thanks, Tiffany. Thanks, everybody, for your time this morning. If you have any follow-up questions you know where to contact me. And please mark on your calendar, November 14, when we will be online discussing our Q3 results. Thanks very much, and have a great day.

Operator

This concludes today's conference call. You may now disconnect.



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