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EDITED TRANSCRIPT

L.TO - Q3 2018 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 3Q18 adjusted net earnings available to common shareholders of CAD562m.



NOVEMBER 14, 2018 / 3:00PM, L.TO - Q3 2018 Loblaw Companies Ltd Earnings Call

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PRESENTATION

Operator

Good morning. My name is Mariama, and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited third quarter results conference call. (Operator Instructions) Thank you.

I would now like to turn the call over to Roy MacDonald, Vice President, Investor Relations. You may begin your conference.

Roy MacDonald - Loblaw Companies Limited - VP of IR

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

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 cause actual results or events to differ materially from our expectations. These risks and uncertainties are disclosed in the company's financial 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 otherwise 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 not financial GAAP 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'll now 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, everybody. We're pleased to report strong operational financial results for the third quarter.

On an adjusted consolidated basis and normalized for the disposition of the gas bar business and the acquisition of CREIT, we delivered year-over-year growth in revenue and EBITDA of 2%, net earnings growth of 2.6% and fully diluted earnings per share growth of 8%.

On an IFRS basis, net earnings available to shareholders declined 88% year-over-year. The decline was mainly due to the \$432 million gain recorded last year from disposal of the gas bar business and a \$367 million charge in the current quarter related to the court decision on the Glenhuron Bank tax matter.

We continue to deliver on our financial plan in the quarter. Our same-store sales grew 0.9% in food retail and 2.5% in drug retail. In food retail, the positive same-store sales were driven by a higher amount of traffic, a higher average item price and higher basket. We benefited from mix in the quarter as we saw overall price inflation in our basket despite a slight decline in our broader internal inflation index, which came in marginally lower than CPI of 0.3%.

In drug retail, Front Store same-store sales were strong at 4.3%, with growth in all categories. Positive pharmacy same-store sales growth of 0.5% was driven by strong prescription growth, which more than offset the negative impact of drug reform.

Retail gross margin was 29.1%, an improvement of 90 basis points from the same quarter last year. After excluding the favorable impact of the gas bar business of 20 basis points and the consolidation of franchises of 60 basis points, retail gross margin improved by 10 basis points.

Strength in food retail gross margin, driven in part by our focus on promotional effectiveness, was partially offset by the negative impact of drug reform and drug retail.

Retail SG&A as a percentage of sales was 20.6% or 70 basis points worse than the prior year. After excluding the unfavorable impact of the consolidation of franchises of 60 basis points and the gas bar business of 10 basis points, retail SG&A was essentially flat.

Our performance reflects our continued progress delivering our cost-saving initiatives driving efficiencies and successful in mitigating the headwinds.

Our effective tax rate in the third quarter came in at 25.7%, lower than our typical range as a result of Choice's acquisition of CREIT. We expect our go-forward tax rate to return to approximately 27%.

On an adjusted basis, net earnings available to common shareholders were \$562 million, an increase of \$13 million compared to last year. Normalized for the disposition of the gas bar business and the acquisition of CREIT, net earnings increased by \$14 million in the quarter.

We continue to deliver strong free cash flow, with \$318 million generated in the quarter. We did not repurchase common shares in the quarter. We expect to resume our buybacks in the fourth quarter.

With the completion of the spin-out of Choice Properties REIT to George Weston Limited, the third quarter will be the last full quarter in which we consolidate the REIT. In the fourth quarter, we will report the Choice Properties segment as a discontinued operation representing less than 4 weeks of the REIT's financial results. Overall, we are pleased with our financial performance and progress in the quarter.

I would now like to turn the call over to Sarah to provide additional color.



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

Thank you, Darren, and good morning, everyone. Our business performed well in the third quarter, and we continued to deliver on our stable trading commitment. As we execute against our strategy, we are seeing a very healthy cycle developing. Our ongoing rollout of our data-driven promotional tool is helping to drive customers into our stores yielding a more profitable mix, which in turn enables us to reinvest and deliver even more value to our customers. Our efforts to streamline our processes and drive efficiencies allows us to accelerate investment into our growth initiatives. These investments are exciting for us and, I think, for our customers.

During Q3, we launched a rebranded beauty website at shoppersdrugmart.ca. Customers can now shop a full assortment that includes prestige cosmetics, fragrances, mass cosmetics, skincare products, cosmetic accessories and hair color products. We have doubled our online assortment which in turn has doubled the number of site visits.

After opening our new flagship enhanced beautyBOUTIQUE store at Dundas Square in late June, we opened 6 new next-generation beautyBOUTIQUE formats in the quarter. The Dundas Square store is far exceeding our expectations. The next time you're in Toronto, I really encourage you to check it out.

We don't often talk specifically about our discount business. Our discount business stores -- our discount stores posted strong comps and delivered strong financial results in the quarter. And not only does our discount team run great stores, they are also a very creative group winning several awards for their #Hauler campaign. If you somehow missed this campaign, I encourage you to check it out on social media.

In our market division, we have become quite sophisticated in the use of our data, and we've delivered a 200 basis point improvement in our promo margin rates while delivering positive same-store sales.

PC Optimum has now grown to over 15 million members. We are delivering meaningful personalized offers to our members every week. Those members will earn over \$1 billion in rewards this year across our retail network and through our partners, including Esso and Mobil gas stations.

Our most loyal customers are also collecting points on their PC MasterCard. We have always known that this was a fantastic card, but our commitment to delivering exceptional customer value was officially recognized in September when J.D. Power ranked PC MasterCard #1 in customer satisfaction in its Inaugural Canadian Credit Card Satisfaction Study.

We continue to aggressively rollout online grocery across the country. We set some meaningful targets for ourselves this year, and we feel good about our progress and the results.

At the end of Q3, 70% of Canadians have access to click-and-collect across 521 stores and 28 spokes, including 19 Shoppers Drug Mart locations. Our home delivery rollout now provides ultimate convenience for 60% of Canadians and 13 markets nationwide. In the coming days, we will expand to 5 more markets.

In Q3, we delivered strong performance in our businesses, delivered exciting services and value to our customers while also continuing to generate the efficiencies that will allow us to invest for the future.

With that, I will turn the call over to Galen.

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

Thank you, Sarah, and good morning, everyone. As you've heard, we had a strong third quarter, reflective of our well-established commitments to stable trading, addressing headwinds and future-focused investments across our business. In our stores, we delivered value to customers and strong traffic and basket growth followed.



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Our Shoppers Drug Mart, same-store sales grew both in front of our stores and over the counter. Same-store grocery sales were healthy and particularly strong in our discount business.

Our gross margin improvements demonstrate our focus on promotional effectiveness. This includes improved pricing strategies with the increased use of data-driven insights. Very simply, we're spending money where it matters and foregoing promotions that offer unclear value to customers or diminishing returns for our business.

The drive to give customers meaningful value is further amplified by the strength of our loyalty program. As PC Optimum continues to grow, it becomes an increasingly powerful platform for our business, our supplier partners and our customers.

As Sarah noted, we also are saving money where it matters. Our SG&A performance demonstrates that we are continuing to meet headwinds head on and finding efficiencies in different parts of our business. Although those savings don't drop to the bottom line every quarter, they offset headwinds and support new growth areas. Again, smart spending and growth are key themes.

Our investments are clearly focused on e-commerce where we continue to drive the on-demand services our customers want, giving them convenience, choice and the speed that defines digital commerce. Our leading omnichannel network will be key to the future, and we continue to invest to be the Canadian leader.

Loblaw is a future-ready business, and we're building a future-ready workforce. We have hired over 1,000 people in software development, UI design, DevOps, AI and machine learning and data science. As evidence of our progress, this fall, our Loblaw digital division was voted as one of the top 10 employers in Toronto for tech workers.

As of November 1, we have completed the spin-out of Choice Properties REIT to George Weston Limited. This reorganization simplifies Loblaw as a pure-play retailer that is focused on enhancing its core business while executing its growth strategies in connected health care, digital retail and payments and rewards. We are encouraged by the market's reaction to this reorganization.

Looking ahead, our core business performance was strong in the quarter. That strength is being unlocked by process and efficiencies by insights and by increasing investments in key areas like leading e-commerce and payments and rewards. There's been a lot of heavy lifting, and there is still a lot more to do. That said, we are bullish about our strategy and comfortable with our progress. It remains an engine that will support our financial model and allow us to invest to drive growth in areas that matter to our customers today and tomorrow.

We'll now open the floor for questions.

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

Clearly, solid same-store sales, good margins, good SG&A control. You alluded to PC Optimum and the new promotional strategies being critical to that. Can you walk us through what changes you're making? And really how we should -- where you are in this process? And how we should expect it to evolve as we move forward?



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

Irene, it's Sarah. I'll take that one. So there's a couple of areas, and so promotional effectiveness covers a large area, but I'll give a couple of examples. The first one on loyalty. The ability of loyalty is that you don't have to do the mass offers that we would do through a flyer, which allows us to customize a promotion to a specific customer. And this can get as detailed as offering different spend structures to different types of customers. For example, if you take produce, for example, one customer might spend \$20 a week on produce and a different customer might spend \$30 a week on produce. And traditionally, we would have given them both the same spend stretch, which, if it was \$25, the person who was already spending \$30 is just getting money when they would have spent that anyways. So what we're now doing is customizing these offers by giving the person who spends \$30 maybe the opportunity to spend \$35 and the person who spends \$20 to spend \$25. So getting much more detailed into the actual offers, which allows it to feel more customized to a customer, so they prefer it, and it also allows us to save some money on promo as well. That would be one example. There's other examples on what we're doing with the flyer as well.

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

That's really helpful. And if you -- presumably you're -- to the extent that the number of PC Optimum members continues to grow, this was kind of early -- where are we in the stages of the evolution of how far you can take this?

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

Oh, I guess, when you consider we launched in February, it's fairly early in the evolution. I feel that every month, we come up with new ways to look at it, and we can test the beauty of our business as we can test a few things with a few customers and try it out and see how it works in different banners or in different parts of the country as well. So I would say we're still fairly early in terms of that. We're still working on getting more members. We're also still working on improving the penetration rates, which are significantly higher than they were in either of the programs before the combination, but we'd always love it to be higher. So still lots to do.

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

That's very helpful. And then just finally, if I may, you noted in your commentary, Sarah, that discount had a very strong quarter, can you talk about the drivers? And can you also talk about the relationship between PC Optimum in driving traffic and discount because I think you're the only ones that really offer this kind of a program in discount?

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

Yes, so I think traditionally, discount has been -- had a lower penetration of -- we started later on the food side. So in No Frills, it would have come later than we would have introduced it into some of our other banners. But what we are seeing is discount customers really are enjoying the program as well. So it would be part of the driver. Our superstore business is actually the highest penetrated now in terms of the loyalty program. So that is helping. So of course, the superstore in the West is a large part of our business. So seeing the high penetration of loyalty there would be part of their performance. I think some of their advertising campaigns have really helped drive some traffic in as well. Certainly talked about it a lot on social media, certainly the #Hauler campaign for No Frills was -- stirred up a lot of the conversation in a positive way. So all of those would be different ways. And then I would also say just some of the work we're doing on -- in flyer, which for us discount is pretty driven by the flyer. So being a little bit more sophisticated in the types of offers we've put in the flyer as well has allowed us to get the traffic, but at a lower cost of promotion.



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

That's great. And then just one more, if I may, more of a housekeeping-type of question. You didn't buyback any shares in Q3. You noticed you're going to resume in Q4. Does this -- should we imply that you're going to be buying back a lot of shares in Q4 to use up some of that free cash flow that you haven't used up?

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

Yes, I think, Irene, we were pretty heavy in the first half of the year, as you know. So we're still looking to do relatively the same number of shares as we did last year. So no change in that, and we'll resume that in the fourth quarter.

Operator

Your next question comes from Kenric Tyghe with Raymond James.

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

I wonder if you could just briefly touch on food inflation and food inflation dynamic in quarter. Certainly, for the market, it seemed to have accelerated less than what's perhaps expected or messaged by a number of players on the last sort of go around. Could you speak to sort of the dynamic there in terms of how and why that evolved as it did and perhaps as to your decisions with respect to your performance or your own internal coming in below food CPI?

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

Yes, so look, I mean I think the first important message is that we're very comfortable with our sales and tonnage performance in the quarter. We've also said on a number of occasions over the years that, that street map as a proxy for tonnage growth is an imperfect measure. CPI doesn't tell the whole story. And so when you adjust our performance for mix, we are seeing cost pressures translate into retail price increases. And you heard from Darren our average item price was up in the quarter and our average basket was up in the quarter. And so our view of price increases is that it's coming in largely in line with our expectations, probably at the low end of the range that we anticipated in the quarter, but still in line with expectations.

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

That's really useful. If I could just switch quickly to online, obviously, you continue to ramp pretty aggressively in terms of click-and-collect. Could you speak to how much of this -- the pace or the acceleration is about sort of paying to lead or paying to play? And how the economics on this -- on the build-out are trending or progressing, again, relative to expectations?

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

Yes, so I think we're not going to provide a ton of detail, but let me give you a couple of themes. So a big part of the growth is obviously that we're expanding rapidly the number of engagement points, so expanding the number of drives through our pickup locations. That's a big contributor to the sales growth, as of course is the increase in the rollout of our home delivery service with Instacart. But if you look at the performance on a comp sales basis as well, so the click-and-collect locations that have been open for more than a year, we see significant comparable store sales growth there, and that is a big contributor too. It would be no surprise to you that the places where you have higher population densities will be the places that we would have the higher volumes, and that the stores that do more volume would also likely be the stores that do more volume in click-and-collect and in home delivery. So we see the underlying metrics in terms of the top line looking very satisfactory, very encouraging in fact. And then in terms of the underlying economics, we've been asked this question before, we understand very, very clearly what the economic



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investment is both in terms of capital and the ramp-up period to get to satisfactory performance, and all of that is trending in line with our expectations.

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

Just a quick final one on Instacart and delivery to home. Is sort of -- our recent competitor's moves with respect to Instacart, do you view that as further validation of the model or perhaps as sort of as much a validation as it is threat? How should we perhaps think about the sort of the evolution there with respect to Instacart and a number of -- or one other key competitor trialing Instacart?

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

Yes, so I think you're probably referring to Walmart in this instance. So Walmart has had a North American-wide deal with Instacart for an extended period of time before we did our deal with them in Canada. So we have always understood that Instacart and Walmart was going to be a likely combination in Canada. We think it is a validation of this gig economy home delivery model, and it's always competitive when other people are delivering similar services. But there's also an advantage as that Instacart delivery network gets scale, most of which will come from us, some of which will come from others and benefits everybody all around.

Operator

Your next question comes from Mark Petrie with CIBC.

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

I wanted to ask about the SG&A rate flat after you adjust for fuel and franchisee consolidation. Obviously, store labor rates have been a material pressure, but wage inflation should moderate in 2019. So just sort of curious looking ahead, do you see SG&A leverage as an achievable target for next year? Or are there enough areas in your business where you want to invest, that leverage will sort of remain kind of flattish?

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

Mark, it's Darren. I want to be cautious to give you a guidance because we're not doing that at this point as we look into next year. But the 2 pieces I would highlight to you is the process and efficiencies focus in the company, it really is a robust program, it covers 7 main areas of the business. It's a multiyear journey, and it's made up of a number of initiatives that we, as a management team, are tackling and managing. So we expect that over a number of years here to continue to generate benefits. The other side of that is exactly as you called out, it's the investments, so we are looking to continue to increase our investments. So really, it's about pace and finding that right balance between the 2. So I don't want to give a number for what you should think for SG&A leverage. But think about it as a -- long-term, we're committed to our financial framework, and we're going to keep funding the investments through efficiencies in the business.

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

Okay, and I wanted to ask about square footage, down slightly in the food business. But I guess more specifically, I wanted to just ask about the composition sort of structure of your full-service stores. And over the years, you've sort of redeployed space to things like apparel or more space to prepared foods. But arguably, the way the industries had it, you're going to -- that's going to be sort of a continuing trend over time. And I guess, just curious sort of, like do you agree with that outlook? And what does that look like for Loblaw? And how should we think about square footage growth, not necessarily 2019, but over the course of the next number of years?



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

So really, where you think about our store footprint, we have about 2,500 stores, about 1,400 of which are Shoppers Drug Mart. So we don't feel -- part of the acquisition was because we love that network of stores. And there's small footprint of stores as well. So in the food business, predominantly, the majority of our stores are actually small as well. We do have the superstore business, but the majority of our stores are actually small. So we have been thinking about this for quite a number of years. We have not been building stores of the size of 150,000 square feet. Our latest superstores are more in the range of 90,000, so we have reduced it. And some of other stores, we've reduced the size as well. And I think for us, we don't think it's something that is something urgent. We've been monitoring it, and we're happy with the performance of all of our stores. We close stores every year, if they don't perform. And as part of being retailers, we've always been looking at different ways to remerchandise our stores. So when nobody's buying videos anymore, we remerchandise it with something that is relevant to customers. When the photo labs are no longer relevant, we remerchandise that as well. So we have found ways to take up the space. We've got click-and-collect that takes up some room. We've got some medical clinics that we've been putting into our stores. So for us, our real estate portfolio has always been a big part of our business in managing it. In terms of the actual number of stores going forward, we're not opening a lot of food stores. We don't plan to. We might be opening 1 a year, maybe 2. On the Shoppers' side, we feel like there is still some room. So there is a higher growth trajectory there. And they've been doing some relocations and expansions, especially in that enhanced beauty side. So overall, not a ton of square footage growth expected in the food side, still some marginal growth on the drug store side. I hope that answers all your questions.

Operator

Your next question comes from Jim Durran with Barclays.

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

Just wanted to focus on the pharmacy business for a second. So within this quarter, you're kind of up against, I guess, fully loaded generic drug reform now. Should we see the Rx comp now as therefore sort of bottomed in terms of the growth rate? And I know that next year, we've at least got Q1 as a noncomp added drain to that. But once we get into Q2 and beyond in next year, is there any other things that would be impacting and suppressing what should be sort of natural Rx growth?

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

Jim, I think you've got the big one there. Really it's the health care reform, which has been impacting us this quarter and most pronounced in Q2 as well, although it did take a bit more time for it to come in. So we expect we will see impacts into the first half of next year from a comp point of view, and then that would be diminished and we should be at negative -- normal reform levels at that point in time.

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

And on national pharma care, have you had much dialogue with the federal government about where they're trying to head with that? And any indications on timing of when they may come out with a program? I assume it will happen before the election comes up next fall.

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

Yes, so we are actively engaged in discussions with the federal government as are the other industry bodies. Those conversations continue. And we think that they're constructive. At this point, we can't comment on any likely outcome that we don't have insight into. And then in terms of the timing, I think it's a reasonable expectation to think that it will land at some stage before the election, but we don't have any confirmation of that at this point.



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

Okay, I have a couple of other just quick follow-ons. On your cost reduction and efficiency initiatives, like do you expect that the amount you can generate next year would be equivalent to what you've done this year? Or are we seeing a ramp-up in the dollars that are being saved?

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

Yes, I don't want to give you a number, but certainly I'd say our ambitions are not changing from this year. So we continue to be ambitious to be able to generate the type of funding we want to do for the business.

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

Okay. And then last on e-commerce. So as you rollout click-and-collect in more stores and we ramp out on home delivery with Instacart, are we seeing yet on a consolidated retail basis any erosion to profit margins? Or is that being done in such a paced way that it's got limited impact?

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

I would say generally, it's being done in a paced way with limited impact and part of our, again, part of our focus on efficiencies in order to keep that stability as part of our stable trading. So I'd say we're managing all these pieces together.

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

And someday when Nielsen or somebody comes out with a new estimate on grocery penetration for the end of, say 2018, given what you're doing and all the competitors are doing, do you expect a material increase in the penetration of grocery online as we close 2018, not just for you, but for the whole industry?

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

Well, I think the way to think about it is, we see significant growth on our platform, and it's still a relatively small number compared to the overall sales base of the business. So growth is accelerating quickly. Impact on the overall industry is still some time away, I would say.

Operator

Your next question comes from Patricia Baker with Scotiabank.

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

I just want to come back to the discussion of the basket and the mix here. So want to make sure that we could square away all the various statements that have been made this morning. And Galen, I really appreciate you pointing out and I understand this that the CPI doesn't reflect inflation in specific mix of goods sold within your boxes. So when you talk about your internal food price index and again telling us that it was marginally lower than the 0.3%, is -- what -- that internal food price index, is that your basket or is that you comparing what happened to items that are in the CPI so that there's another secret number, which happens to be the inflation that's in your basket?



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

Yes, there's a few numbers. So CPI is obviously what's publicly reported. LPI would be our measure of the exact same basket, that CPI. So CPI, that kind of actually does it on our behalf with our basket, so we understand the comparison, and that's what we're saying is slightly lower than CPI. But that's just -- that's not representative of the full mix of our business. And so what Galen was referring to was just the average item price up, all of the items in our business. And so you can imagine that CPI is based on the most relevant items that consumers are buying every month, and that's what they're reporting on. That wouldn't necessarily be where we would be putting price increases because those are the ones that are very obvious to customers and are very relevant to those who are -- because they're core items as well. So when we look at our mix of all prices, we do see some inflation.

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

And you wouldn't consider on going forward just to make it easier for everyone to sort of give us -- to tell us whether or not the magnitude of that inflation? Because that's what we really should be caring about.

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

Well, the thing is, Patricia, that each of these numbers matter. There's a collective picture. There isn't a single number that accurately reflects inflation. That's what we've been saying for many years. And so what we're trying to do is, you guys like CPI, so we're trying to give you a comparable perspective on our performance. CPI is what everybody else compares their performance to. And so that's consistent. And what we don't want to do is change the number every quarter based on a different calculation. So what we're trying to give you is a consistent reference against CPI and then give you some color because, as we've said many times, that, that math isn't exactly right. And so what you need to take away from this is CPI, we're still measuring it consistently against the Loblaw performance. There is inflationary pressure elsewhere that isn't coming through in that metric, and it's in line with our expectations and what we thought was likely to happen in this quarter and beyond.

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

Okay. Just following on that, so if we look at Q3 inflation, your inflation, is it right to assume that, that moved higher sequentially from Q2 to Q3? And then secondly, can you talk to us about what inflated in your mix? Can you give us a little bit of color on the categories, what -- where were you seeing the better average item pricing?

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

Okay. So yes, Q3 was sequentially higher than Q2 in terms of our measure of inflation. And in terms of mix, it's -- there's not specific category. It's actually right across the board, so it really is in our whole use of data finding the areas where it's possible to do that and still have positive sales.

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

Okay. And Sarah, also when you talked in your opening remarks about mix and driving using the data and better promotional effectiveness to drive mix, is it -- are you also seeing a shift into private label? Are you trying to direct shift into private label with those mechanisms?

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

We are. So we would definitely have targets to increase our control brand penetration across our business. So we are trying to do that. We do have a higher profit on average in control brand versus national brand. So that would be part of it as well.



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

Okay, and just you mentioned that there are click-and-collect in 19 Shoppers Drug Marts. I'm just curious whether that's confined to a single province? Or are you doing that sort of testing across regions?

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

I think so far the 19 are all in Ontario, and we've got some more coming out before the end of the year. And we've got a few in January, and then we're going to pause for a little while and see how they -- whether they resonate with customers if that's something that they want to do, but so far just in Ontario.

Operator

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

Peter Sklar - BMO Capital Markets Equity Research - Analyst

On the pharmacy side, your Front Store comp was particularly strong this quarter. I'm just wondering if you could identify anything that could account for the strong comp with their particular categories such as food. Or were you pushing PC Optimum or whatever?

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

Well, I think it is across the board, but [I love] beauty, and it's been performing really well, and we have been putting more beauty boutiques in. So that has helped as well. So I think -- or not putting more boutiques in but adding new vendors. We are putting new boutiques in -- but also adding new vendors into them. So that's helped the comp as well. And really I think for the Shoppers' team, it was a more fundamental change, the loyalty bringing together actually changed more for Shoppers than it did for the food business. So I think really, it took a little bit of time to figure out exactly how to do the redemption events in ways that resonated with customers and that really all came together very well in Q3.

Peter Sklar - BMO Capital Markets Equity Research - Analyst

Okay. And Sarah, while I've got you, in your introductory comments, you talked about using data more effective and targeted promotional programs and you talked about 200 basis points. I didn't quite understand, were you referring to margin or...

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

Yes, so basically, it was just an example. So for example -- so I talked about the loyalty example, how we can be very specific in targeting spend structures for different customers. But on the flyer side, we're also doing work where we're basically trying to pick the item that is the most effective in driving customer traffic at the best possible cost. And so what we are seeing -- it used to be a little bit that we were kind -- we allowed categories -- all categories to be in the flyer. We're a bit democratic about it. And now we're really trying to make sure that, that each item earns its way into the flyer. And being a little more thoughtful about, if we can actually get the same sales lift by only reducing the cost of an item by \$2 as opposed to \$2.50 and yet it drives the same traffic, it would be in that area. So the example I was using in the market side, which has -- really have become very sophisticated in the market part of our business, it was an example of basically increasing the promo pen but at the same time improving the promo margin. So basically being able to have -- very exciting for customers because there's more items on sale, but at the same time improving the margin, which we think is a great mix.



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Peter Sklar - *BMO Capital Markets Equity Research - Analyst*

So the 200 basis points was an improvement?

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

Yes, that's right, in the margin of promo items.

Peter Sklar - *BMO Capital Markets Equity Research - Analyst*

During a one-flyer week?

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

It was during the quarter. The 200 basis points was during the full quarter.

Peter Sklar - *BMO Capital Markets Equity Research - Analyst*

Okay. And lastly, Darren, if I may, a couple of times on this call you've talked about the process and efficiency initiatives. It's a little opaque. Can you give us a couple of examples where you're seeing some of your larger benefits?

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

I mean, yes, across the 7 areas, and Sarah has given examples on previous calls and perhaps she wants to go through another one. But I mean, if you think about it in the stores, it's a lot of the self-checkout. It's more a penetration in that area. If you think about in the supply chain, there's a lot of areas for automation. If you think about in the back office, every single support function has targets and is looking at how to simplify our processes, how to use more automation, how to use AI. So there isn't -- I always say this, there's no one silver bullet. It's a lot of focus and process improvements with technology that's also allowing for a lot more automation throughout the business. So every quarter, we're making progress on that, and Sarah can certainly give you a few examples of that. But broadly speaking, that's the program that we're on.

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

Yes, I think Darren covered most of it. But if we want to look at a concrete example, we've rolled out self-checkouts to over 400 Shoppers. Now so it is all the same initiatives that I have been talking about. I wish there were some new initiatives, but really it's all about us executing better on our business. So things that are working we're just putting in more places. So 400 stores in self-checkouts in Shoppers. On the food side of our business, we've had self-checkout for a long time, but we changed the software to have less interventions in every customer experience so that improves customer service. At the same time, it's the speed and it's allowing us to increase the penetration. So we really are trying to figure out how to increase the penetration in some of these areas. I talk a lot about inventory in our back rooms and processes in place to reduce the amount of touches. That's labor every time if somebody has to touch the inventory, to move it around, it's labor, and that costs us money. So just all of the same stuff that you do in grocery and pharmacy retail, just trying to execute better every day.

Operator

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



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Michael Van Aelst - TD Securities Equity Research - Research Analyst

I think I'll flip over to the financial services side. So the revenues or the sales in financial services were actually quite high. I think they were up over 14%, but your profits were down. And I know you called out the end of the agreement with CIBC as one of the reasons. But you had some pretty aggressive sign-up promotions over the summer. So I'm wondering how that may have impacted your profitability and if any of that is short term only? And then the second part of that question is, you talked about some investment being made in digital strategy. Can you give us some more color on what you're doing there?

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

Yes, Mike, let me touch the first part. Galen might -- can touch on the investment -- what we're doing in terms of investment. So yes, we're very pleased with the bank's performance, certainly within the portfolio. So it was up 14% for revenue, as you mentioned, and that's really drive by across the business, including the credit card and PC mobile and in the gift card business. The profit was impacted. One of the reasons is the exit of the CIBC relationships. So we're no longer having that in the business this year. We also had an impact this quarter of IFRS 9, which continues to bring volatility to us and other people out there given the way that that's calculated. And then, it's making the investments in the business. And I would say that the -- we do expect to continue to see year-over-year pressure as we look into fourth quarter on the -- in the financial services, more related to the daily banking going on and because we continue to make investments. But none of this would relate to the increase in sales activity that we're seeing. In fact, we're quite happy with the growth in the portfolio, and it's leading to actually stronger profit in the business, so not leading to write-offs or higher -- or issues there, that's the loan loss provision based on IFRS 9 in changes an assumption, did lead to an increased charge in that regard.

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

And just in terms of growth, so our payments and rewards strategy, rewards is really the PC Optimum program, payments is the forward-looking strategy for PC Financial. So when we think about PC Optimum, we're really happy. Sarah mentioned that. We're continuing to invest to enhance that program. President's Choice Financial, the new consumer platform, that's a brand-new digital customer experience. We launched it last week -- we launched it this week. And so if you want to get a sense of that, then by all means, if you're a card holder, which I'm sure you are, you can pop onto the website. We're doing a bit of a soft launch in transition there at the moment. But really what that is, is it's a consumer platform, digital experience that will allow us to much more easily add new products and services to our PC Financial customer base, and you should expect to see more of that actually landing in 2019. And then there's the PC Insiders, which, following a very successful pilot in 2018, we are now preparing to ramp that up, and that sits inside the -- not the PC Financial results, but inside the PC Financial team. And it really is a related product.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. And then just to be clear on some of the extra costs or the reduced profit on that side. So the exiting of the regular banking agreement with CIBC, that happened after -- at the end of Q1, I believe?

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

That's when we started to see the impact, yes.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. So we'll see that -- that impact will continue through Q1 of '19.



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

Yes, yes.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

And the IFRS 9 has been there all year?

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

No. The volatility of it, this was an incremental charge this quarter because it's hard to predict. Some of it depends on frankly predictions for unemployment rates and things like that, which is, as you can imagine, a little bit hard for us to do today. So that can just bring some further volatility. And then these investments that Galen was mentioning, no, they have been ramping up and we should -- you should expect to see them sustained for a period of time. I'm not going to give you exactly when it'll stop, but certainly it's about them continuing for a number of quarters.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. And just a follow-up on the earlier inflation questions. Can you just talk about how then your basket inflation trended through the quarter? And whether you're still kind of expecting that 1% to 1.5% run rate at some point?

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

Okay, I'll take that. So as I mentioned, from Q2 to Q3, there was an increase in our basket in the inflation that we saw in our average -- and so it's average item prices, all of the items we sell. So it's just -- it's a very large -- it's not a basket, it's all items. And so it did increase from Q2 to Q3. And I would say, it did start to increase at the end of Q2 and then we had 4 periods in Q3. It increased through the quarter and kind of stabilized. So what you would expect in Q4 is a full -- I would say, a full quarter of what we saw in Q3. So a little bit higher than what we saw in Q3.

Operator

Your next question comes from Vishal Shreedhar with National Bank.

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

Just really related to the inflation data that you're giving us. And I know it's not perfect, but it's the best math we have. So that same-store sales growth number not relative -- relative to your total item price index, is same-store sales growth still higher than that other inflation number that you're referencing?

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

Well, basically, our tonnages are basically flat. So our tonnages -- we would say based on our own math of the -- for all items, our tonnage is essentially flat, and we're pleased with that.

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

Okay. Just switching gears here to a different topic, IFRS 16, I'm wondering for modeling purposes, if you can give us just some P&L help on what the big changes are, maybe in your G&A interest, et cetera?



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

We'll give more color next quarter as we close the year. We'll have more disclosures in terms of quantification. As you can imagine, there's large significant changes and lots of assumptions. And we're in good shape for implementation. We just got to work through finalizing it.

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

Okay. But at high level, you would expect earnings to go down, EBITDA to go up. Is that a fair characterization or -- structurally?

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

Well, I will say EBITDA will go up, but I can't comment on earnings.

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

Okay. In terms of the margin increase that we saw in the retail business, I'm talking EBITDA, I think you noted in your disclosure material that food retail was favorable. Just wondering with respect to that food retail, at the gross margin level, was that particularly mix? Or was that -- was there one or a few items that you'd call out on that?

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

Yes, I mean, the real items where we've mentioned promotional effectiveness is certainly the largest driver, as I said in the prepared remarks. But there are other things like part of our supply chain handling fee goes in there, we're seeing shrink improvements in the business. So there is a combination of items there, and the team just executed a very -- continues to execute very well, and Q3 was a great result.

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

Okay, and I know it's a small consideration. But are there any updates on Loblaw's intention for Canada's perhaps recreational sales? Or is it still medical, is the focus?

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

Yes, so our focus continues to be medical. And very shortly, we'll be in a position to sell medical marijuana. We do have a number of stores in Newfoundland, where we are -- we have licenses to sell recreational marijuana, and we are doing so. Think about it as an experiment on our part to try and understand the recreational market to determine over time whether or not it is something that we want to ambitiously pursue. At this stage, we are interested but not yet fully committed.

Operator

Your next question comes from Keith Howlett with Desjardins Securities.

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

Yes, I have a question -- excuse me, on the online business. You've got click-and-collect at Real Canadian Superstore. I'm wondering how you're viewing that more broadly in the discount channel with No Frills or Maxi, et cetera.



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

Okay. So basically what we've done so far, we started with the market division to rollout and then we did move to the superstore business. And the superstore business, it's very attractive for superstore customers, particularly in Western Canada. So we are piloting some No Frills, where it's a different version. It's actually -- it's not -- you don't have a person bringing it out to your car, you have to go in and get it. But it's all picked for you and then you basically walk into the store and you pick up your groceries. So it saves you the effort of going through the store. And that will be a similar model that we will have in Maxi as well. And so we are piloting both of those, trying to see if that is something that is attractive to customers and cost effective as well.

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

And just in terms of the Shoppers Drug Mart component, the 19 stores, are those just pickup points? Or are people ordering Shoppers' store items?

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

Right now, it's only a pickup point. So you would go on to a Loblaw, you would -- it would be picked from a Loblaw or a food store of some sort and then brought to the Shoppers. It's a pickup point only.

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

And in terms of running that No Frills' experiment, do you have some select group of people with access to a No Frills' website with all the items on it or...

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

It would be stores -- it's determined by the store. So we've picked the stores that we'd like to pilot it in, and those customers would be able to do it.

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

I see. And then just in terms of the credit card business, what is sort of your intention there in terms of -- have you modified your strategy towards whether you want people having balances or whether you want to run it mostly for interchange fees or sort of what's your big thinking on the credit business?

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

Well, the payments industry is changing rapidly in Canada and around the world. And we see that as an opportunity for Loblaw, particularly for President's Choice Financial. Merchant fees, which are an important part of the credit card P&L, have been coming down. We expect them to continue to compress over time. Part of the way that you offset that is by increasing the revolve in the credit card balance as you point out, and we are certainly doing that. And it has been an important source of success for us in 2018. But this is a -- these are very conservative portfolios, sort of loan book. It will continue to be. And we see a path to an exciting source of growth for our financial services business in payments over the next few years. That leans into the changes that are taking place in the industry.



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Operator

Your next question comes from Chris Li with Macquarie.

Christopher Li - Macquarie Research - Research Analyst

Just first question on -- just going back on drug reforms. Just wondering, once you cycle through the generic drug impact in Q1 of next year, is the way to think about the recurring drag on EBITDA, is that you will be revert back to that \$70 million to \$80 million level that you normally experience in any given year?

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

Yes, that's probably the best way to think about the only other -- the only [caveat] I'd give you to what you said is, it most likely will lag into Q2 as well. It's hard to predict a reform, but we typically think in our heads the \$70 million or \$80 million, and we'll see how the year looks.

Christopher Li - Macquarie Research - Research Analyst

Okay, and will that kind of provide some cushion to include sort of unannounced things like potential reduction in branded drug prices? Or will that be in addition to that if it does happen?

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

That could most likely be within that. And it's complex, and we've got to look at all the things that we'll be hitting in any given year. But that's generally where our experience is being in that \$70 million to \$80 million.

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

And really it's our best guess, without any additional information on what's going to happen of what you should factor in, it's what we factor in as well.

Christopher Li - Macquarie Research - Research Analyst

Sure. And just -- and then can you remind us what is your current control brand penetration in food?

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

I don't think we generally disclose that. So I don't think I will on this call either, other than we want to increase that.

Christopher Li - Macquarie Research - Research Analyst

Okay, so that was -- my other question was as you leverage your promotional programs to drive more sales to control labor, it will be reasonable to expect that penetration could increase over time?

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

Yes, that's our goal.



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Christopher Li - *Macquarie Research - Research Analyst*

Okay. And then one of your peers in the U.S. recently highlighted the fact that they believe there's an attractive opportunity to leverage the unique access to customer data to sell more advertising to CPG companies, both inside and the store and online. It's a relatively capital-light and marginal-rich approach. I know Loblaw is doing this to a certain extent. Do you think this is a significant growth opportunity for Loblaw over the longer term?

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

Yes, so we've noticed some of those announcements as well. It's important to call out that the U.S. market is quite different in terms of the rules and regulations around privacy to the Canadian market. And so we are exploring the potential business model in this area, and we'll certainly update you as we have more information on the subject.

Christopher Li - *Macquarie Research - Research Analyst*

Okay, and then my last question is back to capital allocation. Darren, can you remind us, I guess, your CapEx outlook for next year for retail CapEx, can we expect that to be roughly \$1 billion again for next year?

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

Yes, we'll give guidance when we close the year, but it's going to be in the range. It will most likely go a little bit higher as we focus on a number of initiatives and process efficiencies and automation initiatives. So we do expect it to go a little bit higher. But we'll give you that guidance next quarter.

Operator

Your next question comes from Keith Howlett with Desjardins Securities.

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

Yes, so just wondered on the click-and-collect business, if you can share with us the behavior of customers, do they increase their sort of annual trips to the store? Or do they just substitute a click-and-collect for a normal trip? Or sort of what shows up that way?

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

Yes, look, I think we commented at a very high level on this in the past, and we aren't seeing any meaningful change from this. So there seems to be multiple occasions. There's an occasion where somebody's looking for groceries to be delivered to their home very quickly. There are other occasions where they're looking to preorder their groceries and pick them up to save time, and then they're also coming into the store and shopping. For us, we've been at this now for a number of years. We have pretty good visibility into the incrementality that comes from our online grocery business with our customers, and we see it today and continue to see it as a meaningfully incremental source of sales. At some stage, that incrementality may start to compress, but we're not seeing at this stage yet.

Operator

There are no further questions at this time. I will now turn the call back over to the presenters.



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Well, thank you, everybody, for your time this morning. If you have any follow-up questions, as always, I'll be around my office. And please mark your calendars for February 21, when we'll be back online to discuss our 2018 results. Thanks very much, and have a great day.

Operator

This concludes today's conference call, and you may now disconnect.

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