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L.TO - Q3 2016 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 3Q16 adjusted net earnings of CAD512m and adjusted diluted EPS of CAD1.26.



NOVEMBER 16, 2016 / 2:00PM, L.TO - Q3 2016 Loblaw Companies Ltd Earnings Call

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CONFERENCE CALL PARTICIPANTS

Irene Nattel *RBC Capital Markets - Analyst*

Mark Petrie *CIBC World Markets - Analyst*

Kenric Tyghe *Raymond James - Analyst*

Peter Sklar *BMO Capital Markets - Analyst*

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Tal Woolley *Dundee Capital Markets - Analyst*

Keith Howlett *Desjardins Securities - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Loblaw Companies Limited third-quarter 2016 conference call.

For your information today's conference is being recorded.

At this time I would like to turn the conference over to Ms. Sophia Bisoukis. Please go ahead, madam.

Sophia Bisoukis - Loblaw Companies Limited - IR

Thank you and good morning. Welcome to Loblaw Companies Limited third-quarter 2016 results conference call. I am joined by Galen Weston, President and Executive Chairman, and Richard Dufresne, Chief Financial Officer.

Before we begin today's call I want to remind you that the discussion will include forward-looking statements such as the Company's beliefs and expectations regarding certain aspects of the financial performance in 2016 and future years. These statements are based on certain assumptions and reflect management's current expectations, and they 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 discussed in the Company's materials filed with the Canadian regulators from time to time. 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.



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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 measures.

As a note, today's call will end 10 minutes prior to 10 AM. I will now turn the call over to Richard.

Richard Dufresne - Loblaw Companies Limited - CFO

Thank you, Sophia, and good morning, everyone. In the third quarter we continued to deliver against our financial plan, achieving positive same-store sales with stable gross margins. We achieved diluted adjusted earnings per share of CAD1.26, an increase of CAD0.28 per share or 28.6% compared to the third quarter of 2015, and grew adjusted net earnings by 25.5% to CAD512 million. We also continued to return capital to shareholders, buying back approximately 2 million shares in the third quarter.

Our food retail business achieved 1.4% same-store sales growth, while our internal rate of inflation declined this quarter and was lower than food CPI rate of 0.2%. Positive trends for same-store sales in drug retail continued this quarter with total comp sales of 2.8%. Front of store same-store sales grew 3.9%. Pharmacy same-store sales grew 1.6%, with market share gains being offset by a decrease in average value. Prescription count increased by 2.6%. With positive same-store sales growth in both food and in drug retail, total revenue in our retail segment was CAD13.9 billion, up 1.3% year over year.

Adjusted retail gross margin remained within a stable trading band and was 26.1% compared to 25.8% a year ago. This excludes the impact of consolidating franchisees during the quarter. Adjusted retail gross margin increased by 30 basis points. Promotional investments to reduce prices and support sales initiatives in our food retail business were offset by improved drug retail pharmacy margin and better shrink compared to prior year.

Adjusted SG&A as a percentage of sales improved 50 basis points including the impact of consolidating franchisees. Adjusted EBITDA was CAD1.14 billion in the quarter, an 11.8% increase from last year. Our consolidated EBITDA margin now stands at 8.1%, an increase of 80 basis points from a year ago.

Looking ahead, we continue to remain confident in both our strategy and financial plan. Our long-term financial strategy continues to be aimed at positive sales growth in a stable trading environment with a sharp focus on lower costs and reduced complexity across our businesses.

Finally, as a reminder, last quarter we noted that we achieved the CAD300 million synergy target we set when we acquired Shoppers Drug Mart in 2014. As a result, we are no longer speaking separately to synergy benefits being realized. However, we continued to generate benefits from the Shoppers acquisition in the third quarter.

This concludes my comments. I will turn it over to Galen.

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

Thanks, Richard. Good morning. Q3 was a strong quarter and I'm pleased that we continued to execute against our strategic framework, delivering the best in food, the best in health and beauty, operational excellence and growth. We delivered good sales metrics including positive same-store sales in both our food and drug retail businesses. We continued to operate within our financial model, delivering stable gross margins, operating leverage, and earnings growth.

During the quarter we saw the grocery market shift from an inflationary environment to a deflationary one. This shift is consistent with cycling the highest inflation periods from last year. And in keeping with the strategy outlined in previous calls, we made measured targeted investments to drive volume, and it has worked. Customers responded well to our lower prices and we continue to grow the top line. We made these investments while at the same time slightly improving overall gross margin through shrink improvements in the food business and strong front store performance at Shoppers Drug Mart.



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Finally, as Richard mentioned in his remarks, we were able to generate strong earnings growth as result of a particularly good quarter for SG&A at 50 basis points. Although this does not represent a run rate for the business, it is an important indication that our ongoing focus on cost savings and efficiencies is getting traction.

Looking forward, we would expect the food retail business to remain highly competitive. Within this environment we will focus on investing intelligently to grow the top line and offset that investment through our mix advantage and our relentless focus on cost management, and in doing so continue to deliver our financial plan.

Sophia Bisoukis - *Loblaw Companies Limited - IR*

Thank you, Galen. We can open up the bridge for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Irene Nattel, RBC Capital Markets.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks and good morning, everyone. I would like to start, focusing on operating leverage, please, because, if we look at the items that you cite in the MD&A or the press release around the drivers of gross margin, some of those can perhaps be considered one-time items. So, can you give us little bit more color about what is going on on an underlying basis, please?

Richard Dufresne - *Loblaw Companies Limited - CFO*

There are a few one-time items, Irene, but they are relatively small. When we look at our performance, as I mentioned in my remarks, we are still generating benefits from the Shoppers acquisition, although we do not talk about it specifically now. We had good performance on gross margin side. And we have clearly improved traction in generating cost savings in the quarter. So, together that is what resulted in our performance in the quarter.

Irene Nattel - *RBC Capital Markets - Analyst*

If we think about the path towards where you want to be in terms of operating efficiency versus where you are today -- and we use a hockey analogy -- are we in the first period, the second period? How far along that trajectory would you say that we are?

Richard Dufresne - *Loblaw Companies Limited - CFO*

I would say, hopefully, we're just in the first period. I think that should be the story for Loblaw for the next few years as we try to reduce complexity in managing our business. And it won't all come in big incrementals as we've seen this year. But the drop in costs that we've seen this year are sustainable. Our ability to generate further cost increase we don't think will be to the tune of 50 basis points year over year but we will continue to work hard to bring those numbers down.



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Irene Nattel - RBC Capital Markets - Analyst

That's great. Thank you very much. And just one final question, if I may, and this goes to the trading environment. What are you seeing around competitive intensity and consumer behavior at this point in time?

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

It is intense, to be sure. I think it is still very much rational. I think you have heard from us on a number of occasions that we're making targeted investments and what we believe to be intelligent investments. We're seeing the consumer respond really well to those investments. And we're seeing a result in tonnage that is a meaningful improvement from where we were in Q1, which, if you'll recall, was the point where we expressed some concern about how we were trading relative to the rest of the market.

Irene Nattel - RBC Capital Markets - Analyst

That's great. Thank you.

Operator

Mark Petrie, CIBC.

Mark Petrie - CIBC World Markets - Analyst

Good morning. Another strong gross margin performance from the Shoppers business. I wondered if you could just provide a bit of a sense on drivers there. And then also any context you can give in terms of how that business is performing on SG&A.

Richard Dufresne - Loblaw Companies Limited - CFO

Mark, the value proposition of Shoppers continues to resonate very well with consumers. Obviously we've been talking about the addition of food, which is certainly a factor. So, that trend is continuing.

We're actually quite proud to see that despite the strong comp we experienced last year -- if you remember, last year we were comping in front store close to 6% -- the fact that we are still comping at close to 4% is quite amazing. And we see that traction continuing. So, that is the key driver from a performance perspective.

Mark Petrie - CIBC World Markets - Analyst

To drive those same-store sales, that sort of growth, how should we think about the SG&A performance within Shoppers and then, on a more net basis, earnings growth in this period and then into 2017?

Richard Dufresne - Loblaw Companies Limited - CFO

G&A performance in Shoppers is tougher than in food because essentially their costs are driven by script growth essentially. But because we have been experiencing significant growth in front store, it allowed us to actually get some SG&A leverage in terms of rate. So, we hope to see more of it. But our focus is more to try to generate some SG&A improvement on the food side.



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Mark Petrie - CIBC World Markets - Analyst

Okay. And then just on the food side, obviously you guys have made some significant capital investments in the conventional assets over the last few years. And it seems like that segment of the market has become more challenged through 2016. So, how do you balance return on those investments with customer experience expectations? And is this where shrink has been a benefit for you guys?

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

We are pretty happy with the investments that we've made. I think you are probably referring to our Inspire Network that we have upgraded over the last couple of years. That tends to be one of the really strong areas of performance in the market division.

One of the others is the move that we have made to convert a bunch of those old Extra Foods stores out in Western Canada into our neighborhood market format, which is our Your Independent Grocer business. We're seeing a really terrific response in those markets, essentially a fundamental upgrade in the full-service conventional proposition that is being made available to those consumers. For sure, there's pressure in the market stores where we have a high level of direct competition from the discounters and from Walmart, but we're feeling reasonably confident in our ability to offset that. Again, the way to think about it is we're not going to put Inspire-type capital in hundreds of stores because it is only in select stores where we have a customer base that responds positively enough to those value-added services that it generates the right return on capital.

Richard Dufresne - Loblaw Companies Limited - CFO

Mark, what I would add is if you look at the performance of our market division according to plan, it's actually very much on plan.

Mark Petrie - CIBC World Markets - Analyst

Okay, that's helpful. Thanks. I will pass it along.

Operator

(Operator Instructions)

Kenric Tyghe, Raymond James.

Kenric Tyghe - Raymond James - Analyst

Thank you, good morning. Galen, you touched on your targeted investments, and, if memory serves, we are now cycling two years of PC Plus in your discount banners. I wonder if you could speak to how effective that has been in discount and perhaps provide a little bit more color about the uptake of PC Plus in discount and on your ability to effectively target investments in your discount banners, particularly in western Canada.

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

PC Plus continues to be a growing and important part of how we make margin investments to drive targeted sales in the consumer. One of the strongest formats in terms of adopting PC Plus is actually our superstore format, which is one of the major platforms in our discount division. It is something that they are starting to use to great effect to deliver discounts or value that is differentiated from what is available in the market today. So we are really happy with the performance there. No Frills is the other place where we've deployed PC Plus. There, we're growing, we're improving.



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But, far and away, the most powerful mechanism for driving customer traffic and volume through that platform continues to be the flyer and item price. We're not seeing quite the same level of response in the hard discount business so those targeted offers. We're working on it. But very happy with the superstore investments.

Kenric Tyghe - *Raymond James - Analyst*

Great. If I could just switch gears quickly to Shoppers and the front store, you did highlight growth in all categories. I wonder if could just give a little more color on specifics there with respect to which categories you did see growth. And perhaps, also, beyond that, looking at the opportunity set how you're thinking about that going forward given your success year to date and how we should be thinking about that given your successes year to date.

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

That is a big question. You want us to articulate our medium-term front-store strategy for Shoppers. I will try and give you a little bit of a feel for it. But the starting point is that we have strong growth pretty much across the board in the front store at Shoppers Drug Mart.

We think part of what is driving that is the improvement in the food proposition that may actually be driving more traffic, more visits, and that is actually lifting a number of the other categories. But, frankly, we feel good about the overall proposition. Everything seems to be doing well in the front of store.

As far as how we're going to build that business going forward, food continues to be an area of opportunity. Today we have about 35 enhanced fresh food shops and we're continuing to expand that. I think I've commented that where we see really significant success in adding fresh food is in the urban markets, so we're looking all across Canada at places where we can increase the footprint in urban markets.

Then the other area which is a great strength for Shoppers Drug Mart, always has, been and we think is a big part of the next wave for Shoppers' growth, is beauty. We are looking at a number of new sites that we can put various versions of our enhanced beauty boutique. And those tend to over-deliver on the investment that we make in them. So, we're looking for every opportunity to put more of them in.

Kenric Tyghe - *Raymond James - Analyst*

Great. Thank you. I'll leave it there.

Operator

Peter Sklar, BMO Capital Markets.

Peter Sklar - *BMO Capital Markets - Analyst*

Galen, during your commentary I believe you said that during the quarter you went from food inflation to food deflation. I'm just wondering if you could elaborate a little bit more what the trend was like in the quarter, how you exited the quarter, and what you are experiencing so far in the fourth quarter in terms of deflation. Also which categories you're seeing it in. I assume you are seeing a lot of it in meat. What are the other categories?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

You are right, I did comment very specifically on that. Our calculation for inflation or deflation in the quarter was basically flat. But we had more inflation in the first part of the quarter and we shifted quite definitively into a deflationary position as we exited the quarter.



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We think it's meaningful. Deflation -- it's manageable deflation. And it is really a function of, as I mentioned before, the lapping of the peak periods of inflation that the market experienced last year.

And then, also, it is being contributed to in some way by the investments that we are making in the business. And you are right, a part of it is in the fresh food categories. Those are the areas -- particularly meat, produce -- these are places where inflation was in the low double digits for periods last year. So, it's almost impossible to cycle the kind of inflation.

What we actually also saw was customers trading out of categories. So, we are reducing prices to see if we can draw the customer back in, and we're having a reasonable degree of success.

In terms of grocery, grocery is probably responding the best to our price investments, where we're making them. That trade-off between a deflationary dollar and actual unit growth is showing up really nicely in grocery, too.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. And in terms of the investments that you are making in terms of -- and it seems that the investment you're making in price can be promotion, shelf pricing, more dollars in PC Plus -- are those dollars going more into conventional or more into discount? Or is that investment being made across the board?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

I think it's a good question. It's probably the right question but it's not something that I feel comfortable answering. Part of taking a very targeted and disciplined approach to making these investments is not telling people where you're doing it, and trying to make sure that you are, therefore, having the biggest possible impact.

I think I have to go back to the line which is these are targeted investments. We are looking at it very carefully, making sure that the investments are generating a satisfactory return, and we're pretty happy with the results so far.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. And just lastly, are you still seeing trade down from conventional to discount banners?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

Yes.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. Thank you.

Operator

Chris Li, Bank of America.



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Chris Li - BofA Merrill Lynch - Analyst

Good morning. I just have a couple follow-up questions on operating leverage. I think, Richard, you mentioned earlier that the impact on these one-time-ish items were relatively small. So, my question is, of the 50 basis point improvement for this quarter, at least, would you say maybe 40-ish basis points is really more sustainable factors and 10 would be more small one-time factor?

Richard Dufresne - Loblaw Companies Limited - CFO

The actual level of cost is sustainable -- i.e., the savings that we generated, we expect them to be sustainable. What we're talking about is the ability to bring them down even further is going to be tougher. I would be happy to be able to do 50 basis points decrease in SG&A year over year but I think that is too much. So, that is what we're talking about. Of the ones that we're seeing, most of it is sustainable and will follow through in 2017.

Chris Li - BofA Merrill Lynch - Analyst

Got you, okay. Maybe one specific one. One of the factors you mentioned in your press release about the favorable changes in the value of the Company's investments in the franchise business, I just want to maybe get some clarification. Is that a function of the improvement in the underlying profitability of your franchisees, and as you do these valuations on a quarterly basis, if it is improved then you record a gain on that, and that helps your SG&A?

Richard Dufresne - Loblaw Companies Limited - CFO

No, it has more to do with the fact that we are consolidating franchisees and we're reversing certain of the impairments that we had on certain specific stores. So, it is not that significant.

Chris Li - BofA Merrill Lynch - Analyst

Okay. And then my last question is, we talked about what helped your SG&A, but can we talk a little bit about what drove it lower in terms of your deleverage? I'm thinking in particular some of the incremental growth investments in things like Click & Collect and your loyalty programs in this area. Can you give us some insight into how that progressed or how that pressured your SG&A throughout the quarter?

Richard Dufresne - Loblaw Companies Limited - CFO

From a financial perspective, what we're trying to do is deliver a stable financial operating model that generates steady growth in earnings. And when we put that model together we take into account the investments that we're making and initiatives such as loyalty or omnichannel. And so we continue to manage our business that way and therefore we feel confident that we should be able to deliver our financial model going forward.

Chris Li - BofA Merrill Lynch - Analyst

Okay. Great. Thank you.

Operator

Jim Durran, Barclays.



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Jim Durran - *Barclays Capital - Analyst*

Good morning. There's been a lot of chatter that Walmart is going to focus aggressively on its online offering. When we spoke last quarter I believe that you indicated that you were going to potentially take a pause at the end of this year once you had done the rollout you were committed to for the rest of this year. Is there any change in that approach? And can you give us an indication how many stores you will have Click & Collect at by the end of this fiscal year?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

We've got 82 Click & Collect stores now. We are reasonably happy with the way they are performing. And I think relative to the model, the investment model, they are actually performing better. And we will continue to roll out stores through the balance of the year. We will probably get somewhere over 100 by the end of the year. And we have a program to keep expanding throughout 2017.

I think the message that we are trying to express here is we don't yet see such a compelling threat that we need to race to full deployment of Click & Collect across our entire network at the expense of the P&L of the business or at the expense of a poor return on capital. We have more Click & Collect locations in the marketplace than Walmart does today and we expect to continue to grow.

If there is a substantial accelerating pace from the rest of the market or our competitors such that we see a potential long-term disadvantage, then we will have to look really hard at accelerating it. But right now we think it's a measured approach. We think that's the right approach and we still are the leaders in the market in terms of delivering Click & Collect.

Keep in mind, however, that Click & Collect is not the only omnichannel or eCommerce platform that's important to us. We have launched the beautyBOUTIQUE dossier. Beauty is a big business online in the United States and rapidly growing here in Canada. So, that's another area of aggressive expansion that we are considering and deploying over the next number of months.

Jim Durran - *Barclays Capital - Analyst*

You said that there has been some improvement. Are you at or getting closer to the holy grail of breakeven on an online transaction?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

We certainly have a line of sight to it.

Richard Dufresne - *Loblaw Companies Limited - CFO*

We have certain stores that are performing way better than expectation. Obviously not all of them. But that gives us hope that we can get there.

Jim Durran - *Barclays Capital - Analyst*

So, your feeling would be that, while it may be a deterioration to margin, it is not highly destructive and, really, therefore --.

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

If you remember, what this all hinges on is the amount of incremental sales that you actually achieve from having an online proposition. The more it is a direct dollar-for-dollar cannibalization exercise, you can understand how difficult it is to make it work because you are actually adding cost to the system. But if your mix improves substantially, and your basket size increases substantially, and the number of customers who are actually shopping at one of your stores increases in a meaningful way, these are all things that move it along the lines of being a satisfactory investment.



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As Richard pointed out, we have some stores that are showing some very promising results. It takes time for them to scale up to the right level and we do not know at this point how many stores are actually capable of achieving that kind of incremental performance. So, we are proceeding with caution but with some confidence, too.

Jim Durran - *Barclays Capital - Analyst*

Just one last quick question on deflation. Within the quarter and as you look out over the next two quarters, is it FX that's really going to be a driver to the deflation story in the Canadian grocery industry, or is there incrementally some commodity input cost deflation occurring from the source that is going to drive it?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

I think at the moment, you've got to look at the inflation that we're cycling from the previous year. That is probably the biggest force that is contributing to the shift that has taken place over the last few months. And, yes, for sure, another big driver of inflation/deflation is the value of the Canadian dollar. Anybody can speculate on what is going to happen in the US based on recent events and that will certainly affect the outlook.

Then, as I said before, we are making some targeted investments in areas where we think that the actual unit price on items is too high and we are lowering prices. And we are seeing consumers respond in those categories to the lower prices, and that is driving units up. It's really tough to isolate all specifically, but if you had to pick one look at what the cycling of inflation is from last year.

Jim Durran - *Barclays Capital - Analyst*

Great. Thanks, Galen.

Operator

Michael Van Aelst, TD Securities.

Michael Van Aelst - *TD Securities - Analyst*

Thank you. And congratulations on the numbers. On the inflation, it sounded like the price investments started at the end of Q2, if I remember correctly, or near the latter part of Q2, and continued through Q3. However, your price asked from your suppliers of 1.45% will only kick in in September. So, is there a bit of a disconnect between the timing of when you're making that investment and when you're getting some of the rebates from the suppliers?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

There is a bit of a disconnect in terms of the cost of the investments. But suffice to say we had an expectation of how much we were going to get from suppliers as a result of that ask, and that was really built into the way that we designed the investment plans from the end of the second quarter through to the balance of the year.

Richard Dufresne - *Loblaw Companies Limited - CFO*

But, you are right, Michael, in that the money from the vendors started coming in September.



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Michael Van Aelst - TD Securities - Analyst

Okay. So, could we expect a little bit less pressure on gross margins in Q4, or would you be looking to increase your investments further?

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

Again, I think you've got to go back to our stable trading platform. Nothing has changed in terms of our view around delivering stable gross margins over time. We think that we will invest as necessary in order to maintain and improve our competitive position. Beyond that I think it would be inappropriate to comment.

Richard Dufresne - Loblaw Companies Limited - CFO

The only thing I would add, Michael, is obviously our gross margin is helped by the performance of Shoppers and we're starting to see some benefits from shrink which is also helping.

Michael Van Aelst - TD Securities - Analyst

Shrink is in the food or in the drug?

Richard Dufresne - Loblaw Companies Limited - CFO

It's in the food.

Michael Van Aelst - TD Securities - Analyst

All right. And then, finally, your free cash flow has been exceptionally strong year to date. But your buyback has not been all that aggressive. I am wondering why you're not spending more of your free cash flow on your NCIB.

Richard Dufresne - Loblaw Companies Limited - CFO

Actually we are spending all of our free cash flow, Michael. If you notice, we actually paid down CAD525 million of bonds that came due in the summer, or early in the summer. So, we made that decision because we thought it was a good one.

Essentially, if you look at our cash balance, it's actually not moving. So, we are using all of our free cash flow. And there's no debt repayment in 2017 so we should be reorienting our cash flow to buybacks.

Michael Van Aelst - TD Securities - Analyst

All right, I will follow up off-line on that. Thank you.

Operator

Tal Woolley, Dundee Capital Markets.



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Tal Woolley - Dundee Capital Markets - Analyst

Hi, good morning. Just wondering if you can just speak to the factors that drove the improved retail pharmacy dispensing margin.

Richard Dufresne - Loblaw Companies Limited - CFO

We don't specifically talk about the improvement in margin in drug. But overall, the only thing I would say about the pharmacy business is that overall we continue to gain share in that, and that's clearly a positive factor.

Tal Woolley - Dundee Capital Markets - Analyst

Okay. And then just as we look out into Q4 in 2017, any particular areas on the regulatory front you are keeping an eye on?

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

When you say Q4 2017?

Tal Woolley - Dundee Capital Markets - Analyst

Pardon me -- Q4 2016 and beyond, that's what I mean.

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

No, nothing beyond the norm.

Tal Woolley - Dundee Capital Markets - Analyst

Okay. And then just on the QHR acquisition, that was obviously something that you could afford but a meaningful acquisition, nonetheless. You've got some well-capitalized players in that space. How do you view the evolution of that business over time? And where does it fit in between the Loblaw and Shoppers ecosystem?

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

It rolls up into Shoppers. And think about it as part of a medium/long-term view on how healthcare is going to evolve over the next number of years. And our perspective on that is it's fundamentally rooted in the digitization of healthcare systems -- e-prescribing and wellness and so on and so forth.

We think that Shoppers Drug Mart and Loblaw have articulated on a number of occasions our collective belief in the combination of wellness driven by nutrition or food and the health driven by therapy management and pharmacy, the intersection of those two. And the acquisition of QHR adds the medical practice, it adds doctors to create a bit of a triangle. We are developing a strategy where we think our business has the opportunity to prosper as the digitization of healthcare starts to take place.

Tal Woolley - Dundee Capital Markets - Analyst

And, one last question, to date, on that front, are there any concerns, as you start to go a little bit more vertical in the healthcare space, just in terms of patient data, privacy, how do you manage those things going forward?

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Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

Those are good questions. Probably not questions we can answer in a satisfactory fashion on the call. But suffice it to say that, yes, all of these things are considerations that need to be looked at. We are doing that. Those will be a part of how we deploy that strategy.

Tal Woolley - *Dundee Capital Markets - Analyst*

Okay. Thank you very much for your time.

Operator

Keith Howlett, Desjardins Securities.

Keith Howlett - *Desjardins Securities - Analyst*

I wonder if you could speak as to how the general merchandise and apparel business is performing both in sales and margin.

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

Margin is strong, sales are a little tougher, especially since we have had such a warm fall, now heading into a rainy November. That is never great for seasonal merchandise, coats, scarves, and Christmas GM. But it is not something we consider a major source of concern.

Keith Howlett - *Desjardins Securities - Analyst*

And then just on the shrink improvement in the food business, is that part of a larger program that you are part way through, or does it relate to a specific improvement at one category of the store? Or what does that relate to?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Keith, shrink essentially, now that we are fully on SAP, we now can measure it correctly or consistently. And the operators now believe the numbers they're seeing and therefore, I always say when you measure it you can manage it. So, now people are actively managing it, and therefore we are starting to see improvements across the board.

So, we're quite excited about what we're seeing. But I want to make the point that in Q3 of last year it was actually a really bad quarter from a shrink perspective so the year-over-year improvement is significant. But going forward we expect to see more benefit of shrink going forward as people understand it better. It's one of the SAP benefits that we are quite proud to highlight and, therefore, we can see more improvements going forward.

Keith Howlett - *Desjardins Securities - Analyst*

And then just a question on the Shoppers Drug Mart, when you roll out the expanded food assortment, would you prefer to have a larger footprint Shoppers than the 14,000 model? Or is that model sufficient for the food program?



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Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

No, we do not need a larger Shoppers Drug Mart to deliver enhanced food. In fact, one of the things that we are learning as we put more of these enhanced food departments into smaller Shoppers Drug Marts in the downtown core of Toronto is that we can do a lot more with less space than we previously realized and it's very exciting.

Keith Howlett - *Desjardins Securities - Analyst*

Thank you.

Operator

Patricia Baker, Scotiabank.

Patricia Baker - *Scotiabank - Analyst*

I think it would be fair to say that Q3 certainly saw that if you get the price right for consumers they will come and shop and drive the unit volume. If we shift away from that and look at the Shoppers front store, you had a really nice comp there at 3.9%, how promotional, leaving aside beauty, how promotional do you have to be in that segment to maintain volume growth and same-store sales?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

A lot less promotional today than that business needed to be two or three years ago. That is why we keep coming back to this point, which is, as we have significantly enhanced that food assortment -- and forget fresh, just improve the food assortment -- that is a high-traffic repeat purchase part of the Shoppers Drug Mart proposition.

As strong as it is, it is allowing that team to invest a little bit less in some of their more traditional traffic drivers. That might be milk or pop and so on and so forth. That is part of what is contributing to the margin. It is sales with a less aggressive investment.

Patricia Baker - *Scotiabank - Analyst*

Okay. That's very helpful, Galen. But you referenced earlier in answer to someone else's question that you are gaining market share in scripts. Is any of that coming from the fact that you are drawing more traffic to the front of the store with food and you're getting some conversion there? Or is it just the general attrition we're seeing in that market from other players?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

I think we are still benefiting, and it may go on for a long time, from the exit of Target even though it seems quite a long time ago. That business continues to improve the customer proposition in pharmacy. We've been working hard to target areas or customer segments that we under-index, like retirees, and we've seen some positive traction on that. We've made some pricing decisions on the copay over the last couple of years, which has also contributed really positively, bringing new customers into the store.

So, what I would say is that the team is doing a great job in the way that they are trading the business across the board. It is contributing to positive share growth in pharmacy.



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Patricia Baker - Scotiabank - Analyst

Okay. Thank you.

Operator

(Operator Instructions)

Vishal Shreedhar, National Bank Financial.

Vishal Shreedhar - National Bank Financial - Analyst

Hi, thanks for taking my question. Just a quick one here on Shoppers Drug Mart and marijuana dispensing. I just want to get your view on what your thoughts are for pharmacies potentially doing that and what kind of opportunity is there for Shoppers in terms of dollars?

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

Okay, good question. First, maybe I can clarify the two things that are covered in the media as it relates to marijuana and Shoppers Drug Mart. The first is that we have applied for a mail dispensing license so that we can dispense marijuana the way that other mail-order pharmacies can actually do that. That is legal. It is an application process and we hope that that will turn out positively for us.

The second thing that we're doing in conjunction with the pharmacy industry as a whole is we are engaging with the federal government and engaging with the provincial government around dispensing medical marijuana directly from our pharmacies. And we see that as a really compelling change in approach for managing marijuana. We think that the pharmacy business is extremely well-suited for processing controlled substances. And we think that there are significant medium-term opportunities for marijuana to be part of the pain management therapy formula for Canadians as we move forward. So, we are keen on it.

As far as what the size of the opportunity is, let's say it is meaningful, but it is not transformational to the pharmacy business. We make a point of processing drugs and that is what our business model is based on. And this would simply be an incremental addition to that.

Vishal Shreedhar - National Bank Financial - Analyst

Thanks for that. Do you have any idea where the government is regarding the marijuana legislation? Are we years away? Is it near term?

Galen Weston - Loblaw Companies Limited - Executive Chairman and President

I don't think we can comment. That's really in the hands of the government. You'll have to ask them.

Vishal Shreedhar - National Bank Financial - Analyst

Okay. Thanks a lot.

Operator

Keith Howlett, Desjardins Securities.



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Keith Howlett - *Desjardins Securities - Analyst*

I was wondering if you could update us on the beer and wine that you are now able to sell in a small number of stores in Ontario, how that has worked out, whether it adds anything or builds traffic, or what your early view of it is.

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

Yes. Broadly speaking, there are essentially deregulation efforts underway across pretty much every province as it relates to beer and wine specifically, and in some cases, alcohol. We believe that the grocery channel should be a robust and important part of the deregulation of alcohol. It is a great place to improve access for the Canadian consumer. We've demonstrated it very successfully in a number of provinces that we can effectively manage it as a controlled substance.

What's happening in Ontario is one variant on how you deregulate beer and wine sales. We are, I would say, happy with the results. It drives traffic and improves basket more than it is a direct positive contributor in terms of margin.

We are being very careful that we do not overpay for the licenses that we do want to have access to. But we will continue to add as those licenses become available.

Keith Howlett - *Desjardins Securities - Analyst*

Just one last question on the conventional business in western Canada, you've opened some Loblaw market stores and it sounds like you are moving some Extras to Your Independent Grocer. In terms of the residual Extra stores, are they more likely to become conventional versus No Frills? Or is it just specific market by market?

Galen Weston - *Loblaw Companies Limited - Executive Chairman and President*

The first wave was converting them to No Frills. The second wave is converting them to Your Independent Grocers. Right now I would say we are down to the last remaining. And we're looking at them on an individual site-by-site basis, and we are going to make the most efficient capital investment to keep them performing at a satisfactory level.

Keith Howlett - *Desjardins Securities - Analyst*

Thank you.

Operator

As there are no further questions at this time, I would like to hand the call back to Ms. Sophia Bisoukis for any additional remarks.

Sophia Bisoukis - *Loblaw Companies Limited - IR*

Thank you to everyone for joining us today. If you have any further questions you can contact our investor relations team. We look forward to speaking with you all again to discuss our fourth-quarter 2016 results which will be held on February 23, 2016 (sic). Have a good day.

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Operator

Ladies and gentlemen, this concludes the Loblaw Limited third-quarter 2016 conference call. Thank you for your participation today. You may now disconnect.

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