

FINAL TRANSCRIPT

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L.TO - Q2 2011 Loblaw Companies Ltd Earnings Conference Call

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Desjardins Securities - Analyst

PRESENTATION

Operator

Good morning. My name is Matthew and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited second-quarter results conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. (Operator Instructions). Thank you.

Kim Lee, Vice President of Investor Relations, you may begin your conference.

Kim Lee - *Loblaw Companies Limited - IR- Sr. Dir.*

Thank you, Matthew. Good morning and welcome to the Loblaw Companies Limited second-quarter 2011 conference call. We issued a press release reporting on the quarter this morning. The complete second-quarter report including the press release, MD&A and financial statements and notes are available on our website at Loblaw.ca. As well, this call is also being webcast simultaneously on our website.

I'm joined here this morning by Galen G. Weston, Executive Chairman, Allan Leighton, President and Deputy Chairman, and Sarah Davis, Chief Financial Officer.

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Before we begin today's call, I want to remind you that the discussions will include forward-looking statements such as the Company's beliefs and expectations regarding certain aspects of its financial performance in 2011 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 current expectations. These risks and uncertainties are discussed in the Company's materials filed with the Canadian Securities Regulators from time to time, including the Company's Annual Report and Second-quarter Report.

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 as required by law. Certain non-GAAP financial measures may be discussed or referred to today. Please refer to our second-quarter report and other materials filed with the Canadian Securities Regulators from time to time for a reconciliation of each of these measures to the most directly comparable GAAP financial measures.

An archive of this conference call will be available on our website. And with that, I will turn the call over to Galen Weston.

Galen Weston - *Loblaw Companies Limited - Executive Chairman*

Good morning. Thank you for joining us. As we progressed through the second quarter the Company continued to focus on building out its infrastructure and developing opportunities for growth. Unpredictable and competitively intense market conditions continue to put pressure on retail sales and, as in previous quarters, we expect our investment in information technology and supply chain infrastructure to negatively impact operating income for the remainder of the year.

As you know, this is Allan Leighton's last quarterly earnings release. So before passing the call over to Sarah, I want to take a moment on behalf of the Company and the Board of Directors to express my appreciation for his work over the last four years. Allan has led this organization through one of the most ambitious change programs in the Company's history, the results of which will benefit the customers and shareholders for many years to come. Allan, we wish you well.

I am also very pleased to confirm that our new President, Vicente Trius, will join the Company on August 2. He arrived with his family right at the beginning of July just in time for the Ontario heat wave and he is very much looking forward to getting started.

I will now pass the call over to Sarah Davis.

Sarah Davis - *Loblaw Companies Limited - EVP, Finance*

Thank you, Galen, and good morning. In the Retail segment which consists primarily of food, but also includes drugstore, gas bars, apparel and other general merchandise, sales increased by 0.2% to CAD7.2 billion in the second quarter of 2011. Same-store sales decreased by 0.4%.

In the second quarter of 2011, sales in food were flat, sales in drugstore declined moderately, negatively impacted by deflation due to revelatory changes in Ontario and other provinces and the new generic versions of certain prescription drugs. Gas bar sales were strong as a result of higher retail gas prices and moderate volume growth. And sales in apparel was modest, primarily as a result of increased store footage while sales of other general merchandise declined significantly, due to continued reductions in square footage and the optimization of range in an assortment of product.

In Q2, our average quarterly internal food price index experienced moderate inflation, but with lower than average CPI in the quarter of 4%. We saw marginal deflation in internal food price in Q2 of 2010.



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The Retail segment gross profit was CAD1.6 billion or 22.7% of sales, a 30 basis point improvement over the second quarter last year. The improvement was primarily due to improved control label profitability, the shift of pharmaceutical professional allowances from SG&A expenses to gross profit, improved shrink, partially offset by increases in promotional pricing programs and transportation costs. Operating income in the Retail segment increased 6.4% to CAD333 million in the second quarter compared to CAD313 million in Q2 of 2010.

Operating margin was 4.7% in the quarter, a 30 basis point improvement over last year. This increase was due to continued labor and other operating cost efficiencies as well as increased gross profit. This increase was partially offset by a charge related to certain prior years' commodity tax matters, incremental costs for the investment in IT and supply chain, and the impact of share-based compensation net of equity forward.

In Q2 of 2010, an asset impairment charge was included in operating income in connection with changes to the Company's distribution network.

The Financial Services segment includes credit card services, a retail loyalty program, insurance brokerage services, personal banking services, deposit taking services, and telecom. During Q2, revenue decreased by 1.6% to CAD121 million compared to CAD123 million in Q2 of 2010. The decrease was primarily driven by increased customer payment rates resulting from both changing customer behaviors and more stringent credit risk management policies. Although these practices resulted in lower revenues, they favorably impacted the annualized credit loss rate.

Operating income in the Financial Services segment was CAD12 million in the second quarter of 2011, down from CAD32 million in the same quarter last year. The decrease was mainly due to significant marketing investments and customer acquisition costs.

On a consolidated basis, operating income was CAD345 million in the second quarter, flat with Q2 of 2010. Operating margin was 4.7%, also flat with Q2 of last year. Consolidated operating income in 2011 included CAD8 million in incremental costs related to supply chain in IT, a CAD15 million charge related to certain prior year commodity tax matters and a CAD15 million charge related to share-based compensation, net of equity forwards.

Consolidated SG&A expenses in the quarter as a percent of revenue were 19.2% up from 18.9% in Q2 of 2010. This increase is a result of the incremental costs I just highlighted and our investments in PC Financial.

We are adjusting our guidance for the incremental supply chain in IT cost. We now expect our full-year incremental spend to be approximately CAD100 million, down from our previous estimate of CAD135 million. The reduction is a result of rephasing activity, improvements in procurement and a reduction in anticipated depreciation expense due to the timing of capital expenditures.

Interest expense decreased to CAD78 million from CAD81 million last year due to an increase in interest income on short-term investments. Our effective tax rate for the quarter was 26.2% versus 31.4% in Q2 of 2010. The decrease was primarily due to a decrease in income tax expense related to certain prior-year income tax matters and further reductions in the federal and Ontario statutory income tax rate. We continue to anticipate our full-year tax rate to be 28%, but there can be movement between the quarters.

Loblaw realized second-quarter basic net earnings per common share of CAD0.70 compared with CAD0.65 in the second quarter of 2010. Net debt at the end of the second quarter was CAD4.6 billion, down approximately CAD100 million from Q2 last year and flat with Q4 of 2010.

Capital expenditures in Q2 were CAD161 million. Our estimate for capital expenditures in 2011 continues to be approximately CAD1 billion.

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Approximately 50% of these funds are expected to be spent on upgrading IT and supply chain with the remainder being spent on Retail.

I would now like to turn it over to Allan Leighton who will provide some context for the quarter and the year ahead.

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Thank you, Sarah, and good morning, everyone. From a market perspective this quarter was a continuation of quarters past. A 14 successive quarter EBITDA growth, still tough market conditions, no real change in consumer attitude or habits, tight consumer wallet, and plenty of aggressive promotional activity, but with some moderate inflation.

From a business perspective it, too, was reassuringly familiar. Building our infrastructure, renovating our core stores, improving our control brand in general merchandise profitability and, importantly in the quarter, bedding in our two division organization.

On the infrastructure front, we continue to roll out WMS due to the remaining DCs. We [won't] complete it during the quarter and an additional three to be completed in early 2012. This will put 9% of our network on the new WMS and, as you already know, TMS is now complete.

The rollout of purchases on our new forecasting system which is IPFR continues with good progress in general merchandise and produce, and we are working towards our goal of bringing close to 100% of our purchases on to this system by the year-end. As a result, we are seeing good improvement in ordering and replenish in and from our DCs.

The rollout of our Store Timed Attendance Systems, STAS, is progressing to plan. We are seeing benefits of improved visibility into how we schedule and a reduction in overtime and premium pay. Store productivity continues to improve.

Our store renewal program remains on track. We have completed 73 major and minor innovations year to date and we will deliver over 100 by the year end.

Our investment in Western Canada continued. We opened Josh's No Frills in Calgary and we have completed four of our large superstore projects. We opened Shawn's No Frills in Stratford, Prince Edward Island, bringing the total number of [filled in United] to eight and we remain on track for the 20 we targeted.

Q2 was also a crucial bedding down period for the two-divisional structure with the normal noise attached to this type of change, but we largely avoided any pell-mell and Atlantis landed safely.

We now have one third of our merchandising categories on SAP and during the quarter, we converted some of our most complex categories. With a continued focus on clean and accurate data, Wave 3 went live on July the 18 and we now plan to have all of the remaining categories complete in the third quarter of 2011. At which stage, all of our merchandising will be on SAP.

A combination of rephrasing of activity to fit the organization change and better planning and procurement meant that we spent lower than originally forecasted in the quarter. And we'll now spend around CAD100 million incremental in the year.

As well as the continued focus on the core potential of the business, we also start to make progress on our four horizons of growth -- ethnic, health and wellness, Joe, and PC Financial.

On Joe, in Canada in Q2 we opened three new Joe's standalone stores in Bramalea, Vaughan Mills, and CrossIron Mills. We have also confirmed the openings of four additional standalone stores for later this year.



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For Joe US, we opened our first pop-up store in the Hamptons. This is really an opportunity just to start to build awareness in the Joe brand in the US before our flagship store on Fifth Avenue opens later this year.

We opened our 20th T&T at [Yonge and Weldrick] in Richmond Hill, building on our established base and trying to be the number one ethnic player in Canada. We have a clear track towards our target of doubling the number of T&T stores in our portfolio and midterm creating a billion-dollar lineup.

In health and wellness, our service initiatives, which we launched nearly a year ago are starting to pay back with promising script growth. And PC Financial investment really stepped up in the quarter. Our investment in additional store presence delivered our highest ever applications, [our new cresting the growth] of 80%. Our new PC mobile units delivered record mobile and prepaid sales.

So as renewal comes towards a close, the balancing act continues. Sales v margin, infrastructure versus the rises of growth, trading for today, [last] building for tomorrow.

But in summary, we continue to invest for long-term growth. In a highly competitive marketplace, with pressure on discretionary spending and still major infrastructure change of attitudes, as always, we remain cautious in our outlook.

With that, operator, I would like to hand it over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Patricia Baker with Scotia Capital.

Patricia Baker - Scotia Capital - Analyst

Thank you. Good morning.

Allan, notwithstanding the fact that the theme of this year's Annual Report, etc., is Building Out From the Core, I really would like to get back and talk about the core and that is the core food business. And as you are leaving, can you share with us, what is -- what in your view is it going to take to really get volume and sales driving in this core food business at Loblaw? What do you think is necessary? What do you possibly think might be missing in the formula currently?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

I think it is worth putting some perspective on this quarter. It's a -- the market is not strong. Volume is difficult to get. There is not a lot of volume in the market place and that trend has been around for a period of time now and I think that trend will continue for a period of time.

And for us in this quarter, particularly it is very easy -- now I always talk about this balance about chasing volume for the sake of volume. If you look at the spread of comp sales growth in the industry, it is not a very wide spread. And, therefore, chasing volume for volume's sake is still something to be cautious of.

In this quarter, particularly, we were very cautious of it. I mean, this was a major bedding down period for our merchandising organization, with a lot of change taking place and the implementation of some of the most complex -- we decided to go the complex categories first because we have earned the most in that.

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So in this quarter, particularly, this was not a quarter that we were going to go chasing volume. That's not necessary there, it was far too risky and as I say, I think we have actually got ourselves bedded down in a good place and I'm glad that we made that decision.

And so, but what will grow the business in terms of food going forward is exactly the same as happens today. We -- I think the two divisions will make a big difference. I think that bedding in nicely, we can see that some of the things that we thought we would get off the back of that starting to happen. I think that our SAP work getting all the merchandising on SAP, the simplicity that that brings, the data that that brings, the agility and speed that that brings, agility particularly important in markets where actually the difference between is really are you down 1% percent or are you up 1%. I mean, that is really what we're talking about here.

So for me it is the basics, and we have been putting that basic infrastructure in place and, actually, I think it has been quite helpful to us that the markets not been particularly strong and because it has enabled us to hold our position. But I am very confident that what we've been doing and what we will continue to do are absolutely the right thing to do. Not least, renovating our core base.

I don't believe for one minute that this is all about new space, I never have. I think it has a lot to do with your core store base and we are probably now getting close to 75%, 80% away through getting that right.

So if you get the basics right, you got the systems right, the supply-chain right, you get your stores right, you then start to get your offer right in a way which we have not been able to do before. Then, I'm sure that we will get the growth that's there, but I'm not overconfident that there is a lot of growth to be got out of this market in the next 12 months.

Patricia Baker - Scotia Capital - Analyst

That's quite interesting. And I was asking it rather broadly, not specific to the quarter, because I would like to hope and I actually know that you don't run your business on a quarterly basis, but on a more long-term basis.

Maybe, speaking of volumes, and I'm sorry to do a follow-up here, but maybe as a parting present, you could tell us what your actual inflation that you experienced in the business was in the quarter? Rather than just the moderate that was under 4%, but 0 to 4 is a big range.

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Well, unfortunately Patricia, I don't do parting present. And the most important thing is to be -- is consistent. We don't talk about inflation, we don't talk about volume, we talk about it in a generic sense. And I think the only thing I would say about inflation is it's beginning to creep in and the watch out, although I think we are some way from it today, is as I said to you, I think there is a sweet spot for inflation and then I think there is a place where you don't want to be.

Patricia Baker - Scotia Capital - Analyst

No, absolutely and Allan (multiple speakers). Sorry go ahead.

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Just mention if you look at the markets around the world, which we tend to do, the markets where inflation gets out of control the volume falls away; and so there is a sweet spot and we will do everything we can to contain inflation if and when it escalates to that sweet spot.

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Patricia Baker - Scotia Capital - Analyst

Well, you hold the single position of being maybe the only food retailer that most of us look at that don't actually give out that number. And in the past you have been a little bit inconsistent because there have been quarters, if we go back three or four years, when you actually gave it, but I do recognize that we are not going to get it today. So thanks.

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Thank you.

Operator

Perry Caicco with CIBC World Markets.

Perry Caicco - CIBC World Markets - Analyst

Allan, just delving a little bit more into the quarter, as you discussed the sort of traffic and tonnage situation isn't great out there. Just wondering if when you look at your numbers, how much of that do you think is the market and how much of that would you say is Loblaw-specific? And in that context, do you think you are gaining or losing market share?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Again, we will have to talk about [multi-shipper], is -- I think it is but clearly we are in a, well, as you know, we have been talking about for a long period of time. We are in a major part of infrastructure built. And you know better than any that when you do the merchandising area, that is the bit where you have got to be very, very much on it.

And so in the quarter, I would say the markets still continue to play a significant part in this. But in the course, we were very guarded about what activity we did or did not do, going through the amount of change that we've just gone through in this quarter on the (technical difficulty). And it was a very important quarter for us because we had to bed down the teams and we had to put in for SAP, as I say these -- the more complex categories. And as I say, I feel actually pretty good about where we are and feel sufficiently confident in where we are and to a degree sort of taking that bit of a breath that we will complete all of the merchandising categories this quarter, which will make a big difference to the business.

Perry Caicco - CIBC World Markets - Analyst

And so in that context do you think the Company would be able to in a sense release the hounds by Q4?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Well, I'm not sure about releasing all of the hounds by Q4. I think we will have the ability to -- I've just got to be careful what I say here. I think it will be -- we will have more ability and, more importantly, more agility to make some of the decisions that make a difference in the short term that we don't have today.

But I would pull -- I always pull out this caution. If you look at the marketplace, and you look at the spread of performance between anybody in that marketplace, there's not a lot. And I am very cautious and have been from the start about chasing volume just for the sake of volume when it is not there.

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But I think we -- the whole idea of doing everything we did on it is to be in a better place. But remember it is a bit of a [system] and we have done finance, we've done some of the back office, we are now merging into merchandising and it is only when the whole thing is completely linked through to stores that you really get all the benefits. But I certainly agree merch will be in a better place.

Perry Caicco - CIBC World Markets - Analyst

And do you have any sense about what has been happening to your market share over at this time period?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Yes. We have a very clear sense of what is happening to our market share over the period but we, as you know, we tend not to share that information.

Perry Caicco - CIBC World Markets - Analyst

I have a question for Galen. You have got a new CEO coming on and I am sure it is going to take a while for him to set his own agenda, but as Chairman of the company, I was kind of wondering what you hope is on his priority list?

Galen Weston - Loblaw Companies Limited - Executive Chairman

Yes. I think you asked a similar question last time a lot around. And it hasn't really changed. I mean, we recruited Vicente because he has a series of skills and an experience base that is very well aligned with the next phase of growth and development for Loblaw Companies. Clearly, a focus on operational excellence at store level is something where we think there is some upside. And he has a lot of experience in developing ethnic businesses and trading in ethnic markets, a little bit of experience in health and wellness, two of the key areas that we see -- not only for incremental growth, but also growth and improved competitiveness inside the core food business.

So it will take him a little while to get up to speed, but as I said before, he understands the strategy, the path that we're on. He agrees with it and so we expect this to be a fairly smooth transition.

Perry Caicco - CIBC World Markets - Analyst

Okay. That's good for now. Thank you.

Operator

Irene Nattel with RBC Capital Markets.

Irene Nattel - RBC Capital Markets - Analyst

Good morning, everyone. Just continuing to focus on the quarter and trying to get a better understanding of what is really going on out there. Can you talk about what you are saying in terms of consumer response? Are we still seeing really consumers focused on the value add piece, the private-label piece, and if so, what is happening to your private-label penetration?

And also wondering about the impact of weather in the quarter. Because certainly year on year, I would have expected that marginal sales of some seasonal-related food and general merchandise items could have been a little bit weak.

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Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

All right, let me start with the weather. We have a rule in here, which is nobody is ever allowed to use weather as an excuse for anything. And, because my experience is it always gets trolled out when the reason for when sales go down. It is never really trolled out for -- no reason when sales go up.

So we have a sort of rule on the weather. I mean, clearly it has an impact, but we -- people's job is to manage their way through that. And so that is where I think we see on the weather front.

On control band, we are pleased with the performance of control band. It continues to grow in the business. It continues to grow its participation in the business and, more importantly, it continues to grow in terms of its profitability in the business and they are all things that we set out to do.

I think the -- as far as consumers are concerned, there is not a lot of change. I mean, they are shopping less frequently. Let's not underplay-- the fuel inflation is huge, has a big impact on people's -- particularly people who are traveling distance to go to stores. So they tend to shop less frequently. The basket sizes, if anything, are up but you -- it's basically less traffic, less frequency. And people spend to their budget I think. You know, [if I've obviously] got CAD100, CAD200 to spend, that's what I spend and I don't spend any more than that.

So I think that is very much as it has been and frankly, I always -- I've been on this for a period of time and I don't see that changing very much. And I don't say -- you know, I don't play everything down for -- you know, to make everybody feel bad, but I think from a business perspective you have to be realistic about what is happening in your marketplace and what consumers are doing and you have to set your store out accordingly. Particularly when you've got -- you are trying to do two things, which we are, obviously trade the business on a daily basis and build an infrastructure for tomorrow.

So consumer is very tough. Consumers are still very value-conscious and I think that will continue.

Irene Nattel - RBC Capital Markets - Analyst

That's great. And just one follow-up, if I might. On Financial Services, seeing as how all of this disclosure is relatively new to us, it was a fairly significant stepdown in contribution this quarter. How should we think about that on a go-forward basis in terms of getting the payoff from that investment?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Well, two things. First of all, you should look at this sort of level for the second half of the year and well into next year. Because this isn't something -- this isn't a piece of tactics. It is a piece of strategy.

And we have a clear plan of how we think we can really develop this business. And you are beginning to see that take action today. I mean, there's been a lot of investment in terms of marketing; in terms of resource and restores; in terms of building out what we call Pavilion Light, which is a smaller version of the Pavilion into more stores and they have a target of apps without changing the quality of our book, which is a very good quality of book. And they are well on track with that.

So, I think you should see this certainly for the next 12, 15 months; and then we should start to see some payback from that. And it is not just that -- you know, as you say, it's not just in the financial area. We talk about our mobile business. You know, we have a big investment in terms of what we have done there. We put 530 new mobile ends in all of our stores and we've done that for a reason. Because we think that could be a serious player in that market.

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So and of course it also gives us a great data from our customers and all those things. So it is -- it is a strategic move and therefore you can expect to see this level investment as I say for at least the next 12, 15 months.

Irene Nattel - RBC Capital Markets - Analyst

That's great. Thank you.

Operator

Michael Van Aelst with TD Newcrest.

Michael Van Aelst - TD Newcrest/Waterhouse Securities - Analyst

Thanks. Just a few more things to clarify, I guess. Most have been asked, but as far as the customer is concerned, are you still seeing an increasing percentage of sales on promotion or has that stabilized yet?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

It's still high. I would say that it's pretty stable, but at a still in my view too high a level. But that's some -- again, that is where our agility sort of comes into play. I would expect us to be much more effective with that spend as time develops with SAP and merch.

Michael Van Aelst - TD Newcrest/Waterhouse Securities - Analyst

Okay. And can you explain what you think the main reasons for the difference between inflation that we're seeing in [STAS] Canada and what's actually being recorded and whether or not you expect inflation to pick up in the second half of the year?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

There's always -- the fact of the matter is there is always a difference between the two sets of numbers. I think that has been historic.

Plus the fact that there is -- although there is more inflation, still largely Fresh driven, it tends to be a bit PG. But at the same time there's a lot of promoting back, too. So you have got that in the mix and because I think we are all in the same place, which is trying to find a balance here of where you need to be priced effective and where you get some volume off the back of that and where you've tried repricing and maybe you don't get any volume off the back of it.

So you know there's still a lot of people trying to find where's the sweet spot in all of this.

Do I think inflation will pick up? Well, the answer is yes. And I don't -- you saw the Carney stuff that came out this morning. There's a lot of inflation, in commodities, and as you know, 50% or 60% of food produced in Canada is used for domestic use. So there is going to be a lot of pressure, I think, on food price inflation.

And as I say that is a watch out and our task is to make sure that that doesn't go beyond the sweet spot. Because if and when it does, then that's a pretty significant effect on volumes. So I do -- there will be some inflation, but the most important thing on food is that we keep it at a reasonable level.



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Michael Van Aelst - TD Newcrest/Waterhouse Securities - Analyst

And just finally on the IT spend and supply chain. Now that we are heading into the second half of 2011 and you pushed back some of your spending, at least I guess into 2012, can you give us any sense as to the magnitude of the increase you are now expecting for 2012 versus 2011?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Not now. I expect it's probably a bit too early. I think we will do that as we get probably into Q4. And that is not being evasive. It is a -- I mean, actually we're -- there is a bit of flex in this all the time. We are getting much more efficient being able to apply the resources when we need them and I think getting the next chunk, which is the next chunk of merch, I think when we get through that, which is this quarter, very much the focus of the business, we'll have a better idea about how that will all play into 2012.

But the guidance we give you today of around that CAD100 million incremental now, probably fit pretty even over the rest of the year is -- would be good for this year.

Michael Van Aelst - TD Newcrest/Waterhouse Securities - Analyst

Thank you.

Operator

Peter Sklar with BMO Capital.

Peter Sklar - BMO Capital Markets - Analyst

Just back on the IT spend. I can understand you don't want to give up some numbers for 2012, but do you anticipate that the delta will be positive or negative next year?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

It will be -- probably be a high number.

Peter Sklar - BMO Capital Markets - Analyst

Okay. And, Sarah, I wanted to ask you in terms of your disclosure on the IT, that the spend, like the numbers you are giving in the quarter released on page 2, the CAD2 million, the CAD38 million, the CAD66 million, just want to understand exactly what those numbers are. Is that the incremental expense the Company is incurring related to this IT spend versus the base level before you started this whole program? Is that how we should think about these numbers?

Sarah Davis - Loblaw Companies Limited - EVP, Finance

That's right. So we tried to be a little clearer in this quarter to explain exactly how the incremental CAD8 million was calculated. So basically, we would have CAD2 million in distribution network versus CAD16 million last year. So that is a decline of CAD14 million, but we also had an increase in depreciation and amortization of CAD12 million and then we had an increase in the base

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costs related to just the supply-chain project and the IT project. So it doesn't include the IT base or supply-chain-based cost and that was an increase of CAD10 million.

So we have tried to be more specific on these costs because we know that there is always a challenge in figuring out this incremental piece. So it is incremental from the -- basically it started, the incremental if you go back, we really started talking about it in 2009. So it is from there. 2008, there were some costs and then we've increased from there.

Peter Sklar - BMO Capital Markets - Analyst

So the base year was effectively 2008?

Sarah Davis - Loblaw Companies Limited - EVP, Finance

Yes.

Peter Sklar - BMO Capital Markets - Analyst

Okay. And one of the reasons that you talked about that the reduction, the anticipated reduction of expense this year from CAD135 million to CAD130 million was rephasing. Not too sure what that expression means. (multiple speakers)

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

So it's very straightforward, it means rephasing, i.e., in this quarter, as we were changing the organization, we decided to change some of the phasing of when we implement some of the systems. Because remember, the cost is when you implement and we wanted to bed the organization down for a bit before we put the systems in. So we just put them back.

But we are talking about rephasing of weeks, not rephasing of years. And that is what you get in these programs. If you don't rephase, you tend to have a problem.

Peter Sklar - BMO Capital Markets - Analyst

When you say rephasing, you are talking about postponing a number of weeks.

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Yes. Postponing is when we -- I mean rescheduling is a different way of thinking about it. You don't postpone them, you don't postpone the activity, you just do it at a different time.

Peter Sklar - BMO Capital Markets - Analyst

Okay. And the second thing I wanted to ask you about is on inflation. Allan, your comments in the call this morning have mostly been related to retail inflation.

I am wondering what comments you could talk about what you are seeing in terms of cost and food inflation. Are you seeing that? How is the Canadian dollar facilitating that? And where do you think you and the industry are in terms of passing through those additional costs?

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Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Well, the Canadian dollar impact is not that --. I would say a bit less than it was a year ago in reality, so that's not really a factor at the moment. I think in -- I can't talk about the rest of the industry, I can talk about us. I mean, I think we are where there is some rationale behind the price increases going through, we are tending to make that happen. But as I said before, we are not in the game of prices going up and then all -- it just gets promoted back down again because that is even more confusing. So we are still holding the line very much on that.

And because there is a lot of noise in the system, and because there is a lot of noise around commodities, we have a very good tracking system. And so we track commodities, and there is a line into our merchants everyday where they can check the reality or when something comes in with a price increase to see if actually there's any rationale for that.

And so that is the way we tend to handle it. So we have probably been put in a few more -- few through because clearly there has been a rationale for that, but our criteria remains the same of when, if, and how.

Peter Sklar - BMO Capital Markets - Analyst

Okay. Thank you for your comments.

Operator

Chris Li with Bank of America.

Chris Li - BofA Merrill Lynch - Analyst

Good morning. Just curious to see if you were to exclude the impact of the high gas sales in the quarter, what would the same-store sales number look like?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Probably marginally less, but it wouldn't have -- there's not much difference between this quarter and the previous quarter.

Chris Li - BofA Merrill Lynch - Analyst

Okay, so not a mar -- okay. And you don't talk about performance by regions, but I'm just curious to see if you can talk about specifically your -- how the turnaround in the Quebec operations are progressing? Especially in light with Wal-Mart now with the Supercenters in the province?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

I think that we probably feel a bit better about Quebec. And we -- again, I think the organizational change there has made a difference. I mean, the focus on the discount business. And I think the same unconventional.

We've got, we have some [Sylvan and Pierre Danois] who run those businesses for us on the conventional sense and I think they are beginning to make a difference to our business there.



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Chris Li - BofA Merrill Lynch - Analyst

And, Sarah, just a couple of quick ones for you. The share-based compensation, the net of equity forwards, the expense tend to fluctuate, I think it was a CAD50 million charge this quarter and there was a CAD7 million income in the previous quarter. Can you explain the fluctuation? Is that mostly because of the change of the share price or what's driving those fluctuations?

Sarah Davis - Loblaw Companies Limited - EVP, Finance

It's the change in the share price. That would (multiple speakers) cause that would also be the number of ROCs outstanding at a point in time as well.

Chris Li - BofA Merrill Lynch - Analyst

Okay. And what would be a reasonable tax rate to use for the remainder of the year?

Sarah Davis - Loblaw Companies Limited - EVP, Finance

I've used 28 for the full year.

Chris Li - BofA Merrill Lynch - Analyst

For the full year. Okay. Thank you.

Operator

Keith Howlett with Desjardins Securities.

Keith Howlett - Desjardins Securities - Analyst

I had a question on the general merchandise business ex apparel, which I guess is still going down. Just trying to figure out where that process of redesigning the space is and whether it may be profitability is higher than it used to be? Or whether profitability is also going down?

Allan Leighton - Loblaw Companies Limited - President and Deputy Chairman

Yes, personal apparel, I think how we'd describe it is modest or something, you know we are pleased with our apparel business. The apparel performance relative to other apparel businesses would be something that most people would die for. And so we are pleased with our how apparel continues to trend.

On general merchandise, there are two things. The profitability of general merchandise is clearly improved and that's what we were set out to do.

I think as I said last time, and Joe would encapsulate it that now from a range perspective, he probably, if you take what I describe as home, he's probably 75%, 80% of where he needs to be and in terms of ranging.

And then in terms of the right-hand side, which is how we then remerchandise that on a store-by-store basis, we are still in a relatively small number of stores, but beginning to build that up now. The results from the right-hand side store which is a



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combination of where you have the space reduced, the range correct, I would say is encouraging. I would say is very encouraging. And that is because we are looking at two things.

When you take the space out, you are really looking at productivity of sales. [I used to sell] (technical difficulty) going up and they do. And at the same time you are looking for profitability. So it is about productivity and profitability as you reduce space and that is what that right-hand side is about.

So I think we feel very confident about where that is heading. We are now just in a position where we have got to start to get it into more stores, a combination of those two things.

The biggest draw -- drawback on our GM business is electronics which as you know is in a mess everywhere. It is big in revenue, but small, tiny in terms of profitability. And so we tend to [look out at this], pleased with the progress in terms of ranking that Joe has got.

Now we just need to get back into more stores from a merchandising perspective too, looking at productivity and profitability and those tests look very good in that sense, so we can that move on. And we are trying to get out of electronics as fast as we can.

Keith Howlett - *Desjardins Securities - Analyst*

And does -- is there a different general merchandise program for the West versus the East? Or is it going to be similar?

Allan Leighton - *Loblaw Companies Limited - President and Deputy Chairman*

They will be marginally different. I mean, it's like everything else. It's a -- there's a side ranging difference, a slight emphasis difference. But the core idea, we have done this now in stores in the East and the West and we get the same results.

Keith Howlett - *Desjardins Securities - Analyst*

And just on the pharmacy business, can you update us how your sort of smaller format, No Frills program is going and where that could be going?

Allan Leighton - *Loblaw Companies Limited - President and Deputy Chairman*

Yes, I mean on the pharmacy, I think we are pleased. We've done it -- we think we've done eight in this quarter, which five are the small ones. So the majority -- the by far the mass majority as we expand these pharmacies are going in with the light version as we describe it, which seems to be particularly well.

We have been investing a lot of technology. We talk about technology across the rest of the business. We -- in about 350 of our best stores, we put new technology into the pharmacies, which enables us to get things done much faster, much more accurate, which releases time for people, instead of having to spend time doing work from a manual perspective, they can actually -- talking to customers and helping on that way round.

And so there has been some very good -- we got a refill ready program. There is a lot of stuff which is all the service stuff that we talked about last time. That is where our focus has been in pharmacy. It is really improving the service and really being able to put time where our pharmacists can spend time with the customers rather than doing unnecessary manual work.



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Keith Howlett - *Desjardins Securities - Analyst*

And then, just on the technology program. Is it fair that most -- fair to say that most of the work in 2012 is at the store level?

Allan Leighton - *Loblaw Companies Limited - President and Deputy Chairman*

Yes, there will still be a bit of merch and there will be a bit of finishing off in the supply chain. But then we will start to put retail on the back of it. Retail, I should note, has to go last for two reasons. One is because it generally is the culmination of all of the other stuff and, secondly, it is the last thing you want to run on dual systems basically.

So I think we are in -- we've got the bulk of -- we got the difficult merch through, get this merch through, getting merchandising done this quarter, get that behind us then we will be well into the second half of SAP as opposed to the first half of it.

Keith Howlett - *Desjardins Securities - Analyst*

And do you think you would complete the process in 2012 or is it more likely to stretch beyond 2012?

Allan Leighton - *Loblaw Companies Limited - President and Deputy Chairman*

It will always stretch beyond, but I -- you know the important thing is to get the bulk of it done and where you have got more people working on this than you've got on the legacy system. And we will certainly be in that position as we get towards the end of 2012.

Keith Howlett - *Desjardins Securities - Analyst*

I think for Perry's question release the hounds, it is release the Kraken now. (laughter)

Allan Leighton - *Loblaw Companies Limited - President and Deputy Chairman*

But hounds sounds better in a strange way.

Keith Howlett - *Desjardins Securities - Analyst*

Yes. Thanks very much.

Operator

Irene Nattel with RBC Capital Markets.

Irene Nattel - *RBC Capital Markets - Analyst*

It's just a point of clarification. What exactly was the prior year commodity tax matter that you took the charge for?



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Sarah Davis - Loblaw Companies Limited - EVP, Finance

Well, we won't --. I'm not going to get into the specifics, but at any point in time we are always being audited by various levels of government and in this particular case there was a reassessment for some commodity taxes, so we booked it in the quarter.

It related to years far back from today and so it was an out-of-period cost for CAD15 million that we had to book in the quarter.

Irene Nattel - RBC Capital Markets - Analyst

Thank you.

Operator

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

Kim Lee - Loblaw Companies Limited - IR- Sr. Dir.

Thank you. That concludes our 2Q call. Thanks for attending and have a great day.

Operator

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

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