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L.TO - Q1 2015 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 1Q15 consolidated sales of CAD10b, net earnings of CAD301m and adjusted net EPS of CAD0.73.

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Keith Howlett *Desjardins Securities - Analyst*

Peter Sklar *BMO Capital Markets - Analyst*

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PRESENTATION

Operator

Good morning. My name is Michelle and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited first quarter 2015 results conference call.

(Operator Instructions)

As a reminder, today's conference is being recorded. I will now turn the call over to Janet Craig. You may begin your conference.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Michelle, and good morning. Welcome to the Loblaw Companies Limited first quarter 2015 results conference call. I'm joined by Galen Weston, Executive Chairman and President 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 2015 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 as required by law.

Certain non-GAAP measures may be discussed or referred to today. Please refer to our annual report and other materials filed with the Canadian Securities Regulators for a reconciliation of these measures to the most directly comparable GAAP financial measure. I will now turn the call over to Richard.

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Thank you, Janet, and good morning, everyone. In Q1, we continued to deliver against our financial plan and we are pleased with our progress to date. We maintained a stable trading environment with positive same store sales and favorable gross margins. We achieved 30 basis points of SG&A efficiency in food retail, CAD44 million in net synergies, we remain on track with our deleveraging plan and increased our dividend. Our 4% same-store sales growth for our food retail business was aided by inflation and we saw increased basket and traffic. Our internal inflation was higher than food CPI of 4.6%, mostly driven by fresh, particularly meat and produce, but also aided by some inflation in grocery. Both our market and discount divisions had solid comp growth.

At Shoppers Drug Mart the positive trend for same store sales continued with pharmacy same store sales growth of 3.5% in front of stores same-store sales growth of 2.7%. Market share growth in pharmacy grew prescription count up 4.7%. However, this was offset by deflation in the average value of scripts dispensed of 1.1%. In front of store, our performance was led by OTC, food, confection and cosmetics. We did see some benefit in front of store from the timing of Easter as well. Traffic and basket were up.

With positive same-store sales growth in food and drug retail, the top line was strong with sales of CAD10 billion in the quarter, up 38% over last year on a consolidated basis. Revenue in our Retail segment was CAD9.8 billion, up 38.5% year-over-year with our food retail business growing 2% to CAD7.2 billion. Shopper Drug Mart revenue grew 3.1% to CAD2.6 billion in the quarter.

As we talked about in our last quarter's results, the Company restructured its fee arrangements with the franchisees in certain manners. This change has no impact on our earnings. What it does is reduce our gross profit and our SG&A. In Q1, gross profit and SG&A were reduced by CAD33 million. Our Retail segment gross margin improved due to the addition of the Shoppers Drug Mart business with adjusted gross margin of 26.7%, up from 22.6% last year.

Food retail gross margin of 22.1% was flat after adjusting for the change in franchise agreement. Synergies offset shrink, which came in higher than last year due to a catch up an inventory count following the implementation of SAP at store level in 2014. In our drug retail business, gross margin grew about 100 basis points to 39.4% largely driven by synergies. Cost of goods sold in the quarter also benefited from higher retail margins in front of store.

Turning to expense. We remain focused on improving core SG&A expense and seek to better manage volatility in SG&A as well as providing visibility into the drivers. Excluding the benefit to SG&A as the result of the change in our franchise agreement, food retail SG&A improved in Q1. We improved SG&A by 30 basis points in Q1, largely coming from income labor, supply chain and IT. We believe these efficiencies can be sustainable. Shoppers Drug Mart's SG&A increased 10 basis point year-over-year as expected due to higher store level expense, primarily labor and occupancy, largely driven by script growth.

Moving to synergies, we continue to make good progress against our targets. We have achieved CAD145 million of net synergies since closing including CAD44 million in the quarter. We remain on track and feel comfortable with our 2015 target of close to CAD200 million.

At PC Financial, Q1 revenue increased by CAD19 million or 10.6% driven by higher interchange income as a result of increased credit card transaction value, higher interest income and an increase in mobile shop sales. Operating income grew 16.7% to CAD42 million primarily driven by the increase in revenues offset by higher costs associated with the financial services loyalty program and cost as a result of an increase in the active customer base. Our adjusted interest expense for Q1 was CAD131 million and our full-year guidance on interest continues to be approximately CAD575 million.

The acquisition of Shoppers Drug Mart, our consistent execution against our strategic priorities, operational effectiveness, the realization of efficiencies and synergies, all contributed to us achieving net earnings of CAD301 million and adjusted net earnings per share of CAD0.73. We generated free cash flow of CAD144 million in Q1. Since the closing of the acquisition last March, we have reduced our adjusted debt by over CAD1 billion. As we noted on our Q4 conference call, our adjusted debt increased CAD43 million due to seasonal working capital requirements. We continue to remain on track to achieve our target of a CAD1.7 billion reduction by the end of Q1 next year. Our CapEx this quarter were CAD231 million including CAD45 million of CapEx in Shoppers Drug Mart. Also as a reminder, we modified our CapEx definition in Q4 to include intangibles which represented CAD27 million for the quarter.

In closing, we continue to remain confident in our strategy, business performance and financial planning. We continue to be on track to achieve our full-year guidance including growing adjusted net earnings year-over-year. Having said that, adjusted net earnings growth for the balance of the year is not expected to achieve the same level as Q1, as we outperformed our plan for Q1 and expect to be on plan for the rest of the year. Thank you. I'll now turn over the call to Galen.

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Thank you, Richard, and good morning, everyone. As you just heard, Loblaw continues to execute against it's financial plan. We are maintaining a stable trading platform, synergies are in line with expectations, efficiencies are on track and our deleveraging target is unchanged.

This quarter, we saw reasonable tonnage performance in our food retail business. Shoppers Drug Mart continues to see a sales lift for market share gains in pharmacy and continued strength in OTC, beauty, food and confection. Traffic and basket were up across our divisions.

Our leadership team is working together within and across our businesses to achieve our strategic and operational goals. These include enhancing the health and beauty offer in our grocery stores, expanding and improving the food offer at Shoppers Drug Mart and achieving efficiencies, establishing an eCommerce platform and making the investments required to play a larger role in the delivery of health care services in Canada.

It's hard to believe that it's been just over a year since the Shoppers Drug Mart acquisition closed. We've made tremendous progress and are excited about the possibilities going forward. Many acquisitions can create distractions for companies. With the acquisition of Shoppers Drug Mart, in many ways I believe we have become more focused. Focused on our strategic framework of delivering the best in food experience, best in health and beauty, operational excellence and growth. We're also starting to incorporate best-of-breed practices across the companies to further enhance our effectiveness and competitive advantage.

The industries in which we operate remain intensely competitive. But, on balance, we expect to see continued momentum based on our competitive position and moderating square footage growth. Our outlook remains unchanged. As you are aware, we announced a 2% quarterly dividend increase. While we remain committed to deleveraging the balance sheet, we believe it is important to maintain the cadence and discipline of the dividend increase every year.

As we have discussed, we do not expect to engage in stock buybacks except to offset dilution, until our deleveraging target is met. We remain focused on a balanced capital return strategy. Looking forward, I'm confident that as we build are portfolio of strong, complementary but independent businesses, along with a balanced capital return strategy, we will accrue long-term value for shareholders. Thanks.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Galen. Michelle, we are ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Irene Nattel of RBC.

Irene Nattel - *RBC Capital Markets - Analyst*

Richard, in your opening remarks you mentioned that you exceeded plan in Q1 and I was wondering if you could walk us through in which areas that would be the case and what the drivers were, please?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Irene, overall, all our businesses did well in Q1 without exception. So, I'd say it's across the board.

Irene Nattel - *RBC Capital Markets - Analyst*

So, that would go to both top line and efficiency gains?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Top line, gross margin, SG&A for all businesses.

Irene Nattel - *RBC Capital Markets - Analyst*

Outstanding. Thank you. You also noted that you are starting to see some inflation creeping into the center of the store. It's the first time we've heard that in quite a while. Just wondering if you could walk us through that, please?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

I'll take that. It's Galen. We are expecting to see this, really as a result of the depreciation in the Canadian dollar on product coming through the US, pressure from the big multi-nationals to try and put cost increases through. So, in itself, that's not a bad thing. The inflation levels in grocery are certainly are not anywhere near the levels that we've seen in fresh over the last 12 months. But it is moving and there is pressure. Remember, these are the categories that tend to be the most price-sensitive. So, we are cautious and watching very carefully the extent to which the consumer will accept these increases. I think we've said in a couple of occasions over the last few quarters that, yes, we are able to pass on some of the cost inflation but not all of it.

Irene Nattel - *RBC Capital Markets - Analyst*

Thank you. That's very helpful. That leads me to my next question, which is, can you talk a little bit about consumer behavior in the quarter, trade down, reaction to the inflation and also what you're seeing in terms of proportion of transactions on promotion?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

It continues to be reasonably stable. There's not a big shift in terms of the mix of promotional intensity at this point. Everybody's focused in a pretty razor-sharp way of not getting out priced. The discount businesses, I think, are continuing to try to make sure that they are delivering the best value in the market.

What we are sort of flagging, is when you have mid-single digit increases in fresh over multiple quarters, quarter after quarter, you start -- you worry that you're going to see a meaningful shift. We've talked before about people trading down, specific proteins, trading for meat into pork or chicken.

That's been going on for the last, basically, 1.5 years. It's not accelerating at this stage. We'll get back to you in Q2 to see if any of those trends are starting to accelerate. But we're watching it very carefully.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you very much.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Irene. Next caller, please.

Operator

David Hartley of Credit Suisse.

David Hartley - *Credit Suisse - Analyst*

Quickly, on the market share, what would you characterize happened to your market share in the quarter? I note that your tonnage, I guess, look to be down. Could you let me know about that?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

There's the street map calculation of tonnage, which is inflation versus comp store sales, we look at the numbers. We see what's happening in our business and we feel satisfied with our tonnage performance. Customer traffic is up. Items are flat and our tonnage share is outperforming, or it's growing relative to the rest of the market. Those are positive indicators. Despite the fact that we see this CPI inflation, and even our own internal inflation calculations, running ahead of our comp store sales.

David Hartley - *Credit Suisse - Analyst*

I'm just trying to square that all up. Is Loblaw's less interested relative to the street in chasing after promotional sales? Is that part of the answer to why that squares up? Or could you give me a little bit more color on that?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

No. It's go back to this, the basic math calculation, it doesn't provide the level of precision that I think folks might like it to. We are looking at an additional level of detail and it's -- you have three measures that are sending a sufficiently positive message. I said before, that our approach under the mantra of stable trading, is we are not chasing anything. We want to incrementally improve our business. We want to make sure that we're doing the right thing for our customers and then we watch very carefully what's happening to market share, what's happening to tonnage share, what's happening to customer traffic, what's happening to baskets and at this stage, we're quite comfortable with where we sit.

David Hartley - *Credit Suisse - Analyst*

Just as a follow-up, finally, I think one of your competitors recently said that sales on promotion has actually been increasing, perhaps by their math, perhaps by their geographies. But you are saying, I believe, that it's reasonably stable. Am I characterizing that right? What are you seeing that may be different than your competitors? Is it a mix effect? What would it be?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Look, I think our strategies appear to be working. We are not feeling that we need to substantially ramp up our promotional intensity. What you are hearing is a little bit of caution, which is that could change. We are watching to see the way the consumer reacts. We are watching to see whether some of those metrics that we follow in terms of tonnage or tonnage share are starting to move the wrong way. Without question, one of the easiest reactions that a merchant can make when you start to lose ground in any of those areas is to drive up promotional intensity. It doesn't surprise me that you've heard that from others. You might hear it from us, but you are not hearing it yet today.

David Hartley - *Credit Suisse - Analyst*

Okay. I will turn it over. Thank you.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, David. Next caller, please.

Operator

Jim Durran of Barclays.

Jim Durran - *Barclays Capital - Analyst*

I have a number of questions. First of all, Alberta, have you seen any noticeable change in their sales performance in Alberta?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

You mean driven by the economic circumstances or the political circumstances?

Jim Durran - *Barclays Capital - Analyst*

(Laughter). Admittedly, there's more than one contributor right now. Let's stick with the drop in oil price for now.

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Look, I think the Western market is -- we don't typically talk about performance by region. As Richard mentioned, the performance across the board in the Company was pretty strong. We do feel very good about how things are going in the West. We're not seeing a change in the consumer behavior that is negatively affecting us. This is worth remembering that the bulk of our market share there is in the discount side of our business. Our price points are very strong. So, that's probably contributing to a little bit stronger performance there. At this stage, if I was to speculate, we're probably more insulated from an increased economic deterioration for the consumer than perhaps others. So, we feel all right there at the moment.

Jim Durran - *Barclays Capital - Analyst*

If you could, could you update us on a number of your initiatives in place, the e-commerce test, the shoppers food test? Are you ready to roll into more stores now? How are we progressing on Inspire?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Three good ones. Three initiatives that we're feeling pretty optimistic about at the moment. As you know, the Inspire program has moved from pilot to rollout and we've got a couple of more stores under renovation in Ontario as we speak. We're continuing to open that and our neighbor format in Western Canada. We feel good about the way those stores are performing.

We are still very much in the pilot stage when it comes to e-commerce. Although, we're moving from a three store pilot to increase the number of stores. We are going to try click-and-collect in a few super stores over the next four or five months to see how the proposition works there. So far, the consumer response has been really positive. That's not an easy thing to run a click-and-collect proposition with different assortments across multiple different stores but so far, I think the team is really doing a terrific job. All indications suggest that the consumer, a certain type of consumer, responds well to the proposition.

On the food pilots, six stores in downtown Toronto and while it's still early to determine the long-term performance, I can tell you we're encouraged by the progress, pretty much across the board. Both the incremental impact on sales for the store itself, the performance of food sales, specifically, and the fresh food proposition is being well responded to by the consumers, as well. So, it's encouraging. So much so, that in our second stage pilot, we launched it publicly, I think it was on Monday. I'm looking at -- maybe it was Sunday, which is nine stores in Regina.

The difference between Toronto and Regina is that we've taken an entire market with what we think is a disproportionate mix towards suburban as opposed to downtown urban. This is a test to determine really how much reach a convenience, fresh food proposition has in small stores in some of the more suburban markets in Canada. The other thing about what we are able to do when we launch it in an entire market, is that we can start to incorporate those products in the marketing and promotional strategy. You can start to promote some of those more sophisticated fresh food offers in the flyer and you can do some institutional marketing.

Our hope is that should turbocharge customer awareness around the offer, which should contribute to more positive sales. I do want to reiterate that despite the increased number of stores, it's still very much sits in pilot stage for us and we are not in a position to push the button and say this is a program that's going to go over a specific number of stores over a specific timeframe. As we get more comfortable, we'll try and communicate with a little bit more precision what the big picture is with regards to the food pilot.

Jim Durran - *Barclays Capital - Analyst*

Thanks, Galen.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Jim. Our next caller, please.

Operator

Perry Caicco of CIBC.

Perry Caicco - *CIBC World Markets - Analyst*

Back to the discussion on tonnage. Is the negative same store tonnage, when you drill down, a particularly bigger problem in certain categories? Maybe, those that have inflated the most? Is there any sign that it's just related to price inflation?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Yes. So, there are some interesting things happening in the business but it's pretty consistent with what we've shared with you before. This shift that's taking place from the center of the store into the fresh sides of the store, it's something that we see not only in the Inspire business, but also we see it in the discount division as well. And it's not driven exclusively by the disproportionate inflation that's taking place on the fresh side. There are categories where the consumers are changing behavior. Not because the promotional environment has changed, but we believe because their shopping habits are changing.

The carbonated beverage category continues to be under pressure. The cereal category continues to be under pressure. A number of the big traditional categories in the center of the store, customers are shifting away from and where are they going? They're going to fresh. They are moving into natural value. We don't see that shifting back in any meaningful way at this point. I'd say there is a price-point, where the customer might switch back. But, actually, we are seeing price points go the other way at this point because of that little bit of inflation pressure.

Perry Caicco - *CIBC World Markets - Analyst*

If you play that forward, what you are saying, is that the sort of gap between price inflation and your same-store sales should continue, although it's not of concern because of the category shift? Is that a fair statement?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Again, I think people are right to focus on this question. You're going to have to come to your own conclusions. The important take away is that the market data, which shows the performance of all the different food companies, say coming from Neilson, shows that we have tonnage share gains. When you add that to items and traffic, we feel reasonably good about our tonnage position. The underlying trends, so what's actually happening to tonnage in grocery as customers shift their patterns, that is a different thing to our relative competitive performance. So, to answer your question, Perry, I would say if that consumer shift continues at the rate that it's been on in the last 18 or 24 months, you might continue to see this perceived overall tonnage decline. That's pure speculation at this point based on the past 18 months.

Perry Caicco - *CIBC World Markets - Analyst*

So, on the last call, you indicated that your outlook for comp store sales was growth that would be slightly in line with or slightly ahead of inflation. Would you moderate that particular statement at this point?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Our expectation is that we should be able to grow our sales a little bit more than inflation. That's how we try and plan the business and that's how we think about the medium in the long term. We are not going to chase that number, especially if the underlying indicators suggest that the business is healthy from an underlying customer perspective and also healthy from a competitive positioning perspective.

Perry Caicco - *CIBC World Markets - Analyst*

I just want to, if I could, switch gears a little bit to the renovation program. How are your recently renovated stores, particularly Inspire, impacting your numbers? Are they contributing to same store sales and gross margins? Maybe impacting SG&A negatively? Talk a bit about how that program impacts your business?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Just to put it in perspective, if you focus specifically on the food business and our shoppers for a second, we have somewhere in the range of 1,000 supermarkets, to keep it simple math. We have 27 Inspire stores on the way to 32. I think the impact of the Inspire business on the overall performance of the Company, it's not something that people should overweight. If you focus on the markets where we are specifically investing in the Inspire concept, where we expect a big disproportionate market impact, and Toronto would be a great example of that, we are seeing an effect. We are seeing the effects they you would expect. Each one of those Inspire stores is driving strong sale's performance. Each one of those Inspire stores is driving strong margin performance improvement.

And it's also having the effect of drawing some customers away from the unrenovated stores which is a negative impact, not unexpected, but certainly something that we look at. We like to get as many of those Inspire stores converted in a particular market as we can so that the erosion are coming at the expense of our competitors as opposed to the expense of ourselves. We are on a journey to do that and feel that in the meantime, we're certainly able to manage that renovation program within the context of not just the overall company budget, but actually the banner and divisional budgets that are experiencing the biggest investments.

Perry Caicco - *CIBC World Markets - Analyst*

My last question, and it's related to Inspire. The investment in a particular store for Inspire is fairly heavy. As you move the program forward, will you change the investment to fit the store and the site? Is there sort of lighter versions of Inspire?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

A great question. You can imagine our expectation is that the cost of the Inspire stores will continue to go down. It goes down because you get better at doing it. It goes down because you're able to buy fixtures at scale. Those are all the things that come with moving from a pilot program to an extended rollout.

As we move into markets where perhaps, the sales density of the store is not as high, then we look at it and say, well you can't afford to spend that full amount to generate a satisfactory return. So you pull back on certain elements. That may be choosing not to move a bakery from the back corner of the store to the front side of the fresh hall. That's a great way of saving some money in a store that doesn't do the business to warrant it. These are important trade-offs that we make. You'll start to see -- you may not see it, although Perry, you notice this stuff pretty well, is a sort of an Inspire light. If we can do an Inspire light with the same sales uplift, then you might see more of those because that's more efficient from a capital perspective.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. Thank you.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Perry. Next caller, please.

Operator

Vishal Shreedhar of National Bank.

Vishal Shreedhar - *National Bank Financial - Analyst*

Thanks for taking my call and good quarter. With Shoppers, with the ongoing drug of forms, just wondering if the average generic prescription drug still generates more gross profit dollars than the average branded?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Yes.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. Just wanted to dig a bit deeper on the synergy number. You had CAD44 million in Q1. If you annualize that and subtract what you did last year, it looks like the run-rate is about CAD94 million and the synergy target is about CAD100. The implication is that there is no further synergies captured above what's in the CAD44. Is my math right?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Your math is right. Our objective continues to be that we are going to finish the year at CAD200 million. After Q1, we remain committed to that number. We should continue to meet our target.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. Just on the synergy, just on the reasoning for that CAD100-ish in 2015. Is it because there's more cost to get the new synergies so it will take more time? Or, is a because the synergies don't really start to kick in until next year?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

No, it's more it takes more time because last year, we did the easy stuff which was the cog piece. There's still a bit of cog that's annualizing this year. But we're getting more into GNFR piece, which is much harder work, much smaller dollars. We're seeing traction with that program already, but it's going to be slower this year than it was last year. We have good visibility on that program as of today and so therefore, we remain committed with that number for 2015.

Vishal Shreedhar - *National Bank Financial - Analyst*

Given that you have good visibility, it's probably unlikely that there will be a large deviations from what you target?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Yes.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. In terms of the ROC of calculation that you disclosed, just a quick one here. The ROC, does that exclude the REIT and financial?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

The return on capital?

Vishal Shreedhar - *National Bank Financial - Analyst*

Yes, you disclose it in your and MD&A?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Good question. I don't have the answer to that. I will get back to you. One thing with that figure you need to be careful, is we have not lapped shoppers yet. The denominator is still moving on. You will see that figure actually go down as the year progressed because it's going to capture all the capital that was issued as part of the transaction next quarter. I will get back to with the answer to your question.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. A peer of yours noted that inflation has peaked, at least from their perspective. Do you guys feel the same way?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

I'm not sure that we are quite as definitive on the subject. So, P three was an important lapping period for us to try and assess that. That's because we were coming up against strong fresh inflation from the prior year and so you would expect it to compress dramatically. I think we haven't seen it compress as dramatically as we thought that it might. Again, the indication suggests that you have slightly higher than anticipated fresh shrink with the fresh inflation and an accelerating over moderate inflation on the groceries side. We're not calling the peak just yet. But, I would say it's slowing. It's not going to get a whole lot rapidly higher. But I wouldn't say it's flattening out.

Vishal Shreedhar - *National Bank Financial - Analyst*

Got it. Just the last one, here. You mentioned shrink. In the materials, it said that shrink costs went up. As you implement SAP, shouldn't those go down? Maybe you could help me understand that?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Last year, because we were rolling out our corporate stores we actually decreased the number of counts significantly. It was very tough to actually count stores as they were converting. Now, we're catching up. Therefore, we've been capturing shrink that has not been, I guess, accounted for a while. So, that's a factor. Plus, as we've talked about a few times over the last few quarters, we're in the new world of working with SAP and there's some costing issues that are occurring in the system and that's resulting in additional shrink. We are working through those right now and hope to close those all in 2015. Clearly, in 2015, we are going to reset the new levels of shrink and that will form the base by which we'll be measuring the performance of the business going forward.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. Thanks for your time.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Vishal. Next caller, please.

Operator

Michael Van Aelst of TD Securities.

Michael Van Aelst - *TD Securities - Analyst*

You've covered most of it. On the inflation, when you say are just over the 4.6% CPI, at least one of your competitors was closer to 4%. The difference between your numbers and where the CPI data is in your competitors, do think that's more mix? Or, is that difference and timing of price investments? How would you explain that?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

I think it's probably a combination of things. I wish there was more precision that we could deliver as an industry to everybody when it comes to inflation. The fact of the matter is, you can't rely on one specific measure. There's a little bit of judgment and that's why I keep going to we look at multiple metrics. We are not trying to kid ourselves. Our objective is to determine what's actually happening in the business and it's the second and third level metrics that are more robust indicators of what's actually happening. That's why -- we're not driving tonnage at an accelerated rate. It's progressing in a manner that we are satisfied with.

Is mix playing a role? Yes, for sure it's playing a role. This mix shift into fresh drives inflation if you are buying and your tonnage can go down on that basis. I always use the example of the coffee pods. Coffee pods in the grocery aisle, we've had massive inflation. You go from CAD0.02 a cup to CAD0.60 a cup and you're not seeing any increase in tonnage based on the way that the calculation is done. For sure, there is a mix element in there. You can spend a whole lot of time trying to chase this down item by item or category by category. What you've got to do is look at the overall directional indicators to get a sense of it.

Michael Van Aelst - *TD Securities - Analyst*

Thanks. Are you able to quantify the Easter shift benefit?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

On food, it was minimal, Michael. Really minimal.

Michael Van Aelst - *TD Securities - Analyst*

And on drug?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

On drug, a few percent. Not that significant. It was more the shift in promotion than the shift from one quarter to the other. Nothing to worry about.

Michael Van Aelst - *TD Securities - Analyst*

Of the 2.7 in the front store, it wasn't a meaningful portion of that?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

No.

Michael Van Aelst - *TD Securities - Analyst*

Great. Thank you.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Michael. Next caller, please.

Operator

Keith Howlett of Desjardins Securities.

Keith Howlett - *Desjardins Securities - Analyst*

I was wondering if you could give some direction on your capital spending this year in terms of the formats? What weighting different formats are getting more regions of the country? What's the broad direction of capital spend?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

I will give you a bit of a directional sense. Where are we spending capital? We're spending capital on new stores on balance disproportionately in the West and in Shoppers Drug Mart, which you would expect in the West because the food business has lower market share penetration there. We also only have representation of two of our key formats. No neighbor stores and Inspire stores going new in the West. The Inspire program is an important driver for renovation.

In terms of capital, I've already mentioned that you are seeing not 100 sense of the investment there going into Toronto, but certainly a disproportionate amount of it. And you are seeing a little bit less in terms of investment and renovations in new stores right now in Quebec and the Atlantic. That's because, if you remember, the Atlantic went through its renovation cycle upgrade about three years ago so you would expect that to be less. And in Quebec, we are moving a little bit more slowly when it comes to Inspire but still pretty comfortable with the way they are performing in that province.

Keith Howlett - *Desjardins Securities - Analyst*

I think there is an Inspire store North Vancouver. When you refer to the neighbor store, what do you mean there?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

The neighbor stores would be if you went to a recently renovated Zehrs, most of your independent grocers that we have renovated in recent years, that gets classified under a bucket of neighbor. And neighbor is really important. It represents, lets just say, somewhere in the range of 80% of the total market division network. These are markets where the sophistication that we offer in Inspire just isn't suited to the customer, the demographic or the price-point. So, that is an important part of the market division strategy.

Keith Howlett - *Desjardins Securities - Analyst*

Just if I could ask a broad philosophical question? You have a lot of very large format stores, particularly in the West. Do those stores have more of a challenge as the center of the store is under pressure, as people flee to the fresh perimeter or whatever? Or is it proportionally about the same problem as any grocery store would have?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

It's a fair question. I'd say it may be slightly more impacted. Of course, you have to remember there's a lot more promotional intensity and volume driving investment going into the center of the store in discount which has an offsetting impact. It's certainly not a meaningful shift that we see at this stage that would cause us any incremental concern or cause us to change our strategy in a meaningful way.

Keith Howlett - *Desjardins Securities - Analyst*

Thank you.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Keith. Next caller, please.

Operator

Peter Sklar of BMO.

Peter Sklar - *BMO Capital Markets - Analyst*

Just two questions at this point. We thought that your performance in Shoppers was particularly strong. Was there anything in addition to the synergies? And as well, earlier in your comments you referred to some strength in particular categories. Was there anything unusual going on in Shoppers beyond that?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

As we start to learn the drugstore business with a little bit more depth, there are a few things that can shift performance on the top line and can do so in a positive way on the bottom line, as well. The cold and flu season, you heard it many times over the years when you listen to shoppers. It was pretty good late winter and -- for us. We've also had a pretty good early allergy season, which is kind of -- would surprise you. Those things are contributing to stronger sales performance. The prescription volume has been running a little bit ahead of probably what we expected so we feel good about that. These are all kind of around the edges, as opposed to real disproportionate swings in the business itself.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. Lastly, on a different topic. Going to your food retail business, in the writeup, you talked about costs related to higher investment in the franchise business. Can you elaborate on what you mean by that?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Peter, in an effort to simplify the way we do business, we restructured our arrangement with our franchisees to make it more simple. The accounting impact of that was that stacking shifted from gross margin to SG&A. It's just a change in geography from the income statement perspective. It's going to help manage our business in a much better way without going forward.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. I'm fine, thanks.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Peter. Next caller, please.

Operator

Chris Li of Bank of America.

Chris Li - *BofA Merrill Lynch - Analyst*

Just on the Shoppers business. Gross margin was stable, excluding synergies this quarter. Do you expect this trend to remain stable for the rest of the year? Or, do you expect the trend to deteriorate a little bit as you continue to hit some drug reform headwinds?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

We are always striving to keep our gross margin safe. There's always pressure that have affected Shoppers gross margin over the last few years. Right now, we're trying to hold it as best we can and we are being successful. So, I'm not going to comment specifically about gross margin for the rest of the year but our plan is always to keep it as close as possible to where they are.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. Galen, I think last quarter you mentioned that you weren't quite satisfied with the private label brands in the Shoppers stores with respect to the install positions and branding. Just wanted to see if you could give us an update of what's been improved since the last call?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Yes. Thank you for asking. I'm pleased to say that the service levels have improved quite substantially. I think the teams that have been working on it are proud of what they've accomplished. It's not quite there, yet. There is some great positive momentum and the particularly gratifying thing is that when those products are in stock, they sell really well at Shoppers. So, we've made progress.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. The question on your deleverage target. You are still looking to pay down about CAD600 million of debt by Q1 of next year. Do think this is conservative? Do you think you can do it sooner? Or, other expenditures that you think you have to spend that would not allow you to shift that target sooner than Q1 of next year?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Chris, where we stand today, we feel very confident that we'll meet our target by Q1 of next year.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. That's it. Thank you.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Chris. Next caller, please.

Operator

Jim Durran of Barclays.

Jim Durran - *Barclays Capital - Analyst*

I just had a couple follow-up questions. First of all, any update on the Target stores and the Canadian Tire and out today that is hoping to land 12 of the remaining stores?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

No update beyond what everybody already knows, which is the stores closed faster than folks expected. That's a positive impact. We expect somewhere in the range of 50% of them to go to the large retailers in some capacity, Canadian Tire and Wheel we thought would be one. Walmart we think will be one and there will be a few others. We are certainly involved in discussions there, although we don't expect it to be meaningful from our perspective. There's not a huge number of sites that would be particularly complementary to us. You shouldn't expect any meaningful news from us in the coming months on that.

Jim Durran - *Barclays Capital - Analyst*

Okay. Just going back to your food gross margins. The indication was that it was flat year-over-year, excluding the adjustment for franchisees. If we looked at it minus gasoline, you provided the top line impact of gas prices, obviously. But it would look like gas margins as a percentage might be supportive of the margin. Would food have been still flattish if we extract that?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Oh, yes. The gas margin, yes, your right. They're benefiting from the current situation. Absolute gross margin of the business, it won't grow (inaudible) in dollars.

Jim Durran - *Barclays Capital - Analyst*

Thanks, Richard.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks, Jim. We have time for two last caller's.

Operator

David Hartley of Credit Suisse.

David Hartley - *Credit Suisse - Analyst*

Your comments, Galen, on the coffee pots in particular, and other things category just is very helpful. I just was wondering how the Company feels on the food side about how the stores and the offering have evolved versus the competition? It sounds like food service is pushing forward well. First to market in offerings and perhaps your PC products and private label are doing well. Can you provide any commentary on that that would be supportive of that?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Yes. I think there is two elements where we believe the business is delivering improvements in terms of the customer proposition. The first is, that basic blocking and tackling that you've heard from us over the last two or three years, which is a bigger commitment to strategic category management, a bigger commitment to just good planogramming and working to bring vendors' most recent innovation to the market in a timely fashion. These are areas that we consider to be a weakness relative to the rest of the market. Probably two years ago, I think we would now say that we are at least at par with the rest and looking to continue to improve our capabilities there.

Obviously, President's Choice and our commitment to control label continues as a competitive advantage and we are innovating there. A good example of that is our free from program, particularly in pork. It's been a big positive impact in terms of changing the way that customers think about certain types of protein that they buy. Really strong, strong response there. Another good category that we've seen terrific, outstanding growth would be on the pet food side when it comes to our control label program there, Nutrition First.

The other thing that I think we benefited from as the businesses got more stable and more focused on the customer and more outward looking, we are bringing specialty items to market in a more comprehensive and compelling way. With the market division, these would be artisanal products, local products from different parts of the region where we are getting a great response. Natural Value has always been a strength of ours, it continues to improve.

And then on the discount side, we're really starting to pick up the pace in terms of the strategic implementation of our multicultural programs. Remember we have bought Q&F, which is the leading South Asian distributor. We've got T&T which has an Asian distributor attached to it. We also bought this Middle Eastern business called Arz and this is giving us an insight to the product assortment that we should carry almost by location in those key multicultural areas. We are seeing steady and quite encouraging improvement across the board there. This just gives you a sense of how we think we're pushing the customer proposition forward.

Then I would be remiss if I didn't also mention we retain our commitment to delivering value. Whether that's in no-frills in the center of the store, we've got a great ad on the street today that represents our commitment to that. Also, across the super store business, we feel better positioned from a competitive perspective than we had. It just continues to improve. Then, we are focused on value, as well, in the neighbors stores and, you might not believe it, but the center of the store price proposition in Inspire is also something that we watch carefully to make sure that there's real value on the shelf.

David Hartley - *Credit Suisse - Analyst*

Just to finish off on that point, how impactful are some of these strategies around ethnic offering whether it be your own sourced products or others? Then, your private label presence, choice, no-name offering, how much does that affect that relationship between on the street math between inflation and tonnage, et cetera.

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

You know what, I don't know. My guess is, if you are looking for that set of initiatives as an explanation for this inflation element, I think it could be contributing, for sure, like lots of things will be contributing. But, I couldn't tell you specifically if that represented 20% of GAAP or 50% of the GAAP or 2% of the GAAP. It's not something that we would be spending a ton of time on trying to figure out here. Again, that's because the underlying metrics suggest to us that our business performance is just fine.

David Hartley - *Credit Suisse - Analyst*

Understood. Thank you very much.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks. Last caller, please.

Operator

Michael Van Aelst of TD Securities.

Michael Van Aelst - *TD Securities - Analyst*

Talking about target, there was a lot of pre-positioning in retail in advance of their entry and obviously a lot of competition that continued after. What change in the market behavior have you seen in either of your businesses since Target has closed their stores?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Is the question how much of a tailwind is the Target business delivering to our performance? Is that what you are getting at?

Michael Van Aelst - *TD Securities - Analyst*

I'm sure it wasn't a big sales impact on your business. But, from a market competitiveness standpoint, it seemed like it was and on the industries in general. I was wondering if any of that has started to fall off?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

You're asking is it getting less competitive because Target has closed up? Is that the question?

Michael Van Aelst - *TD Securities - Analyst*

Yes.

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

Not that we see at this point. There are two forces at work in terms of impacting your top line sales. The first, and the disproportionate force, is new square footage. New square footage growth, if it's rapid, it has a big impact on your top line if you have high market share and you are not growing your square footage very much. That's been what we've faced into over the last three or four years. As the competitive square footage growth has slowed, that does advantage us and I think systemically, not just because of Target. It's easier for us and it's easier for the market, in general, just to have more satisfactory sales growth.

In terms of the competitive position, for sure, everybody sharpened their pencils when Target came into market. They focused on renovating stores. They wanted to make sure their programs were up to snuff, that their innovation was in the right place. By and large across the categories Target competed in, people delivered on that promise. Now that they're gone, I don't think it's changing much. I think there's still a lot of competition here. People are still fighting hard in different circumstances to grow their sales and deliver market share. So, we haven't really seen an easing off.

The way to think about it is the way I think about it is, if you can't pass through 100% of the cost inflation that your getting from the market, which is the circumstance that exists here, than there continues to be meaningful pressure on your gross margin. The job of a merchant is to mix that back in some way, to deliver on our commitment to have flat gross margin and also to continue to deliver the right competitive proposition to the stores. And that's what we're doing. That's what our other competitors are endeavoring to do. So far, we are doing all right.

Michael Van Aelst - *TD Securities - Analyst*

Just a brief follow-up to that. Are you hearing of any potential of other entrants coming into the market, whether it be Aldi or others like that?

Galen Weston - *Loblaw Companies Ltd - Executive Chairman & President*

No. I'm not suggesting we know everything that's going on out there. But, there's certainly no drum beat that we've picked up. Are you hearing anything? Let us know if you do. (Laughter)

Michael Van Aelst - *TD Securities - Analyst*

Alright. Thank you.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Thanks. Just before we pass it back over to Michelle, I think Richard was going to follow-up on Vishal.

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Vishal, I've got the answer to your question. The return of capital that we show in our result in on a consolidated basis, i.e, is includes the bank and the REIT and everything.

Janet Craig - *Loblaw Companies Ltd - SVP of IR*

Great. Thanks, Richard. Back over to you, Michelle.

Operator

Thank you. That does conclude the conference call for today. You may now disconnect your line and have a great day.