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EDITED TRANSCRIPT

L.TO - Q1 2012 Loblaw Companies Ltd Earnings Conference Call

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PRESENTATION

Operator

Good morning. My name is Melissa, and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited first 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. Ms. Kim Lee, Vice President of Investor Relations, you may begin your conference.

Kim Lee - *Loblaw Companies Ltd. - VP IR*

Thank you, Melissa. Good morning, and welcome to the Loblaw Companies Limited first quarter 2011 conference call. This call is also being Webcast simultaneously on our Website at loblaw.ca.

I am joined here this morning by Galen G. Weston, Executive Chairman; Vicente Trius, President; and Sarah Davis, 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 its financial performance in 2012 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 first quarter 2012 report.

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Certain non-GAAP financial measures may be discussed or referred to today. Please refer to our first quarter report and other materials filed with the Canadian securities regulators from time to time for 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'll turn the call over to Galen Weston.

Galen Weston - *Loblaw Companies Ltd. - Executive Chairman*

Good morning. Thank you for joining us. In the first quarter, we executed on our plan. And despite a decline in year-over-year earnings, store conditions are improved. We made steady progress on our IT implementation. And we took a disciplined approach to improving our customer proposition.

Our outlook for 2012 remains unchanged. We expect full-year net earnings to be down with more pressure in the first half. We are confident that our ongoing investments and infrastructure will enable efficiencies and expense leverage, setting the stage for future earnings growth.

I'll now turn over the call to Sarah to walk us through the results.

Sarah Davis - *Loblaw Companies Ltd. - CFO*

Thank you, Galen, and good morning, everyone. Let me start with the performance in our retail segment. Retail sales increased by 0.8% to CAD6.8 billion in the first quarter of 2012. Same store sales decreased by 0.7%. Both absolute and same store sales were negatively impacted by approximately 0.8% to 1% due to one less day of store operations when compared to Q1 of 2011.

Gas bar and apparel sales were strong. Sales in food, drugstore, and general merchandize, excluding apparel, were essentially flat. During the quarter, our average quarterly internal food price index experienced modest inflation, which was lower than average CPI in the quarter of 3.7%.

In the retail segment, we reported operating income of CAD225 million, down CAD60 million or 21.1% year over year. This decrease is attributed to a CAD25 million reduction in retail gross profit, CAD19 million increase in stock-based compensation, a CAD15 million increase in cost associated with the transition of certain Ontario labor agreements, and approximately CAD14 million, which is primarily due to the changes in the value of investments in our franchise business, partially offset by operating cost efficiencies.

The changes in the value of investments in our franchisees were primarily driven by opening of new stores and the transition of existing stores to new franchisees.

Our reduction in IT and supply chain costs of CAD5 million and nil in realignment costs compared to CAD8 million incurred in Q1 of 2011 helped to partially offset the reduction in year-over-year operating income.

The decrease in the retail segment's gross profit of CAD25 million or 50 basis points on a rate basis was primarily driven by increased transportation costs as well as higher input costs that we did not entirely pass onto the consumer and included CAD10 million of our previously announced CAD40 million incremental investment in our customer proposition. A higher proportion of gas bar sales, which have lower margins, contributed to the decline in gross profit rate.

Now, turning to our financial services segment, revenue in the segment increased by 12.2% to CAD129 million compared to CAD115 million in Q1 of 2011. The increase was primarily driven by higher interchange fee and interest income, resulting from an increased credit card transaction volumes and receivable balances. Higher PC telecom revenues also contributed to our financial services revenue growth.

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Operating income in the financial services segment was CAD14 million in the first quarter of 2012, down from CAD18 million in the same quarter last year. The decrease was mainly due to higher credit card customer acquisition costs and other operational costs related to investments in the segment that ramped up in the latter half of last year.

Increased cost associated with PC point loyalty and the launch of PC mobile kiosks also contributed to the decrease in operating income.

On a consolidated basis, operating income was CAD239 million in the first quarter compared with CAD303 million in Q1 of 2011. Operating margin was 3.4% compared with 4.4% in Q1 of last year. Interest expense was CAD74 million, up CAD1 million compared to Q1 of 2011.

Our effective tax rate for the quarter decreased to 23.6% from 29.6% in Q1 of 2011. The decrease was due to further reductions in the federal and Ontario statutory income tax rates and a decrease in income tax expense related to certain prior income tax matters.

With respect to the Ontario government's recent budget announcement, we do not expect the deferral of certain reductions in corporate tax rates to have a significant impact on our net earnings. We still expect our full-year income tax rate to be in the range of 27%. But, it will fluctuate by quarter.

For the quarter, Loblaw realized basic net earnings per common share of CAD0.45 compared with CAD0.58 in the first quarter of 2011. Free cash flow was negative CAD305 million versus negative CAD246 million last year. The decrease in the free cash flow was due to the decrease in year-over-year EBITDA and seasonal non-cash working capital requirements, partially offset by lower fixed asset purchases. Free cash flow is typically negative in the first quarter but is expected to improve during the remainder of the year.

During the first quarter our capital expenditures totaled CAD134 million. We continue to estimate our 2012 capital expenditures to be approximately CAD1.1 billion.

For 2012, our outlook remains unchanged. We continue to forecast costs associated with the transition of certain Ontario labor agreements to range from CAD30 million to CAD40 million. Our estimate for incremental expense related to our investments in IT and supply chain continues to be CAD70 million.

In addition, as previously discussed, we expect to invest approximately CAD40 million in our customer proposition. We do not expect our operations to cover these incremental expenses. And as a result, we expect our full-year 2012 net earnings per share to be down year over year with more pressure in the first half of the year.

I would now like to turn it over to Vicente, who will provide some context for the quarter.

Vicente Trius - *Loblaw Companies Ltd. - President*

Thank you, Sarah. And good morning, everyone, and thank you for joining us this morning. If you remember, in February, we told you that, in 2012, we're not going to cover incremental costs of CAD70 million related to investments in information technology and supply chain and CAD40 million on ongoing investments in our customer proposition, also that it was going to be more challenging in the first half of the year.

As you just heard, Sarah reported on the financial results for the quarter, which showed a decline in earnings. I want to give you some context for what has been happening in the business. In the quarter, we maintained our focus on improving and doing the right thing for the customer. We took measured steps to strengthen our customer proposition while our SAP implementation stayed on track with minimal to no disruption.

We're making sound and balanced investments. During the quarter, consistent execution and a better experience in our stores drove growth in customer count and same store sales growth, excluding the impact of a lost day of operations, as we held steady on our investments in margin, which we established in the second half of 2011.

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With plans firmly in place, we're making headway in terms of offering the right value, right assortment, and great service. Our teams are improving overall execution. We're seeing better in-store standards. Our colleague engagement is on the rise. And our own customer experience is improving.

Our customers are telling us that they are seeing improvements in the quality, availability, and value across all of our banners, with our fresh offers seeing the biggest increases in net promoter scores.

Our overall nonfood offer has continued to improve with Joe Fresh apparel leading in sales increases in -- on both an absolute and same-store basis. Recently, we opened our sixth Joe Fresh store in the US at 510 Fifth Avenue. Opening day was a success with over 300 people waiting in line for the doors to open. Customer reaction exceeded expectations as we sold out of a number of top items within hours.

While it's only a little more than a month, we're pleased with how the store is being received and have seen a positive halo effect on our other US Joe Fresh stores.

We have taken an accelerated approach in resetting the right-hand side of our stores. We're adjusting layouts, adjacencies, updating planograms, and improving shopability and customer experience.

Leveraging our brand strengths, we're focusing on the right offer of everyday needs for fashion, beauty, home, and kids for our target customer. While still early days, customer reaction for the 33 stores that we have already reset have been positive with good momentum on sales and profitability. We're on plan to have 100-plus stores updated bye the end of the year.

Our drugstore business is strong, with script count growth in the quarter. Our drugstores are the cornerstone of our commitment to becoming Canada's health and wellness destination. With a growing network of pharmacies and medical centers, we see opportunity for continued growth, growth that will be complemented by our recent agreement to purchase the substantial majority of Zeller scripts.

Our customer transition plan will help us provide continuity of care to Zellers Pharmacy patients. And we will work closely with them to ensure that their health needs are met with little to no disruption or inconvenience.

During quarter one, we opened two new stores and refreshed seven stores, including two major renovations. Our renovations continue to outperform our financial targets and improve on customer experience. We're on target to expand our retail space by half a million square feet in 2012.

As you know, our IT system renewal is a key enabler for driving additional efficiencies, which is the cornerstone of future earnings growth. We made good progress with SAP implementation in quarter one. With pricing on the system, we have started to convert full costing to SAP.

We're still on plan to rollout our -- out SAP to our first pilot store by Q4 2012. In preparation for store rollout, we're getting our stores ready for conversion. A small group of [the] stores have already completed SAP readiness, which includes strengthening standards and processes to ensure logistics, replenishment, stocking and execution processes are aligned with the system. Our target is to complete readiness in all-purpose stores by year end in time to start SAP rollout in 2013.

As we ramp up and gain critical mass in our store rollout, we expect to start seeing the benefits of this system, including perpetual inventory, reductions in shrink, and improved replenishment, which will further improve execution in store, [provide] efficiencies, and help leverage expenses.

Despite the declining earnings, we're confident that we're on the right path and journey. We're focusing on doing the right thing for the customer and for the business. We're taking measured controlled steps to strengthen our customer proposition.

It's still early days to make claims on trends. But, we're encouraged that our sales and customer count are moving in the right direction. At the same time, SAP remains a key priority and a critical component of driving earnings growth.

A strengthened customer proposition combined with an efficient infrastructure will enable us to further build on our inherent strengths, our strong assets, the power of our brands, and our talent colleagues and grow profitability against the increased competition over the long term.

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With that, let's open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Perry Caicco from World Markets. Your line is now open.

Perry Caicco - *CIBC World Markets - Analyst*

Thank you. Vicente, you've talked about you're feeling a little bit of a positive momentum in the business. I'm just wondering, other than customer satisfaction surveys, what exactly is it, what data points are there that give you any indication that you're beginning to turn around the sales problem?

Vicente Trius - *Loblaw Companies Ltd. - President*

Yes, I mean, as -- Perry, as we told you in February, I mean, this is a journey, right? And this is a journey that we will build it steady and consistently to do what's right for the customer.

We see us gaining traction versus the market. And I think it's very important in this business to measure leading indicators. In my mind, when I look at net promoter store, it is a leading indicator because it tells me the loyalty of our customers. And it is improving. And it's improving at a pretty decent pace. And when I say a decent pace, it's at a pace that I in my experience with other businesses, let's say, is more accelerated than what I have seen.

Our customer count is improving, which tells us also that customers, more customers are coming into our stores. There's many things that we have done around fresh and in the way we have positioned more and more better assortments that [feels] us comfortable that the customer is telling us that the stores are better. And the stores like -- and the customers are liking our stores better.

Perry Caicco - *CIBC World Markets - Analyst*

And then on the CAD40 million fund to improve the customer proposition, you spent I guess about CAD10 million this quarter. I just am wondering a couple things. Was there any direct impact from the -- I'm assuming it was pricing programs that resulted from that investment.

And then how will you know if CAD40 million is the right number or not enough or even too much?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, I mean, again, I mean, in this quarter, it's CAD10 million. That's CAD10 million that has translated in us passing, let's say, less inflation to the cost of goods. So, I would say that I believe that we're more competitive.

Those investments, again, they're balanced. There are two divisions. We have discount, and we have conventional. And they're balanced by banners. I don't believe that you see in a journey a reaction overnight.

And if it was that easy, then it would be easy to just [trust] that investment and get a reaction quickly. But, I do believe that we're doing the right thing. It is important that the customer is telling us that and is telling us that through a pretty tough measurement, which is the net promoter score. And we see some good traction. So, I feel comfortable that the plan is correct and it's consistently and over time.

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Perry Caicco - *CIBC World Markets - Analyst*

But, just -- but, how will you know and when will you know if that's the right number or if you need to throw more at it?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, I mean, customer count is one, right? Now, am I happy with the sales? No, I would like the sales to be better. But, I'm getting more customers. My tonnage trends are improving. They're not what they should be, but my tonnage trends are improving. So, I see some leading indicators beyond the customer that I believe that we're doing the right thing. We know we're doing the right thing actually.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. Thank you.

Operator

Your next question comes from the line of Irene Nattel from RBC Capital Markets. Your line is now open.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks and good morning, everyone. Vicente, just following on the discussion about tonnage, guess in Q3 and Q4 of last year, you reported tonnage growth in food. This quarter, you were talking about flat tonnage in food. Can you give us a little bit more insight into what exactly is going on?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, it is true there's been a flat tonnage, although we've seen better trends later in the quarter. But, it's also true that I would say that the market overall has not been performing at the same level. And when I say that we're gaining traction, it's because we believe that versus the market we're gaining traction.

Irene Nattel - *RBC Capital Markets - Analyst*

So, when you say that the market is tough overall and that you're gaining traction, what data points or what indicators are you looking to that give you that view?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, I get the view because of, let's say, data that we have seen. I get that view because of share that we have seen and data obviously that other competitors report. And when we do some sort of comparisons, we believe that we're gaining traction.

Irene Nattel - *RBC Capital Markets - Analyst*

So, then it's your view that you're not in fact losing share in the marketplace.

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Vicente Trius - *Loblaw Companies Ltd. - President*

I am -- we are -- I'm not going to say we're not losing. We're losing share. But, I'm not -- but, we're not trending in the wrong direction.

Irene Nattel - *RBC Capital Markets - Analyst*

Okay.

Vicente Trius - *Loblaw Companies Ltd. - President*

We're trending in the right direction.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Now, as you look at some of your initiatives, in addition to price, you also mentioned product quality. You also mentioned in-store service. Can you talk a little bit about some of the key things above and beyond price that you did in Q1 and how you see that paying off?

Vicente Trius - *Loblaw Companies Ltd. - President*

Yes, there's a lot of things that we're taking forward. Let's start with fresh. So, when we look at fresh categories, there's many initiatives that we have taken, especially in conventional out of best practices that we did in Maple Leaf Gardens. And those initiatives are being taken across the whole business.

And it's all product related. So, there's product related in bakery, with breads, with categories like cupcakes. There's product related in beef. There's product related in produce, with ethnic, and organic products and additional assortments.

So, we have -- we are rolling this out. Remember, this is not something that happens, again, overnight. But, this is happening and being rolled out. And when you look at the net promoter scores, where we come up the highest, it's actually in fresh by the customer.

We have taken a very, very detailed approach on category management and how we build assortments. We have an aggressive plan to review most of the categories. In this process, you're looking at assortments. But, you're looking at the [be-all] category, consumer trends, whether it's ethnicity, diversity, with our own brands, national brands, and the proper pricing.

So, when you look at pricing, there's a step where we put the proper pricing jointly with the category. So, and obviously, it would depend whether it's a conventional business or a discount business where you position. And it would depend on the item and the potential on that item and where that item is positioned today.

I strongly believe that the execution of the stores from a standards perspective has definitely been improving. Again, the customer tells us. We as a company visit stores always unannounced. And as we see the stores, they're moving in the right direction. Are they where I want them to be? No, I'd like them to be a lot better. But, they're going definitely on the right direction.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. And then finally, just one question on financial services. Clearly, you're continuing to invest. When do we see this trend reverse itself and this segment no longer being a drag on overall earnings?

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Sarah Davis - *Loblaw Companies Ltd. - CFO*

Okay. I can answer that. It's Sarah. So, basically, what we did say is that 2012, for the full year, we expected the earnings of PC financial to be roughly equal or slightly positive versus their 2011 performance. And so, given that Q1 is down, we should see that turn in the remaining three quarters.

Irene Nattel - *RBC Capital Markets - Analyst*

So, you're still confident, Sarah, that you will -- that earnings will in fact be equal or slightly better.

Sarah Davis - *Loblaw Companies Ltd. - CFO*

Yes.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you.

Operator

Your next question comes from the line of Patricia Baker from Scotiabank. Your line is now open.

Patricia Baker - *Scotiabank - Analyst*

Thank you and good morning. Sarah and Vicente, in the release, there's a discussion around the CAD60 million hit to EBIT in the quarter. And there's a reference to changes in the value in the Company's investment in franchises. And look at the cash flow statement, it shows a CAD17 million change in the quarter around franchise investment and other receivables.

So, number one, how much of that was franchise related? Number two, I know that this quarter-to-quarter trend and fluctuation is IFRS related. But, is there a qualitative aspect to the valuations? Can you talk a little bit about what sort of events drive the changes as competition, performance, etc.? And then thirdly, what base of stores would be associated with the number that we would've seen this quarter, so confined to a single geography or across the board? Any color at all you can share on helping us really understand that line would be helpful.

Sarah Davis - *Loblaw Companies Ltd. - CFO*

Okay. So, just on -- okay. There's lots of different pieces. So, yes, the CAD17 million that's going through the cash flow does result -- is a piece of it. And it would be the majority of the change that you see is related to the change in the value of the franchise.

Patricia Baker - *Scotiabank - Analyst*

Can you tell us the number?

Sarah Davis - *Loblaw Companies Ltd. - CFO*

I would say the majority of it. But, I don't have the specifics. But, that would be the biggest. It would be the majority of that change.

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Patricia Baker - *Scotiabank - Analyst*

Okay.

Sarah Davis - *Loblaw Companies Ltd. - CFO*

And then I would go on to say what impacts it. So, basically, the franchise business is impacted by the performance in the same way that the corporate stores are. So, the lower performance in all of our business has an impact on the earnings of the franchise business as well and therefore has an impact of our -- in our valuation of that business.

What IFRS does do is it means that, every quarter, you actually have to value your investment in each of your franchisees. As you know, we have over 460 of them. So, at any quarter, there would be volatility related to that.

So, what can cause the volatility is the overall performance of the franchise. It also can be impacted by if you open a new franchise. It can be impacted by if you flip from one owner of a franchise to another owner. And when your -- yes, those would be the components of it.

So, I would say, in this quarter, over time, we're hoping that we'll be able to manage it not to have these -- this volatility. Unfortunately, in Q1, there was some impact. I think 2010 -- actually, 2011, when we went through -- would've had a full year of IFRS, we really didn't have any huge lumpy quarters, other than I think Q4 we had a positive impact from this.

And so, it is something -- we're not going to split it out as a specific number because, to us, it's just a part of our business. And it's the business that we're in. We have a major -- a lot of our stores are franchised. But, it is a factor in this quarter's results.

Patricia Baker - *Scotiabank - Analyst*

Very well said, Sarah, particularly that last part. Thank you.

Operator

Your next question comes from the line of Peter Sklar from BMO Capital Markets. Your line is now open.

Peter Sklar - *BMO Capital Markets - Analyst*

Sarah, just following up on the -- on these costs related to the franchisee -- the revaluation of your franchisee business. The CAD14 million of cost that you referred to in your comments, is that a tax -- is that the bottom line impact. Is it tax affected, or is that a pretax amount?

Sarah Davis - *Loblaw Companies Ltd. - CFO*

It's a pretax amount. And really, the CAD14 million relates to the impact of the franchise and everything else. And it's really just a grouping of everything else that was impacted in the quarter. But, it's pretax.

Peter Sklar - *BMO Capital Markets - Analyst*

And when you develop your financial statements, do you tax affect that?

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Sarah Davis - *Loblaw Companies Ltd. - CFO*

Well, yes, because when we would get to the net earnings, it -- everything would be tax affected, yes.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. On the incremental expense for IT and supply chain, I believe it was actually a reduction of CAD5 million year-over-year this quarter. Your guidance is for CAD70 million incremental over last year. So, we're going to get quite a whack of it in the remaining three quarters. How does -- do you have some sense of how it unfolds through the remaining quarters of the year?

Sarah Davis - *Loblaw Companies Ltd. - CFO*

Yes, so, basically, you're right. We had a CAD5 million decrease, primarily related to the supply chain -- well, entirely related to supply chain reduction as that project comes to an end. We did have incremental spending in IT in the quarter. And the numbers are split out there. And so, when we look at the remainder of the year, it's CAD75 million of incremental expenses that we would expect.

And I think if you just spread it evenly over the quarters with a little bit more in Q3 because it's a four-period quarter, that would be a pretty good assumption.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. And, Vicente, I just wanted to ask you a little bit about what your thinking is about the Quebec region. As you know, the competitive landscape will intensify over the next couple of years as Wal-Mart continues its conversion to Supercenter and to a lesser degree as a result of Target entering the market. So, I presume that's going to have somewhat of an impact on your discount banner.

Can you talk a little bit about what your thoughts are about Quebec and how Loblaw is going to react to these changing competitive dynamics?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, I am encouraged on, first of all, on our performance in Quebec across all banners, whether it's Provigo, whether it's Loblaw, whether it's Maxi. In reference to the discount banner, actually, it's performing very well for us.

So, this means that we're seeing a good performance. We're seeing growth. We have repositioned the stores, a great majority of the portfolio per stores. And we see those stores actually performing very well. And I think we're very well positioned for whoever wants to come. I mean, whoever wants to come, let them come. But, we have good stores.

And I feel the same way in conventional, although the way you position a conventional business is different than a discount business, as you compare yourself versus Wal-Mart, because more about the experience. We have started a little bit of a refurbishing of some of the Provigo stores with very good results this far.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. That's all I have. Thank you.

Operator

Your next question comes from the line of Michael Van Aelst from TD Securities. Your line is now open.

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Michael Van Aelst - *TD Securities - Analyst*

Hi. Just getting back, first of all, to the customer proposition costs, I think you originally said you started those in Q3. Can you remind us what the costs were for Q3 and Q4 last year?

Vicente Trius - *Loblaw Companies Ltd. - President*

The costs on investment on the customer proposition, or the -- when you say cost, is that what your question is?

Michael Van Aelst - *TD Securities - Analyst*

Yes, what were the equivalent of the CAD10 million you said you invested in Q1, what was that number for Q -- ?

Vicente Trius - *Loblaw Companies Ltd. - President*

-- The way I would answer the question is, if you were to go back and look at our rate from a gross profit perspective, you look at Q3 and Q4 versus Q1, I would say they're pretty much in line.

Michael Van Aelst - *TD Securities - Analyst*

Okay. So -- .

Vicente Trius - *Loblaw Companies Ltd. - President*

-- See the data, and you'll see that they're pretty much in line, all three quarters.

Michael Van Aelst - *TD Securities - Analyst*

Okay. So, similar -- let's say similar investments. Now, I know you say that we're not -- you don't expect an immediate improvement in sales. But, we're three quarters into it now. How do you get customers to translate the improved feeling about the stores and improved perception into greater tonnage?

Vicente Trius - *Loblaw Companies Ltd. - President*

I think it's about -- I'm going to go back on being consistent. And it's how we balance the investments and being consistent on our plans to improve the overall experience of the customer. It just doesn't come overnight. But, I can assure you that the execution is better. I can assure you that we're making substantial improvements on assortment, how we localize the assortment, how we build our fresh offer, and how we balance the investment in our value proposition. And we're becoming more competitive. Now, this is step by step. This is step by step.

Michael Van Aelst - *TD Securities - Analyst*

Okay. Switching over to general merchandize, I think this is the first quarter where you haven't seen a decrease in your sales on nonapparel general merchandize. Is that an indication that we're kind of near the end -- we're at the end of this now and we should start seeing some growth as you reset the other -- the up to 100 stores this year?

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Vicente Trius - *Loblaw Companies Ltd. - President*

Yes, actually, first, we like what we saw from a performance standpoing in apparel. And when you look at the other part of nonfood side of the business, a lot of it is the downsizing that we're doing in assortments, like electronics, maybe not a spread -- not as much spread in seasonality and focusing more in the core concepts that we talk about, which is home, is the kids' and moms' world, and it's beauty, which are designed for the everyday needs of our female customer. And we're in the middle of a process of resetting north of 100 stores this year. We're about to finish, I would say, within a week, about the first set of 11 stores.

So, actually, we see -- we have seen some good traction, for example, in home. This means in a positive territory. I'm not going to give you a number, but in a positive territory. So, we see some good traction in home.

And I think the beauty of it is the strength of -- it's a little bit like Joe Fresh. So, you're innovating. You're putting good design and very good value behind product. And we start to see that in home. We're starting to see that in categories that we call jump kits, which is basic needs of storage and basic needs of furniture for the kids' rooms, so nice products.

I would encourage you to visit some of the stores and see them because they're there. And they're getting traction.

Michael Van Aelst - *TD Securities - Analyst*

Okay. And actually, just one more question back on the food side. So, customer said you said was up. Tonnage was flat. So, I'd assume basket was down?

Vicente Trius - *Loblaw Companies Ltd. - President*

Yes, basket was slightly down.

Michael Van Aelst - *TD Securities - Analyst*

So, if basket is down but you've got a higher customer count, do you believe it's because there's more cherry picking of the flyer specials and that the value that your customers are seeing, they're not necessarily shopping a full basket, but they are coming in and appreciating your wider flyer specials?

Vicente Trius - *Loblaw Companies Ltd. - President*

Part is that. Part is as well, remember, we're not passing inflation, right? We're not passing inflation. So, you have also a piece that we're not passing the inflation. Also, we're not penetrating in promotions, like our competitors are. Even though it's gone up in the market, we're going up less because we believe in a much more consistent offer to our customers.

Michael Van Aelst - *TD Securities - Analyst*

So, how do you get the customer to shop a broader basket then if they're going after the flyer specials? How do you get them to buy everything so that they actually have a better impact on the margin?

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Vicente Trius - *Loblaw Companies Ltd. - President*

It is about how you position the pricing. And again, this will depend on banners. And this will depend on divisions. But, it's how you position the pricing, in my mind, that it's less weighted on promotions and more weighted on your everyday overall offer that you offer to the customer.

But, this is combined with improved assortments. This is combined with an improved fresh offer. This is combined with improved standards and improve execution and service at the stores. It's the whole piece.

But, I strongly believe in that. And we've seen -- yes, you have some cherry pickers in the market. And this is part of -- in Canada, it's there. But, I see, let's say, our solid customers improving at the same time. And we have that data. So, our solid customers are buying more. That's what it means.

And I think I have a great opportunity to convert more and more of those customers into categories that maybe the detailed analysis and the quality of assortment and positioning was not there.

And that's what I mentioned before, the category management process. I think it sounds like it's something that has been there for a long time, like category management. But, when you look at what the team is doing, how they look strategically, how they look at consumer transfer repositioning, it's good.

And we're seeing on some of the categories, it's -- that we just said, we're seeing some good traction behind in those categories.

Michael Van Aelst - *TD Securities - Analyst*

Thank you.

Operator

Your next question comes from the line of Jim Durran from Barclays. Your line's now open.

Jim Durran - *Barclays - Analyst*

Good morning. Just wanted to go back to a couple things, first of all, the pricing environment itself. Would you say that, in the quarter, pricing got more competitive than what you saw in the fourth quarter?

Vicente Trius - *Loblaw Companies Ltd. - President*

No, I have not seen -- I've seen high-low activity, like I said. So, when you look at the market, the promotional activity has gone up. I have not seen the market substantially change when I measure them on an overall basket, which is a broad sample of items, right?

Jim Durran - *Barclays - Analyst*

Yes.

Vicente Trius - *Loblaw Companies Ltd. - President*

And I see us getting traction when I measure it that way.

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Jim Durran - *Barclays - Analyst*

And so, the sort of implied slowing of your sort of real comp store sales results this quarter versus the fourth quarter, do you attribute that more to the competition responding to some of the pricing you put in place in the fourth quarter?

Vicente Trius - *Loblaw Companies Ltd. - President*

I think it's -- to me, it's -- I would attribute it more to the market because, like I said before, I believe we're trend versus the market, we're gaining traction. So, I would attribute it a little bit more to the market. And remember, we had one less day of sales as well, right? But, I'm sure you're filtering that already.

Jim Durran - *Barclays - Analyst*

Yes, no, absolutely. From an inflation standpoint, can you give us some idea as to where the hot buttons are in terms of inflation as you look out over the next 12 months? Are you seeing much price inflation from the consumer packaged goods coming from the center of the store and what's going on with products inflation in your stores?

Vicente Trius - *Loblaw Companies Ltd. - President*

Again, we see less inflation if you were to compare to last year. And again, I'm going to say we're passing as well less inflation. And a highlight maybe in the quarter is some deflation in produce that we see this tapering off, probably the month of May, June. We see this tapering off. And it's based on -- over crops mainly in areas like California and so forth.

Jim Durran - *Barclays - Analyst*

And last question, just Real Canadian Superstore, I assume that a lot of these right-hand resets are going to affect those stores. Where do you think you are on that banner in terms of having it where you want it to be? And how much longer do you feel it'll be before the tonnage of that business is where you want it?

Vicente Trius - *Loblaw Companies Ltd. - President*

We're seeing actually good trends in the Superstore. And I'm going to say on both Ontario and the West. But, we see better trends in the West, but in both cases positive.

We have taken measured steps on how we position the value proposition in those stores. And we're taking them back from a value proposition perspective back to the core of the Superstore, how the business was built. And it's -- we're getting good response from our customers.

As far as the right-hand side, I think it will enhance our offer, like I said before, whether it's Joe Fresh apparel or the other categories that I spoke to. And I think it position us very well with a distinct assortment behind design, product, and value versus other competitors.

Jim Durran - *Barclays - Analyst*

Thanks, Vicente.

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Vicente Trius - *Loblaw Companies Ltd. - President*

And by the way, the renovations as well, on that part of the business, we're getting good traction. We're pleased with the renovations. And that's one of the banners that we're renovating the most.

Jim Durran - *Barclays - Analyst*

Great. Thank you.

Operator

Your next question comes from the line of David Hartley from Credit Suisse. Your line is now open.

David Hartley - *Credit Suisse - Analyst*

Yes, thank you and good morning. Just ask -- why don't I follow up first on Jim's question there with the Real Canadian Superstores? I'm getting a sense perhaps that maybe you're going to change the price perception around that banner. It seems that the price perception was taken down. Would you maybe be taking this back up a little bit?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, I mean, we're improving the customer proposition.

David Hartley - *Credit Suisse - Analyst*

Right.

Vicente Trius - *Loblaw Companies Ltd. - President*

Which part of that is value. Part of that is assortment. Part of that is fresh. Part of that is service, and again across all banners. And one of them is the Superstore. So, we're improving the overall customer perception in the Superstore. One piece is value. But, we're doing it very well, very balanced in the items, in the categories that we believe the customer wants. But -- and it's coming in the right direction.

David Hartley - *Credit Suisse - Analyst*

So, would you say perhaps with RCSS you're kind of balancing it more towards proposition than value?

Vicente Trius - *Loblaw Companies Ltd. - President*

No, I mean, RCSS has always been a discount retailer. We are priced very competitively in this market. And we just need to ensure that we continue doing that with the proper assortments for those customers as a Superstore, which has more breadth than maybe a No Frills or a Maxi, right?

David Hartley - *Credit Suisse - Analyst*

Okay. Thanks. Just on the CAD70 million -- I guess CAD75 million incremental IT supply chain costs for the rest of the year, was that always planned to kind of spread it through the back three quarters of the year, maybe perhaps given the franchise issue during the quarter?

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Sarah Davis - *Loblaw Companies Ltd. - CFO*

Yes, so, basically, we're on our plan. So, really, the spending is actually fairly consistent because we did actually spend money in Q1 on IT. The difference is what we spent last year on restructuring related to the supply chain infrastructure. So, we had a big chunk of money spent in Q1 of 2011. So, that's the difference. But, the spending in IT is fairly consistent across the year.

David Hartley - *Credit Suisse - Analyst*

Okay. That's great. And with the franchise adjustment, people reference CAD17 million of the cash flow side. Is that expected to not, as far as you know, recur in the next three quarters?

Sarah Davis - *Loblaw Companies Ltd. - CFO*

It depends on how the franchise business performs.

David Hartley - *Credit Suisse - Analyst*

Sure.

Sarah Davis - *Loblaw Companies Ltd. - CFO*

And it depends on other -- if we make decisions to flip. So, it's a hard one to predict. What we are planning to do is try to make it less volatile. And -- but, it depend -- it really does depend on the performance of each of store. And there's 450 -- 462 of them. So, it's difficult to predict exactly.

David Hartley - *Credit Suisse - Analyst*

Okay. But, I think that's helpful. And then on the CAD40 million, I always got the impression that there was a lot more being invested in kind of labor I guess. But, does that CAD40 million kind of wash through the whole mix of labor promotions, pricing, etc.? How do you look at that CAD40 million?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, the CAD40 million are invested differently by banner and by division. So, if you look at conventional, that investment is going part on the value proposition and depending on the banner and part on service and the experience. Like, we're improving, let's say, the service in fresh areas, for example, as we speak. So, it's balanced. And there would be maybe even some initiatives on marketing and how we communicate the value proposition and so forth. So, it's a -- .

David Hartley - *Credit Suisse - Analyst*

-- Okay -- .

Vicente Trius - *Loblaw Companies Ltd. - President*

-- Investment.

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David Hartley - *Credit Suisse - Analyst*

Okay. That's helpful. And just, Sarah, one more for you, I think in Q2 every year, last bunch of years anyways, you've expensed somewhere in the nature of CAD20 million, CAD25 million related to amortization of merchandise write-downs. Or, perhaps you can correct me on the item exactly. Are you expecting that in Q2? And given some of the comments Vicente has provided us about the progress being made on the right-hand side or with merchandise in general, could we expect that to be coming to an end soon?

Sarah Davis - *Loblaw Companies Ltd. - CFO*

I think what you're referring to, just for everyone else, is the provision we would take for -- related to inventory and markdowns basically. That does go through our P&L. So, basically, we do take a bigger -- generally, we do take a bigger provision in Q2. It's related to seasonal items, often related to patios and furniture, barbeques, things like that.

So, as we do reduce the amount of seasonal items we have, we should see a reduction in that. But, it depends on the performance in Q2. And -- but, I would expect, as we do change out the stores and have more of a -- less seasonal items, emphasis on seasonal items, it should reduce.

David Hartley - *Credit Suisse - Analyst*

Okay. That's helpful. And last question, just on the Joe stores, could you give us an indication of, first of all, how many Joe stores or we'll call them locations that you actually have now in Canada and the US and what the average square footage being employed for those locations is?

Vicente Trius - *Loblaw Companies Ltd. - President*

We have -- in Canada, it's 15 stores. And now, we have five stores in the US. The average square footage, the average would be 10,000 square feet, some higher. Some are a little bit lower. But, it would be about 10,000 square feet.

David Hartley - *Credit Suisse - Analyst*

And what about the locations? How many locations do you have in bannered stores, Loblaw Stores, etc.? And what would be the average square footage of those locations?

Vicente Trius - *Loblaw Companies Ltd. - President*

Four hundred in -- across our supermarkets and superstores and about 8,000 square feet that is allocated on an average. Be careful because there's some supermarkets that would be less and others that are larger, right? But, (inaudible) we would be allocating inside our stores.

And very pleased -- again, I want to reemphasize very pleased with Joe Fresh and the strength of that offer.

David Hartley - *Credit Suisse - Analyst*

Great. Thank you very much.

Operator

Your next question comes from the line of Keith Howlett from Desjardins Securities. Your line is now open.

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Keith Howlett - *Desjardins Securities - Analyst*

Yes, I had a question on the general merchandise resets. What is the total number of stores that that would apply to? Is it roughly the same as the 400 Joe Fresh unit count?

Vicente Trius - *Loblaw Companies Ltd. - President*

I said this was north of 100 that we would be doing this reset.

Keith Howlett - *Desjardins Securities - Analyst*

No, I meant in -- when you do the rest of them. Like, beyond this year, what's the total universe of general merchandise areas that will be reset in the future?

Vicente Trius - *Loblaw Companies Ltd. - President*

At the very most -- again, this is future looking, and I need to look at -- it would depend a lot by store. But, I would say maybe anywhere between 115 and a couple hundred stores.

Keith Howlett - *Desjardins Securities - Analyst*

Including the 100 that you're doing this year.

Vicente Trius - *Loblaw Companies Ltd. - President*

Altogether, yes.

Keith Howlett - *Desjardins Securities - Analyst*

Altogether. And then on the Joe Fresh business in the US, do you sort of have a general expectation as to when that would be at breakeven?

Vicente Trius - *Loblaw Companies Ltd. - President*

So, this is basically -- let's remember this is early stages. I mean, we've been in the US since last October. This is a measured approach. Our -- the brand has been very well received, having said that. And you have all kinds of, let's say, what I would call opinion makers voluntarily talking about the brand, from Oprah Winfrey and others, (inaudible) magazines. So, it's not only us and what the customer says. People are seeing that.

And again, this is a pilot. And this is a startup. So, it's about -- now, it's about building the business. And having said that, we do not see any incremental P&L investment in the US.

Keith Howlett - *Desjardins Securities - Analyst*

Great. Thank you. And in terms of food inflation as you went through the first quarter, was it declining as you went through the quarter driven by produce, or is it pretty much the same through the January, February, March?

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Vicente Trius - *Loblaw Companies Ltd. - President*

Well, part of it, like I said, is self inflicted, right? We're passing less inflation to the market. And the other piece that I highlighted is produce because produce did have inflation. Produce did have inflation. But, that's throughout the whole market that produce had inflation.

Keith Howlett - *Desjardins Securities - Analyst*

And maybe just finally on capital structure, is there -- are there any plans to adjust the capital structure this year, or is that sort of a 2013 or 2014 decision?

Sarah Davis - *Loblaw Companies Ltd. - CFO*

I think what we had said at the Investor Day, so, from doing any kind of buyback of shares, we're not planning to do it until we see or confident that the benefits are going to come through coming out of SAP. So, it's not something we expect to do this year.

And from a dividend, same thing on -- same answer on the dividend, increase in the dividend as well.

What we have been doing is buying back shares just related to the dilution and based on stock-based comp. That would be the only pieces we've done and plan to do.

Keith Howlett - *Desjardins Securities - Analyst*

And just finally on the SAP implementation and the -- I think the merchandizing model was viewed as one of the higher-risk pieces. Just where are you at -- in terms of implementation?

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, we're on target and on plan. We implemented pricing with minimal disruption. And as we speak now, we're implementing costing, which is -- it relates to assortment. At the same time, we're putting the right processes in the stores in preparation for the rollout of SAP into the store and collecting it all the way supply chain with merchants and all the way to the store.

So, we -- I would say that we're on plan. And we will rollout our first store in Q4 of this year.

Keith Howlett - *Desjardins Securities - Analyst*

Great. Thanks very much.

Operator

Your next question comes from the line of Kenric Tyghe from Raymond James. Your line is now open.

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Kenric Tyghe - *Raymond James - Analyst*

Thank you. Good morning. In the quarter, you saw an increase in your PC Points loyalty cards. And I'm wondering whether that was just a function or a realignment of your loyalty offering against your key players in the market, given that a number of those have also done a refresh in quarter, or whether it is more sort of a function of your reset or reset of your thinking around loyalty ahead of the 2013 standalone loyalty release.

I wonder if you could just provide some color on your thinking there, both in terms of the incremental cost in quarter and the sort of the read through looking at the standalone loyalty launch in '13.

Vicente Trius - *Loblaw Companies Ltd. - President*

Well, I would say, if I look at the PC Points, the PC Mastercard, there is a relation to the fact that we have more active cards than we had a year ago. So, we have about 500,000 more active cards.

And this continues. Remember that our plan for this year, we said that the Investors Relations is to acquire another 1 million apps, which should translate for us another 500,000 cards. And this translates into more loyal customers. And that's why we believe that what we're doing in 2011, what we're doing this year is the right investment for the future. And that's why you see it. That's it.

Kenric Tyghe - *Raymond James - Analyst*

And in terms of that, do you think that that investment is going -- is really part of, as I said, a broader rethink? I mean, I know we're talking about the cards in year. But, certainly, next year, are we going to be discussing a standalone loyalty program? Is there something sort of more to read into that repositioning outside of the increased -- ?

Vicente Trius - *Loblaw Companies Ltd. - President*

-- No, there's nothing more to read into the positioning. And yes, we are on plan to launch a loyalty card next year in 2013.

Kenric Tyghe - *Raymond James - Analyst*

Great. And just a follow up, I mean, is that a first half or second half story, or is that wishful thinking on the question?

Vicente Trius - *Loblaw Companies Ltd. - President*

Wishful thinking.

Kenric Tyghe - *Raymond James - Analyst*

Perfect. Thank you.

Operator

(Operator Instructions). Your next question comes from the line of Chris Li from Bank of America/Merrill Lynch. Your line is now open.

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Chris Li - *BOA Merrill Lynch - Analyst*

Hi, good morning. Did the improvement in the controllable profitability have a material impact on gross margin this quarter? I think it was mentioned as a driver for the last four quarters, but it wasn't mentioned this quarter. So, just wondering if you're starting to see sort of some of the cycling through some of the improvement benefit.

Vicente Trius - *Loblaw Companies Ltd. - President*

No material impact in this quarter. And our profitability and controllable remains strong, but no material impact in this quarter.

Chris Li - *BOA Merrill Lynch - Analyst*

Okay. And just a quick one on pharmacy business. What was your script count growth for the quarter?

Vicente Trius - *Loblaw Companies Ltd. - President*

Our comp growth, considering that you have one less day, was 2.2 in script count this quarter.

Chris Li - *BOA Merrill Lynch - Analyst*

And with respect to the Zellers acquisition, given that they're prone to higher churn, do you have any plans to -- in terms of promotions or try to -- to try to mitigate the churn on those patient files?

Vicente Trius - *Loblaw Companies Ltd. - President*

Yes, we have a very comprehensive plan. As a matter of fact, over the last week, we started with (inaudible) first two stores. And I would like to say it's early stages because it's the first two. But, let's say that ahead of model and ahead of plan.

And this comprehensive plan includes the Zeller stores as well as our locations. And it's very specific the way we communicate, the way we communicate even in the press, the way we communicate in our store, the way we communicate directly with patients. So, it's a very well done plan. And first reactions are very positive. So, we feel good about it.

Chris Li - *BOA Merrill Lynch - Analyst*

Okay. And just with respect to free cash flow for the year, I believe you generated just north of CAD900 million last year. Can you give us some guidance in terms of the free cash flow level you expect to generate for this year?

Sarah Davis - *Loblaw Companies Ltd. - CFO*

We haven't actually given out a guidance on it. I think if you take your estimate on your EBITDA and you take off the CAD1.1 billion of CapEx and you use -- basically keep some of the other ones -- items fairly stable, you'll get to a pretty good estimate.

Chris Li - *BOA Merrill Lynch - Analyst*

Okay. Great. And just last one on -- in terms of modeling, does the CAD30 million remaining on the customer proposition, am I correct in hearing most of that would still be coming off of your gross profit line, or do you expect some to come off of your operating expense line?

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Vicente Trius - *Loblaw Companies Ltd. - President*

Well, the way it's going to be invested is going to be in both, like I said before. Now, remember, in the operating line, we also have, at the same time, savings because we're implementing -- have implemented stocks. There's many different pieces, right? But, we are investing it in a balanced manner. That includes labor as well as it would include in the value proposition.

Chris Li - *BOA Merrill Lynch - Analyst*

Thanks a lot.

Operator

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

Kim Lee - *Loblaw Companies Ltd. - VP IR*

Thank you, everyone, for joining us this morning. We look forward to speaking to you on our Q2 call in July. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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