# FINAL TRANSCRIPT

**Thomson StreetEvents℠**

## L.TO - Q2 2010 Loblaw Companies Earnings Conference Call

**Event Date/Time: Jul. 22. 2010 / 3:00PM GMT**





THOMSON REUTERS

## CORPORATE PARTICIPANTS

**Kim Lee**
*Loblaw Companies Limited - Senior Director IR*

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

**Sarah Davis**
*Loblaw Companies Limited - CFO*

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

## CONFERENCE CALL PARTICIPANTS

**Irene Nattel**
*RBC Capital Markets - Analyst*

**Perry Caicco**
*CIBC World Markets - Analyst*

**Patricia Baker**
*Scotia Capital - Analyst*

**Michael Van Aelst**
*TD Newcrest - Analyst*

**Jim Durran**
*National Bank Financial - Analyst*

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

**Winston Lee**
*Credit Suisse - Analyst*

**Keith Howlett**
*Desjardins Securities - Analyst*

**Chris Li**
*Bank of America - Analyst*

## PRESENTATION

**Operator**

Good morning. My name is Stephanie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited Second Quarter Results Conference Call. (Operator instructions). Thank you. Kim Lee, you may begin your conference.

---

**Kim Lee** - *Loblaw Companies Limited - Senior Director IR*

Thanks, Stephanie. Good morning, and welcome to the Loblaw Companies Limited second quarter conference call. This call is also being Webcast simultaneously on our Website at www.loblaw.ca.

I'm joined here this morning by Galen G. Weston, Executive Chairman; Allan Leighton, President and Deputy Chairman; 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 2010 and future years. These statements are based on certain assumptions and reflect management's current expectations, and they are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from current expectations. These risks and uncertainties are discussed in the Company's materials filed with the Canadian securities regulators from time to time, including the Company's annual report and second quarter report. Any forward-looking statements speak only as of the date they are made. The Company disclaims any intention or obligation to update or revise any forward-looking statement, whether as a result of new information, future events, or otherwise, other than as required by law.

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

Our second quarter report, as well as the archive of this conference call will be available on our Website.

With that, I'll turn the call over to Galen Weston.

---

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

Good morning, and thank you for joining us. Well, we continue to make progress on our renewal program. However, we are now in the critical period of heightened risk for the infrastructure and information technology components of our plan. And, as previously stated, we expect investments associated with our supply chain and IT programs to continue to negatively impact our operating income during this period.

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

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

Thank you, Galen, and good morning.

Sales in the second quarter of 2010 increased by 1.2% to CAD7.3 billion. Same-store sales decreased by 0.3%. The acquisition of T&T, which was completed in the third quarter of last year, positively impacted sales by 1.9%. Excluding T&T, sales declined 0.7%.

In the second quarter of 2010, sales growth in food was flat, and sales growth in drug store was modest. Sales growth in apparel was strong, while sales of other general merchandise declined significantly. And gas bar sales increased significantly as a result of higher retail gas prices and strong volume growth.

In Q2, national food price inflation as measured by the consumer price index for food purchased from stores was flat. We saw further internal retail food price deflation relative to Q1 of 2010, and, in Q2 of 2009, we saw internal retail food price inflation.

Gross profit in the quarter was CAD1.8 billion or 24.5% of sales versus CAD1.7 billion, or 23.4% of sales in the second quarter last year. The improvement was primarily due to continued buying synergies, disciplined vendor management, improved control label profitability, inventory management, and a stronger Canadian dollar. This was partially offset by investments in pricing.

Operating income was CAD330 million in the second quarter, compared to CAD324 million in Q2 of '09. Operating margin was 4.5% in the quarter, flat with last year. The improvement in operating income was primarily due to the increase in gross profit. This was partially offset by an CAD11-million charge related to stock-based compensation, net of the equity forwards, a

CAD23-million impairment charge related to the closure of a distribution center, and CAD41 million in incremental costs related to the Company's investments in information technology and supply chain.

Loblaw realized second quarter basic net earnings per common share of CAD0.64, compared with CAD0.70 in the second quarter of 2009.

Net debt at the end of the second quarter was CAD2.7 billion, compared to CAD2.8 billion at yearend and CAD3 billion at the end of Q2 '09. The year-to-date decrease in net debt was primarily due to cash flow from operating activities, partially offset by fixed asset purchases.

Capital expenditures in Q2 were CAD236 million and CAD384 million year to date. We continue to estimate capital expenditures for 2010 to be around CAD1 billion.

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

---

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

Thank you, Sarah. And good morning, everyone.

The performance in the second quarter continues to show that we are making solid progress on our renewal plan. The market remains spotty. The economic outlook is becoming more pragmatic and less bullish. And, for retail businesses, unemployment, household debt, and rising interest rates remain cautionary challenges with little relief on the immediate horizon.

Deflation is deepening. In Q2 for Loblaw Companies, we deflated at a faster rate versus Q1. And we were deflating at a deeper rate as we exited the quarter than as we entered it. We see this trend continuing well into Q3, and it's more difficult to predict when inflation will return to the market. We therefore continue to fixate on volume and item growth and continue to make progress on these metrics.

Our gross profit continues to improve with, as planned, both in control brand and apparel/general merchandise margins playing a significant role in that increase. The Canadian dollar impact was less than in Q1.

Our other clear focus is our supply chain and infrastructure projects. And, on these too, we move forward. This week-- actually, on Sunday, we went live with our second SAP deployment. We now have our general ledger and the related financial reporting across the business integrated on SAP. Along with our earlier release in January, we now have close to 1,000 central colleagues working on SAP.

We continue to roll out TMS, our transport management system, and WMS, our warehouse management system, to our supply chain network. This quarter, we implemented WMS in our Edmonton DC and have five more go-lives for TMS. We now have 93% of our transport operations and 35% of our warehouse operations on new systems. Both these programs remain on track.

However, we now have ended the darker side of the moon, and all of these major infrastructure projects are now in the period of maximum risk.

Our retail programs have had a significant quarter. We touched over 40 stores as part of our ongoing store renewal program and continue at this cadence with similar projects.

Also in the quarter we announced that we will open six nofrills in the Atlantic this year and believe the opportunity for nofrills' banner is close to 20 in that region. nofrills expansions continue in the west too. We now have 22 stores, and that number will be at 30 by yearend.

On the pharmacy front, we push forward with a number of customer-facing programs. We extended pharmacy hours in 25% of our Ontario stores with more to come. We standardized to a lower, CAD8 dispensing fee across all nofrills stores, and our new technology that improves prescription and processing time is allowing much more face-to-face time between our pharmacists and their patients.

Yesterday, we opened our first small-footprint, 400-square-foot pharmacy at our Erin Mills nofrills. We believe there is an incremental 200-store pharmacy opportunity at this [size].

We also opened four more medical centers, bringing the total to 88, and are well advanced in our planning to have 200 across the country.

We also continue to add footage to our Joe Fresh business. Joe now has 1.5 million square feet in our core store base, and that will increase by close to 10% by yearend. We will also open a new, standalone store on [Gramble] Street in Vancouver in Q3 and two other standalones by yearend. We believe there is an opportunity for 20 similar, high-traffic standalone Joe Fresh stores to be opened over the next couple of years.

So, in summary, continued progress. Market conditions remain unhelpful. We've entered the period of maximum risk. The balancing act continues. And, as always, we remain cautious in our outlook.

With that, operator, I'd like to hand it over to questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator instructions). Irene Nattel, RBC Capital Markets.

**Irene Nattel** - *RBC Capital Markets - Analyst*

Allan, you've been through several SAP rollouts in the past. And I was wondering if you could just give us a little bit of color on, if we're going to get into significant glitches, at what point is it likely to happen? And what nature--? What would likely be--? What are the areas that you in particular are looking out for as particularly risky?

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

I think it's-- There's two things, really. I think we're probably entering that phase now. You know, we call it the period of maximum risk for a reason, because, clearly, the more people that you have on the new systems and that you're trying to coexist with the legacy systems, now that tends to be when the problems begin. But, also, in this next quarter, we will really start to touch merchandising. And, clearly, that is an area with finance where, if you get it wrong, then you can have the biggest problem.

The issues are always the same. It's really all around the data, and it's really making sure that the data that's going through is clean. And it's also around how you manage the coexistence because it does mean for the next 18 months, in large parts of the businesses, we'll be running two lots of systems as opposed to where we've been running one today.

Where exactly-- where I expect us to be-- You have good days, and you have bad days. The most important thing is to understand that things do go wrong. That's my one piece of constant learning. And, therefore, the key thing is in how fast that you can recover. And, frankly, we've had a couple of glitches along the way to where we've got to today, but we've turned them around pretty quickly. Clearly, where the impact starts to happen-- the biggest impact is if it starts to affect ordering or somehow product coming out of the DCs into the stores. They're the areas of major risk. And we're-- We've been through this a few times, so we have a pretty good contingency in place.

---

**Irene Nattel** - *RBC Capital Markets - Analyst*

And, on a go-forward basis, Allan, while you're running the two systems, are you going to be able to somehow quantify for us what the cost of that system duplication is to the extent that it's reflected in the actual financial results on a go-forward basis?

---

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

It's probably difficult, Irene, until come out the other side, to be honest. And I think, clearly, what we're trying to do in articulating what we think the costs of implementation are-- We've taken in that thinking that there are the transition costs that go along with that. So I think the only thing we're trying to do for you guys is to sort of isolate what we think the real costs of implementation of these things are to give you some idea about what costs may be removed at the end of all of that.

And, clearly, all the benefits when they come through, and, clearly, we see them in the supply chain already, tend to come-- flow into margin in some way, shape, or form.

---

**Irene Nattel** - *RBC Capital Markets - Analyst*

So, then, the CAD200 million of incremental costs this year do include your best estimate at this point of what the true costs are going to be to the organization?

---

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

Yes, pretty close, as much as you can get.

---

**Irene Nattel** - *RBC Capital Markets - Analyst*

That's great. Thank you, Allan.

---

**Operator**

Perry Caicco, CIBC World Markets.

---

**Perry Caicco** - *CIBC World Markets - Analyst*

Allan, several times over the past year, you have in your outlook alluded to increased competitive activity. And that usually comes at some cost to gross margins as you battle your way through it. If there has been increased competitive activity and if you've responded to it, has it turned up in your gross margin performance at this point?

---

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

Yes, it has, Perry. I think the gross margin, and you're on a very good point here, is-- There are all the usual suspects of why our gross margin is improving - the buying synergies, vendor management, inventory. But the big two changes, I think, which are structural to our P&L are what's happening with control brand and what's happening with general merchandise. And both of those two-- As you know, we've planned for some time to improve our control brand margin. And we're seeing that. And the way that we're improving the control brand margin is through sourcing and being much cleverer about how we source products. And therefore it's not impacting the price. So that's real margin, which is enabling us to do two things. One is clearly take that margin through to the bottom line and, secondly, in some instances, invest actually back into pricing of control brand.

And the second piece is, with our general merchandise business, and I take apparel out of it for this conversation, is-- One of our issues has always been we've got sales in a pretty mixed way, but, probably, 35% or 40% of those sales (inaudible) were clearance. We've never got the range right. We've never been able to edit it right. We've always had too much inventory. We're now beginning to get a much better, much more focused range of products in core GM through Joe, and we're beginning to see the margin impact of that flow through to our bottom line. Even though, actually, the sales comparison looks pretty poor, a lot of the sales we've had historically we made no money on.

So, I think, for you guys going forward to think about is the control brand and GM structurally are impacts on margin which are very positive, because, actually, in our core businesses, we've been investing margin back into price because the market is pretty competitive. I mean, I implore people who don't believe that just look at all the flyers that are out this week. Everything's CAD1, CAD2, CAD3, half-price sales, the whole caboodle. So we're investing money in our pricing, but, at the same time, we've been able to grow our gross margin because structurally we're tackling the two issues on our P&L, which have been poor in the past.

---

**Perry Caicco** - *CIBC World Markets - Analyst*

And your sales performance obviously continues to be a bit sluggish. I'm guessing it's having some impact on your SG&A rate, even if we strip out the IT costs. So I'm wondering, outside of the gradual reduction in IT spending, are there any actions you're taking in the near term to reduce your SG&A rate? Or is it simply a matter of waiting for sales growth to return or duplicated efforts to end?

---

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

Well, actually, we think we're in pretty good shape on SG&A. We're pretty tight on controlling our costs. Clearly, in the stores, because you've got deflation quite a big impact on that top line, then you've got wage rates rising at 5%, and you've got no top line sales to compensate that. So that has a marginal effect. And we put a bit more money into some of the areas in the stores; particularly, we invested quite a bit of money back into bakeries. So we're investing in store costs. But, generally, we feel pretty good about our SG&A position.

I think the other thing to think about here is, as I said to you before, we're very fixated on item and volume. Deflation is deepening in our business. And, as I said, we exited-- We had more deflation in Q2 than Q1. And we exited with more deflation than we went into it. At the same time, we've been able to drive our items up and our customer count up too. And our basket's roughly where it's been.

So there's always a bit of a balance in this. But the top line is being affected by this pretty deep deflation that we've got, certainly, in our business at the moment.

---

**Perry Caicco** - *CIBC World Markets - Analyst*

So same-store customer count is up?

---

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

Yes.

**Perry Caicco** - *CIBC World Markets - Analyst*

Okay. Thank you.

**Operator**

Patricia Baker, Scotia Capital.

**Patricia Baker** - *Scotia Capital - Analyst*

I would just follow up on Perry's questioning about not necessarily the SG&A but, certainly, the sales. You're sort of implying, Allan, I think, that the bulk of what's going on here is deflationary. But is there anything else you can do other than waiting for-- as Perry said, waiting for the sales to come? What specific things are you doing to try and really drive the sales line?

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

Well, we're focused on all sorts of things. Clearly, we're also playing a slightly midterm game here. Clearly, all the work that we're doing in renovating our store base is for a reason. And, when you've got the amount of store change going on that we've got in some of our biggest stores-- At any one time in the moment in the west, there's eight, nine, or ten of our superstores all going through 12-week transitions. That has an effect. And, as I said to you before, I think we're probably two-thirds of the way through. We've probably got another 12 months of getting that store base right. And then two things happen. The number-one thing is you have less impact on your core business today. And, secondly, those businesses are being renovated to grow the sales.

And the other thing, Patricia, I think which is important is we're constantly-- Because of the reconstruction of our P&L, it does give us more opportunity to, particularly in our discount banners, sharpen up our prices significantly. And that has certainly started to happen.

I think the other piece of this is that we should all bear in mind is that we're not in the square footage game. Although we're building out new stores, we're also closing stores. Our net new footage is pretty neutral because our number-one objective is to get our core base of store right. And we've always been more interested in quality of footage than amount of footage. That will also start to adjust sometime next year, where you will start to see that we really start to have some new footage into the business.

**Patricia Baker** - *Scotia Capital - Analyst*

So, new footage in excess of what we saw? Or do you mean the new footage that you're adding now will start to be productive or that the run rate will be above the 1%?

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

No. The run rate will be above the 1%.

**Patricia Baker** - *Scotia Capital - Analyst*

Okay. And just another question then. You talked in your opening remarks a fair bit about your drug store initiative. You put out a press release yesterday on opening a store. Can you share with us perhaps some of the metrics there, particularly with this-- You were talking about a new model. So you put a new model into a nofrills, so that means you've got 50 nofrills with a drug store. How does that model differ from the other nofrills drug stores? And can you tell us about what kind of scrip volume will you need under that new format to get to breakeven?

---

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

Well, rather than go to the scrip-- Let me give you some parameters rather than specifics. It's basically-- It's half the size. So you've got half the size of pharmacy that we would run traditionally. It's worth going to have a look at. I actually think it's very, very good because it doesn't feel as if it's half the size. But all the economics behind it and all the ability to manage behind it, particularly as we've now also put our new IT in to support the pharmacists, I think it will become a pretty powerful model. So you could run at, probably, in my view, probably 30% to 50% less scrips than you would in a traditional, conventional store and still make probably a better return than you do in a conventional store. So it's a sort of-- For me, it's a very interesting model.

We've got the-- We've only initiated-- It's been open for 24 hours. So one of the things we're doing-- We'll have about a dozen of these up in the next three or four months. And the idea is to really get to have a look at what those metrics look like. But the scoping of the metrics seems to suggest that you can do significantly less volume and make more money than you would in the conventionals.

---

**Patricia Baker** - *Scotia Capital - Analyst*

Okay. Fair enough. I just want to clarify a point. When you say they're roughly half the size, roughly have of the size of a pharmacy that's inside a conventional store?

---

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

Yes.

---

**Patricia Baker** - *Scotia Capital - Analyst*

But not roughly half the size of what you've already got in nofrills?

---

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

No. No.

---

**Patricia Baker** - *Scotia Capital - Analyst*

How does it differ from your current nofrills?

---

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

It's about the same.

---

**Patricia Baker** - *Scotia Capital - Analyst*

So it's not different.

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

The nofrills are about 500 or 600 square feet.

**Patricia Baker** - *Scotia Capital - Analyst*

Okay. Thank you.

**Operator**

Michael Van Aelst, TD Newcrest.

**Michael Van Aelst** - *TD Newcrest - Analyst*

Just first picking up on your comments about tough deflationary environment here, there has been some signs that some suppliers are trying to get price increases through. Are you seeing that in the pipeline now? And, if so, how do you expect to deal with that in the second half of the year?

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

There is some pressure for price increases. But, actually, if you really look at what's happening is, in a strange way, people are trying to push price increases through and then promote it back. If you look at really what's happening to average item price, largely across the industry, it's down. And so my sense is that, clearly, people are trying to put price increases through. Where they make some sense and there's a rational reason for doing them, we tend to support them. If not, then they'll have to wait because the market, as you can see, is pretty aggressive. And you can fool yourself easy. It's very easy to put the prices up and then promote it back. You end up in the same place. And you've become a busy fool along the way. But we don't have a huge backlog of prices ready to go through. And my view of the back half is it won't be much different to what happened in the front half.

**Michael Van Aelst** - *TD Newcrest - Analyst*

Okay. And then, switching to the IT side, is CAD185 million incremental still the right number for this year?

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

Yes. And we were much closer to what we thought and we'd given you guidance of in this particular period. But it will be the number. And this-- Clearly this quarter because it's a four-period quarter will be a pretty big one.

And, again, another piece of guidance because these things do move around a bit. If you look at the two quarters that are left and you roughly split what we haven't spent versus the number we gave you, it proportionately to those quarters will be pretty close to where we're going to be.

**Michael Van Aelst** - *TD Newcrest - Analyst*

Okay. I'm not quite sure I caught that. So Q3 is going to be higher than Q4, but maybe not quite as much higher as the four weeks would suggest?

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

Yes. I mean (inaudible). We gave you a number for the year. We're going to spend that number for the year. And, if you look at-- We've got seven periods left - one quarter of four and one quarter of three. And you roughly divide the number that's left by that number; you'll be pretty close.

**Michael Van Aelst** - *TD Newcrest - Analyst*

Okay. Got you. Not a problem. And, then, when do you expect to get it into the stores - the new systems?

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

Which ones?

**Michael Van Aelst** - *TD Newcrest - Analyst*

Which stores?

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

No. Which systems?

**Michael Van Aelst** - *TD Newcrest - Analyst*

The retail base, like--

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

Sorry. A lot of the system work at the moment has gone into the DCs and into finance here. Merch will be in the last quarter this year. We're probably about 12 months away from it really getting down in the stores. And the idea behind that is that we want-- Coexistence is very difficult. And we don't want the stores ever to be in coexistence. So we're trying to do all of the work ahead so that, when we flip to the stores, we absolutely flip over to the one system. So the stores are last for a reason.

**Michael Van Aelst** - *TD Newcrest - Analyst*

Okay. And so that brings me to the labor negotiations. I guess that's not going to be an issue in terms of trying to put it in while you're negotiating with this large union. But you've got these four unions that you're negotiating with. I think you said that nothing's-- you're likely going to negotiate through Q3, even though I think the last date is in early August of negotiation. Do that means you expect more negotiations to be announced for later August or September and then this could go longer?

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

Well, I mean, I can't comment on how long the negotiations will be. I mean I'll just make a couple of observations. Number one is that, clearly, we will try and get to a negotiated settlement.

The second thing is that, as I've said before, we are the best payer in the industry by some way. And we have less flexibility, which means we don't have the right people in the right place at the right time for our customers. And I don't mind being the best payer in the industry. In fact, I like being the best payer in the industry. But I also want to give the best customer service. And, to give the best customer service, we've got to have the flexibility that allows us to put the right people in the right place at the right time. And there is a watershed in this industry. There are more non-unionized players than unionized players. And, therefore, it's time for a change. Now, I'm-- my objective and the objective of negotiating is to negotiate that. But it is a watershed for the industry.

---

**Michael Van Aelst** - *TD Newcrest - Analyst*

Okay. And just, finally, Sarah, the depreciation in the first quarter was 15% year over year. I think you said at that point that it should be roughly up the same for the rest of the year. And Q2 was only up 10%. So is there--? What do we expect for H2, for the second half?

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

It does move around a little, so I'll say we're up 13%-- almost 13.7% or something, I think, year to date. And that's a pretty good number for the rest of the year.

---

**Michael Van Aelst** - *TD Newcrest - Analyst*

Great. Thank you.

---

**Operator**

Jim Durran, National Bank Financial.

---

**Jim Durran** - *National Bank Financial - Analyst*

Allan, I just want to go back to deflation. Can you give us some idea as to what's going on with the deflation? Is it largely Safeway and Wal-Mart lowering prices in western Canada? Or is it broader than that? And what's the driver to the incremental lift as we move from Q1 to Q2 and now into Q3?

---

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

Well, you've got two-- a number of factors in play. One thing, clearly, we're cycling inflation a year ago. So you get a cycle effect. And that plays some role in it. It's very aggressive anyway. The markets are pretty aggressive. And generally, therefore, prices are coming down. And that is a driver of that. And I think, as I said in the last quarter, it is-- no matter what you read in the newspapers, most of the food customer base in Canada is much more value-conscious and price-conscious than they were 12 or 18 months to two years ago. So it's a bit of this is now what the markets are like. And they are the three things that are driving that.

And, as I say, we were much deeper deflated in Q2 than Q1 and exited the quarter with even deeper deflation. And it is very difficult to predict when inflation will return to the market. There will be a cycling effect that that's really in Q4. But I think that there is a bit of-- some of the fundamentals have changed. And what customers want has changed slightly too. And, therefore, I think pricing has become much more acute and will become much more acute in the minds of the Canadian consumer.

**Jim Durran** - *National Bank Financial - Analyst*

Okay. With respect to Quebec, you started to deploy sort of your change in banner strategy there. Can you give us some update as to how far along you feel you are now and what kind of results you're getting?

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

We're sort of moving on. We've had a lot of-- As I mentioned last time, there's been a lot of focus on Maxi and Maxi & Co. in this quarter. There's been a lot of work taking place there in terms of product and fixtures and ranging and, to a degree, pricing and a lot of focus on fresh food and training on fresh food.

We converted another one of the Provigos to a local Marche de Ville. Those numbers are quite encouraging. And we've converted another couple of Maxi & Cos. So is just really, I'd say, work in progress. But, as I outlined last period-- the last quarter, we've got a pretty comprehensive plan there that really works us through up until about week 44 or 45 of this year in Quebec. It's a sustained, longer program than we've done in the past.

**Jim Durran** - *National Bank Financial - Analyst*

If you were to compare Maxi to nofrills and sort of index them on sales productivity, how would that compare?

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

Maxi would have lower sales productivity than nofrills, and that's the opportunity.

**Jim Durran** - *National Bank Financial - Analyst*

Okay. And then just the last question is talking about the DC changes. As you sort of sit here today, I think you've said that you've finished the physical plant changes in terms of capacity improvement and productivity improvement. You're now still rolling out some of the software, but you're largely, I guess, almost done there. What are the next big steps on the supply chain, aside from IT?

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

Well, on IT, we're pretty much there on TMS. They've still got a lot of work to do on WMS. We're about, I'd say, two-thirds through on TMS and a third through on WMS. So there is probably another six to nine months of IT work, but it's the sort of finishing off.

We've still got a couple of depots that we're working on in terms of renovation. And we've got our new Regina depot, which will open next year. So there's quite a bit of work still to be done in terms of the physical structure. But it's work that's decided. It just needs to come through.

The next big stage for the supply chain is to move to flow. I mean, the whole idea between-- on this whole SAP supply chain 2010 infrastructure program is to get the DCs to flow and to get the stores to PI. That's the objective because both those two things are the things that will have the most dramatic impact on the business. So we will start to-- We've already started piloting in a small way. But we will move much more to flow next year, which is the major next stage in the supply chain.

**Jim Durran** - *National Bank Financial - Analyst*

And so when would you expect any significant reduction in inventory you have to carry? Is that a late 2011/early 2012--?

---

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

Yes. I think so. Our inventory is down. We're managing our inventory much better than we've done in the past. Inventory is down both at retail and in the DCs. But there is an opportunity, clearly, to bring that inventory down more. And that's what flow's designed to do. If you look at the inventory levels that we would carry compared to some of our international peers, even if you adjust for the fact that Canada is a large country, but it is centered around six cities, then there's a real opportunity to reduce our inventory. And that comes largely driven by flow.

---

**Jim Durran** - *National Bank Financial - Analyst*

Great. Thanks very much.

---

**Operator**

Peter Sklar, BMO Capital Markets.

---

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

I think you pretty well covered it all. I just had a couple of just quick follow-up questions. On the CAD185 million, I noticed in your disclosure that you related one particular expense or charge related to your Quebec-- I believe it was your Quebec distribution network. Is that highlighted because it's in excess of the CAD185 million? Or is that part of the CAD185 million?

---

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

No. It's part of the CAD185 million. In our thinking of the CAD185 million, we've always included, remember, supply chain and IT. And that includes sort of network transition costs, which is what we would-- That's what, in essence, that is.

---

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

And what is the significance of those costs that you chose to highlight them?

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

The only reason we highlighted it is because, when we did say that we were closing the Quebec City DC, we said we'd take a charge of approximately CAD30 million to CAD40 million. So, really, what that included was the CAD23 million impairment cost that you see that we've booked and the CAD16 million of costs that were part of the CAD185 million.

---

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

(Inaudible) the answer.

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

That's right.

---

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

Okay. I understand. And just lastly, Sarah, I noticed that your tax rate is kind of ticking a little bit lower here. Can you talk a little bit about how the tax rate is unfolding and what the outlook is?

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

The tax rate for the quarter was around 29.3%. And, year to date, we're at 29.9%; so, around 30%. It does move around. There's nothing actually specific in the quarter. It varies by where the income-- what jurisdiction the income is earned. But I would say a good-- We've often said 32%. I think 31% is probably a better guess for the rest of the year.

---

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

And, going forward in 2011? Can you comment directionally where you expect the tax rate?

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

I would leave it at 31%.

---

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

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

---

**Operator**

Winston Lee, Credit Suisse.

---

**Winston Lee** - *Credit Suisse - Analyst*

I wanted to just clarify on the IT. There were CAD16 million with regard to severance there. Is that part--? Was there CAD12 million of that in the P&L this quarter?

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

All CAD16 million is in the P&L.

---

**Winston Lee** - *Credit Suisse - Analyst*

Okay. Thank you. And, with regard to the pharmacy rollouts, I'm hearing nofrills, for the most part--

---

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

I wouldn't hear nofrills is the most part, since that's the first one that we've done to test how you put them in and how they work. So I wouldn't read nofrills into that.

---

**Winston Lee** - *Credit Suisse - Analyst*

Okay. So how shall we kind of think about that? And, Allan, did you say that-- I mean, is it going to be across more than just nofrills? Is it going to be--? Well, you have them in your Real Canadian Superstores. But in some of your conventional stores in Ontario--

---

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

It's where we don't have pharmacies is the idea. The number-one thing is, where we don't have pharmacies because we don't have space, this is a smaller footprint which enables us to put the same pharmacy service that we would normally give, but we can put it into the smaller stores in a way that we've not been able to do before. So it's across-- It would be across nofrills and our other conventionals that do not have pharmacies in them across the country.

---

**Winston Lee** - *Credit Suisse - Analyst*

So, just to clarify, did you say that there was an ultimate potential there of 200, or did I mishear that?

---

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

About 200. Yes.

---

**Winston Lee** - *Credit Suisse - Analyst*

200. Okay. And 200 across the country.

---

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

Yes.

---

**Winston Lee** - *Credit Suisse - Analyst*

Okay. And could you tell us what percentage of your stores right now--? Well, maybe switching this a little bit-- sorry. General merchandise and control label fueled some of the growth in the margin. And, when you look at that, is that going to be more fuel for you in terms of investing in price to keep [it sharp] there for the consumer? Do you expect that level to kind of be the same as we saw in this quarter or to intensify?

---

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

Let's not talk about levels but talk about the principle. The whole principle of control brand should always be more profitable than national brand and hasn't been. And, therefore, the fact that we're doing that creates a small margin either to take to the bottom line or to invest in driving those businesses. And it will be a combination of those two as far as control brand is concerns.

Exactly the same-- The idea of selling GM in food stores is to make a higher margin on the GM than you would on the core foods. And, therefore, it becomes additive. Our problem has been and the problem of lots of people who do this is that the reverse happens because most of the product you spend clearing. So you end up making less money than you do--on general merchandise than you do on food.

And what you're beginning to see in our business is the structural-- the structure of our P&L beginning to take shape the way that the structure of our P&L should be, with some elements of that being able to contribute a higher margin. And then that gives you the firepower to invest in more pricing if that's what you choose to do.

---

**Winston Lee** - *Credit Suisse - Analyst*

Great. On the control label, it sounds like you're more optimistic there than you were in the past quarters. I think in the past quarters you had given us a level where you thought control label would be in terms of being at par with what you want it to do. I didn't think it was quite high. But can you give us a sense as to where that is right now?

---

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

I think we're not quite halfway there.

---

**Winston Lee** - *Credit Suisse - Analyst*

Okay. And my last question is on the cash flow from operations. It was down year over year. And it looked like a lot of that was due to lower increase in the noncash working capital. Can you help us understand why it went down? It seems like payables went up quite a bit in accrued liabilities. Was there something there that you're providing for that's kind of one-time or really specific for this quarter? How should we think about cash flow from operations that are lower when your earnings are higher?

---

**Sarah Davis** - *Loblaw Companies Limited - CFO*

Okay. It's really the one-time happened last year, where we did-- initiated some payment term changes, and we increased our payables to a higher level last year and tried to reduce our inventory at the same time. This year, we have seen improvements primarily through reductions in inventory, and our payables are staying at about the same level. So I would say, going forward, our payables we're quite happy with. The inventory we continue to work on in order to bring it down.

---

**Winston Lee** - *Credit Suisse - Analyst*

Okay. That's great. Thank you.

---

**Operator**

Keith Howlett, Desjardins Securities.

---

**Keith Howlett** - *Desjardins Securities - Analyst*

Yes. I had a question on the general merchandise assortments. You've been editing those. So I was wondering how far along you are in that process. And then how many of your stores have the assortment that you want in terms of general merchandise, ex Joe?

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

Well, across the whole piece, none of them have yet got all of the assortment that we want for general merchandise. There are bits of it coming in. I think you'll see the biggest-- the real breakthrough will be in Q4 because these things have got 12-month lead times attached to them. And say Joe's been busily editing, re-spacing, and buying in a different way for a different product group. And I think you'll really see that coming through in the ranges in Q4.

**Keith Howlett** - *Desjardins Securities - Analyst*

And, in the release, it mentions that Joe is up strongly-- or apparel is up strongly, and the other general merchandise is down significantly. Does that mostly reflect a space shift or, as well, sort of strong same-store sales performance?

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

Joe is just doing incredibly well. As I said before, it's got-- By the end, it will have 10% more footage (inaudible). A lot of that's going in in the Superstores and conventional stores as we speak. So most of that Joe growth is comp-store growth is the way to think about it.

General merchandise sales-- I'm not particularly troubled by the fact that they are down. They tend to be down across the industry. In terms of market share, we're not doing too badly. And it's very easy to have a lot of general merchandise sales and no general merchandise profit. And we're just trying to make sure that that balance is redressed.

**Keith Howlett** - *Desjardins Securities - Analyst*

And, in terms of the [20 Joe-- or potentially 20 Joe, I guess, high street or stores], is that--? Obviously, you want to make money on it. But is that more a brand profiling, or what is the strategy there?

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

We don't do anything for brand profiling. We do everything to make money. And so, therefore, all of these stores will make money. We have a pretty good-- We got the studio stores, as you know. They perform at a significantly higher sales entity and level of profitability. And our modeling expects these to be the same. So this is two things. Clearly, it helps the branding. But, importantly, they're there to make more money, and that's what they'll do.

**Keith Howlett** - *Desjardins Securities - Analyst*

And just perhaps-- I'm not sure perhaps-- I haven't actually been to the Loblaw Marche de Ville. Is that sort of an urban format that might come to other parts of Canada?

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

It's a very good urban format. And that's what it's designed to be. There's clearly learning from that. And, as over the next couple of years we begin to lay out for you where our footage acceleration will come, it may well feature in that program.

**Keith Howlett** - *Desjardins Securities - Analyst*

Just in terms of the T&T acquisition, I guess if you could speak how it's going relative to expectation at time of acquisition and whether you're starting to bring the product benefits into your other stores--

---

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

Yes. We're very pleased with it. It's almost exactly on where we expect it to be from where we started in terms of acquisition. As you know, our intention is to double up the size of that. We've got some very good sites in the bank that will enable us to start to do that. We've gone one or, possibly, two stores that will open this year. And then we've got the top 50 selling T&T lines in the majority of our ethnic-facing stores now.

---

**Keith Howlett** - *Desjardins Securities - Analyst*

Great. And then just maybe finally, on the nofrills, you're now in Saskatchewan and BC, Alberta, New Brunswick. Do you find the economics of the store pretty much the same in all markets?

---

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

They actually look slightly better in those other markets. But, generally, the idea with nofrills is to a sentiment on economics that are consistent across the country. I will tell you that we're biased. I think it's probably the most potent format there is around at the moment. And every time we expand it, whether it be to the west or to the Atlantic, it's incredibly well received by customers. I mean it's clearly the format both for the moment and for the future.

---

**Keith Howlett** - *Desjardins Securities - Analyst*

Thanks very much.

---

**Operator**

Patricia Baker.

---

**Patricia Baker** - *Scotia Capital - Analyst*

Sorry to have follow-ups, Allan. But, with respect to the discussion around the renovating of the stores, and I fully understand how that impact sales-- and I should really know the answer to this, but I'm going to ask you anyway. Where are we--? When did you start those heavy renovations, so that we can just try to figure out the lag between when we move out of that and we start to see the pickup in the sales coming from the renovations actually hitting the top line?

---

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

Well, we've really been-- We've probably been on them for six months.

---

**Patricia Baker** - *Scotia Capital - Analyst*

Okay.

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

But the big slug of the renos is actually-- we're right in the midst of it now. And we will be in Q3. This-- Q2 was quite big. Q3 is even bigger. And so the bulk of the program has really been Q2 and Q3 and a bit of end of Q3 of last year. But they're major-- We'll have 60 projects out there at the moment.

**Patricia Baker** - *Scotia Capital - Analyst*

Okay. So, by the time we get to Q4, it will start to level off.

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

Yes, because we try not do so much work--

**Patricia Baker** - *Scotia Capital - Analyst*

-- in that critical quarter.

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

-- in that critical quarter. Yes.

**Patricia Baker** - *Scotia Capital - Analyst*

Okay. And, if I may ask one more drug store question, even though it's a small amount of space that you'll be putting into these stores, what are you taking out to put that space in?

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

Generally, we adjust it a bit. We've taken-- There's a minor-- If you go to Erin Mills (inaudible). We took a bit of grocery out, and-- Well, we took a bit of space from grocery, and we took a bit of space from some of the other (inaudible) products because we've been-- you'll see if you go to Erin Mills we've been able to merchandise those products around and inside the pharmacy.

**Patricia Baker** - *Scotia Capital - Analyst*

Okay. And where you've taken out of grocery, have you taken out categories or just narrowed the categories?

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

We've taken a few SKUs out basically.

**Patricia Baker** - *Scotia Capital - Analyst*

Okay. Thank you.

**Operator**

(Operator instructions). Chris Li, Bank of America.

**Chris Li** - *Bank of America - Analyst*

I'm just wondering if you can tell us, of the CAD41 million of incremental investment in the IT and supply chain system, how much of that was seen in the increase in the depreciation line for the quarter?

**Sarah Davis** - *Loblaw Companies Limited - CFO*

We haven't actually been providing the split. So, basically, what we're saying is it's CAD185 million for the year. And the CAD41 million for the quarter includes both. And then I've just specified that a 13% increase in depreciation for the year in the remaining two quarters is a pretty good guess. So that's the guidance we'll give you.

**Chris Li** - *Bank of America - Analyst*

Okay. So, is it fair to assume the majority of the increase in depreciation was related to that?

**Sarah Davis** - *Loblaw Companies Limited - CFO*

Well, there's all the store renovations, as well, that Allan was talking about that have been happening for the last year as well. So that would be part of it as well.

**Chris Li** - *Bank of America - Analyst*

Okay. And, Allan, just to follow up on an earlier question on price competition, as you know, Sobeys last month sort of alluded to the fact that western Canada was seeing a bit more price competition. But it sounds like from your answer earlier that the price competition is a bit more broad-based. Is that a fair assumption?

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

It is. I can't think of a market where that isn't the case. We are-- Western Canada-- (inaudible) because we have the lowest price format in RCSS by some way versus the other formats. So I think there's a lot of trying to catch up with us. But the whole-- There's price aggression, really, across the whole marketplace. A lot of that is flyer driven. But you can also start to even see that on the shelf a bit as well.

**Chris Li** - *Bank of America - Analyst*

Okay. And just on the general merchandise sales, in the press release for this quarter, you mentioned again it was the reduction in assortment and square footage was the drivers for the lower GM spending. But last quarter you also mentioned lower discretionary spending. But that wasn't mentioned this quarter. Does that mean you've seen maybe some improving trends in the discretionary spending?

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

No. I mean, it is none at all. It's very much as it's been. As I say, the one thing that is clear is that Canadian consumers view on price has become more paramount, no matter where they shop, no matter what type of business.

---

**Chris Li** - *Bank of America - Analyst*

Okay, so no meaningful changes.

---

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

No.

---

**Chris Li** - *Bank of America - Analyst*

Okay. Thanks very much.

---

**Operator**

There are no further questions at this time.

---

**Kim Lee** - *Loblaw Companies Limited - Senior Director IR*

Thank you for joining us this morning. We appreciate your interest in Loblaw Companies. Thanks, and have a great day. Goodbye.

---

**Operator**

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

---