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EDITED TRANSCRIPT

L.TO - Q2 2015 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 2Q15 adjusted net earnings attributable to shareholders of CAD350m and adjusted basic net EPS of CAD0.85.

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CORPORATE PARTICIPANTS

Sophia Bisoukis *Loblaw Companies Ltd - IR*

Richard Dufresne *Loblaw Companies Ltd - CFO*

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

CONFERENCE CALL PARTICIPANTS

Irene Nattel *RBC Capital Markets - Analyst*

Perry Caicco *CIBC World Markets - Analyst*

Jim Durran *Barclays Capital - Analyst*

Patricia Baker *Scotiabank - Analyst*

Michael Van Aelst *TD Securities - Analyst*

Peter Sklar *BMO Capital Markets - Analyst*

Vishal Shreedhar *National Bank Financial - Analyst*

David Hartley *Credit Suisse - Analyst*

Chris Li *BofA Merrill Lynch - Analyst*

Keith Howlett *Desjardins Securities - Analyst*

PRESENTATION

Operator

Good morning. My name is Michelle and I will be your conference operator today. As a reminder, today's conference is being recorded. At this time, I would like to welcome everyone to the Loblaw Companies Limited second quarter 2015 conference call.

(Operator Instructions)

I'll now turn the conference over to Sophia Bisoukis. Please go ahead.

Sophia Bisoukis - *Loblaw Companies Ltd - IR*

Thanks, Michelle, and good morning. Welcome to the Loblaw Companies Limited second quarter 2015 results conference call. I am joined today by Galen Weston, President and Executive Chairman, and Richard Dufresne, Chief Financial Officer.

Before we begin today's call, I want to remind you that the discussions will include forward-looking statements, such as the Company's beliefs and expectations regarding certain aspects of the financial performance in 2015 and future years. These statements are based on certain assumptions and reflect Management's current expectations and they are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from our expectations. These risks and uncertainties are discussed in the Company's materials filed with the Canadian regulators from time to time.

Any forward-looking statements speak only as of the date they are made. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than what is required by law.

Certain non-GAAP financial measures may be discussed or referred to today. Please refer to our annual report and other materials filed with the Canadian securities regulators for reconciliation of these measures to the most recent directly comparable GAAP financial measures.

I will now turn the call over to Richard.

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Thank you, Sophia, and good morning, everyone. In Q2, we continued to deliver against our financial plan and we are pleased with the progress we are making.

We maintained a stable trading environment, with positive same-store sales and a stable gross margin. We delivered efficiencies in our Food Retail SG&A of about 20 basis points, synergies are on track and deleveraging should be completed this year.

As we continue to advance our strategy, it becomes more difficult and less relevant to distinguish or allocate expenses and investments between Shoppers Drug Mart and the rest of our business. You have noticed that we are reporting our financial results on a total retail basis. That said, we will continue to provide color in key metrics, such as same-store sales, both the Food and Drug retail businesses going forward.

Today, we announced a restructuring plan related to the closure of 52 of the Company's retail stores across a range of our banners and formats. In the year following the acquisition of Shoppers Drug Mart, we completed a financial review across our network of more than 2,300 stores and have made a decision to close 52 underperforming stores. The closures include the previously announced Joe Fresh locations, plus grocery stores in both our Market and Discount divisions, drug stores and several gas bars. The store closures will all be completed before the end of the first quarter of 2016.

The restructuring charges associated with these closures are expected to total approximately CAD120 million, of which CAD45 million was recorded in Q2 with the majority of the remaining amount in Q3. The total cash cost is estimated at CAD93 million, which will be incurred in the next few quarters. The affected stores represent approximately CAD300 million in annual revenue, but will generate an improvement of CAD35 million to CAD40 million in annual operating income. On a net basis, Choice Properties will not be impacted.

Turning to our Retail results. Total Food Retail same-store sales grew by 4.2% in the quarter, excluding gas and tobacco. Both our Market and Discount divisions had solid comp growth.

Our internal inflation was higher than food CPI of 3.9%. Inflation continues to be driven by meat and produce, with rates moderating as we lap high inflation periods. Inflation in grocery continued in Q2.

Positive trends for same-store sales in Drug Retail continued with total comp sales of 3.8%. Pharmacy same-store sales grew 3.9%, with moderating deflation in average script value and market share growth. Prescription count increased by 4.3%.

Front of store same-store sales grew 3.7%, led by growth in OTC, health and beauty, food, confection, with higher traffic. With positive same-store sales growth in both Food and in Drug Retail, total revenue in our Retail segment was CAD10.3 billion, up 2.2% year-over-year.

As reported, our Total Retail gross margin was 26.4%, up 10 basis points from last year. Excluding the impact of changes in our franchise fee arrangements, total retail gross margin improved by 40 basis points. As a reminder, changes from restructuring certain franchisee arrangements in 2015 resulted in a reduction in both revenue and SG&A, with no impact on earnings.

After excluding the negative impact from this change, Food Retail adjusted gross margin increased by 20 basis points, as higher retail margins, lower transportation costs, and synergies were partially offset by higher shrink. In our Drug Retail business, gross margin grew 90 basis points, driven by synergies.

Turning to expenses. As reported, our Total Retail SG&A rate was 18.5%, 30 basis points better than last year, but flat after excluding the impact of the change in franchise fee arrangements.

In Rood Retail, we achieved 20 basis points of efficiencies across supply chain, admin and IT. Excluding the impact of the change in franchise fee arrangements, Food Retail SG&A improved by 30 basis points, driven by efficiencies and other factors.

I'm pleased to report that we delivered CAD53 million in net synergies in the second quarter. To date, we have focused primarily on cost-of-goods-sold wins. In the second half of 2015, GNFR and a focus on investments in revenue initiatives will set us up for success in achieving our 2016 synergies target.

Our adjusted interest expense was CAD131 million in the second quarter and our full-year guidance on interest has declined to approximately CAD560 million, as rates and our level of indebtedness decreases. Adjusted net earnings attributable to shareholders increased 17.8% to CAD350 million, and adjusted basic net earnings per share increased by CAD0.11 to CAD0.85 in the second quarter.

We generated free cash flow of CAD589 million in the quarter.

CapEx this quarter were CAD221 million, a decrease of CAD18 million compared to the same quarter last year.

Since the close of the acquisition of Shoppers Drug Mart, we have reduced our adjusted debt by CAD1.35 billion. With the progress achieved to date, we are in a position to achieve our deleveraging target in 2015.

Looking to the second half of 2015, we do not expect growth in earnings to be at the same level as in the first half of the year. Expected headwinds from both known and unknown healthcare reforms, increased labor costs, and cycling of last year's strong synergy performance will reduce year-over-year growth in earnings in the second half.

We continue to remain confident in our strategy, business performance and financial plan. Thank you. I will now turn over the call to Galen.

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

Thank you, Richard, and good morning, everyone. As you just heard, Loblaw has posted strong results for the second quarter of 2015. We continue to execute well against our financial plan. We are maintaining a stable trading platform, synergies are in line with expectations, efficiencies are on track, and our deleveraging target will be achieved in 2015.

Same-store sales growth in our Food Retail division remained strong amid intense competition; and we remain pleased with our tonnage performance, reflecting growth in both traffic and basket.

In Drug Retail, same-store sales performance was also strong, driven both by pharmacy and front of store. Script growth more than offset the effect of deflation in pharmacy and we continued to see strength in OTC, Health and Beauty, Food and Confection.

Against the backdrop of provincial healthcare budget cuts, our pharmacy business will continue to face pressures. We are working as collaboratively as possible with governments to identify innovative services that can both reduce cost and improve patient outcomes.

Our business remains focused on the strategic framework that has supported our progress over the last year, providing the best in food experience, best in health and beauty, operational excellence and growth. In doing so, we continue to deliver on our purpose, to help Canadians Live Life Well.

For example, through our PC Plus loyalty app, over 9 million Canadians now have access to the nutritional value of their personal grocery baskets. They can get Guiding Stars nutritional rankings on more than 50,000 products and track the nutritional history of their food purchases over time. We begin by helping educate customers about healthier products, and ultimately will reward them for making healthier choices.

Customers are at the heart of our strategic framework. In the second quarter, we launched My Optimum, a fully digital, one-to-one customer-centric version of the Optimum loyalty program. As of today, over 700,000 Optimum members have been registered for the digital Optimum account that enables them to load and redeem personalized digital offers directly on their Optimum card.

As we continue to invest significantly to serve our customers with the best possible products, services and stores, we also actively monitor our underperforming assets and made the difficult decision to close the 52 stores that Richard mentioned. I am pleased to note that despite these closures we will still grow our network in the year.

Looking forward, I am confident that as we build our portfolio of strong, complementary, but independent businesses, along with a balanced capital return strategy, we will continue to accrue long-term value for shareholders.

Sophia Bisoukis - *Loblaw Companies Ltd - IR*

Michelle, you can begin with those questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Irene Nattel, RBC.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks and good morning, everyone. If we could just focus for a moment on the synergies.

In your outlook, you say that synergies this year will quote-unquote slightly exceed your prior target, or the target of CAD200 million. And you're at CAD198 million cumulative run rate at this point in time. So is this a timing issue in terms of the slightly exceed, or do you now see opportunities to upsize the entire synergy target perhaps?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Hello, Irene. There is math at play here, because if you look at the amount of synergies we booked last year in Q2 and Q3 -- in Q3 and Q4, sorry -- those amounts were significant. So while we're expecting to continue to add to the synergy bucket, the dollar, the incremental dollars will become lower going forward. So we're not thinking of increasing the size of the opportunity, but it's probably happening a little bit faster than we thought.

Irene Nattel - *RBC Capital Markets - Analyst*

Okay. That's great. Thank you.

And just on the underperforming store closures, very interesting. Is this a reflection of an increasing focus on returns and returns on capital within the organization? And should we be thinking, or is this something that you're really focused on, on a go forward basis?

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

Yes, I think that's fair. I think that's a fair reflection.

We've always felt that we were pretty disciplined in terms of the way we invested capital. Certainly, when you have a big debt load like we do and your growth is not as significant as perhaps it has been in previous periods in the Company's history, really getting better at managing capital efficiency, making sure that you don't have inefficient assets in the business is something that Richard and I are endeavoring to do. And this is certainly the reason that the number of stores that we're closing in this particular restructuring is as it is.

But it is worth keeping in mind, we would, as part of the normal course, close somewhere between 10 and 15 stores every year. So yes, it's an increase in the normal course, but it's not radically different. And it doesn't signal any kind of change, from a strategic perspective, in any of our businesses. And we continue to plan to invest and grow in our network.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. And if I could just add that one final question, please.

You noted that there was a strong same-store sales growth across both the discount and market divisions. Can you talk a little bit about consumer behavior and whether you are continuing to see a slowing of traffic shift from discount to market?

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

No. Both businesses are performing at a fairly similar level. Both businesses are generating traffic at a similar level. So we're watching carefully to see if there's a shift towards discount that might take place as a result of this deteriorating economic circumstance in Canada.

But as I've mentioned before, there is this additional force out there, which is the lifestyle change that people are attributing to food, buying more fresh, very interested in higher quality product. We're seeing meat, beef prices at all-time highs at the moment. We're not able to pass through the full extent of the inflation that we're seeing on the cost side.

But actually tonnage is continuing to grow. And that, we think, is because people are choosing to trade up when they have a little bit of money and they are choosing to buy a steak. So it's not -- things are not unfolding in the typical way at the moment. That's not to say they won't. But we'll let you know if we see a meaningful change.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you.

Operator

Perry Caicco, CIBC World Markets.

Perry Caicco - *CIBC World Markets - Analyst*

Thanks. Can we get just a little more data on the store closures, perhaps the mix between drugstores and food stores, and the square footage that might be coming out, and perhaps even the geographical split?

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

You're asking for a lot of information there, Perry. And there's a number of reasons that we haven't disclosed that, one of the most significant being that we have not yet communicated to the stores that will be affected. And that is actually going to happen over a period of the next couple of quarters. So we really don't feel comfortable giving you a lot of detail.

I think the message that we've tried to communicate is this includes drugstores, it includes food stores, it includes Joe Fresh stores, and it includes some of the stores from our emerging business division. And it's pretty well distributed across the country.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. Sorry?

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

I was just going to say, from a square footage impact perspective, it's somewhere in the range of 1%, if you averaged over the course of the two years. And so we'll still grow net square footage in our network through 2015.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. Just over the same-store sales for a minute. If we take out inflation, what was the performance on basket size, traffic and tonnage? And maybe you could talk a little about where you're at in terms of tonnage market share.

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

We look at, we watch that carefully. And you guys do a calculation, CPI versus same-store sales growth, to determine tonnage. We were a little bit behind in previous quarters. We are a little bit ahead in this quarter.

But in terms of the stable trading bands that we consider operating in, we're running exactly on track with where we would expect. You don't get too fussed if we're up in one quarter or down in one quarter. We think about it over time. And on balance, we're seeing our sales in a tonnage share flattish area over the last three or four quarters, and that's exactly where we'd like to be.

Perry Caicco - *CIBC World Markets - Analyst*

And how does that mesh with what appears to be a shift from center store goods to fresh goods?

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

Yes, it stacks. We may be doing a little bit better from a total tonnage perspective than otherwise, because of that shift. We're seeing strong performance in some categories that aren't actually picked up in the Nielsen market share measurement that we use.

But it is important to note from our release that we are beginning to see inflation in grocery, and that's driven by this continuing deterioration in the value of the Canadian dollar. And over time, that pushes cost pressure from the big US CPG companies. We're finding that we can pass through some of it. We're not able to pass through all of it, but that does help offset the slowdown in inflation that we're seeing in fresh.

Perry Caicco - *CIBC World Markets - Analyst*

And just one last question. You've been aggressively renovating conventional stores. I'm just wondering what the next steps are in that program, and what have you learned and adjusted along the way?

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

We continue to feel very good about our Inspire program, specifically in Ontario. Although we're also pretty pleased with the way it's performing in Quebec.

Probably the big highlight, we don't usually talk about the regional performance, but we've done a number of conversions to YIG in Western Canada and they are really performing well, as well. What do we watch? We watch that we don't spend too much capital in those Inspire stores. And we're continuing to get more efficient with that program as we move it forward.

Perry Caicco - *CIBC World Markets - Analyst*

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

Operator

Jim Durran, Barclays.

Jim Durran - *Barclays Capital - Analyst*

Thank you. Going back to your guidance and the outlook, as you noted, very strong first half and you had cautioned us about second half, in terms of a number of moving parts. But despite some slight earnings beats and despite synergies coming in stronger than expected, the guidance for the full year really hasn't changed much. So can you help us understand what is causing this more caution or you've seen unfold that caused you to feel more concerned about the second half than you might have originally?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Hello, Jim. As I mentioned in my remarks, I guess when we did our budget at the beginning of the year, we were budgeting some drug reform that was mostly affecting the second half of the year. And as the year progressed, we started to hear that there will be more.

We're not able to quantify it yet, like we've yet to hear. But that's going to be on top of what we had budgeted. We also had budgeted some labor cost increase associated with the labor negotiations that happened in June. So that was also budgeted.

But also, just pure math, if you look at the growth in our earnings is largely driven by synergies. And if you look at the impact of synergies in Q3 and Q4, the incremental dollars are going to be less than what we've been experiencing since the last five quarters. So therefore, if you factor all of that together, that's how we can safely say that our growth in earnings in the second half is going to be lower than the first half.

Jim Durran - *Barclays Capital - Analyst*

And is there anything on drug reform that you can share with us in terms of what you see unfolding in Ontario and Quebec?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Right now we don't have the details. We have a rough number. But even for ourselves, I'm not putting that on paper anywhere, because we're not sure. So we need to hear the details to understand exactly what it is.

But it's going to probably begin in Q3, and it's probably going to be fully felt in Q4. And by the way, our outlook discussions are on a 52-week equivalent basis, by the way.

Jim Durran - *Barclays Capital - Analyst*

Duly noted. Last question, just on store closures. Joe Fresh was mentioned.

Is this Canada only or is this Canada and US? What's the mix there?

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

It's consistent with what we mentioned previously, which was store closures specifically in the US. There's a couple in that list that would reach into Canada, but it's not a material change to the Joe Fresh apparel network in this country.

Jim Durran - *Barclays Capital - Analyst*

So is that to be seen then as a potential pulling out of the US for Joe Fresh?

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

No.

Jim Durran - *Barclays Capital - Analyst*

Okay. Thank you. I appreciate that.

Operator

Patricia Baker, Scotiabank.

Patricia Baker - *Scotiabank - Analyst*

Good morning. Thank you for taking my questions.

Just want to come back to the discussion you had with Perry and I think it was you, Galen, gave a reference on the square footage being around 1%. I guess from my perspective, anyway, what I really care about is the square footage that's coming out of the food market in Canada. So is that 1% the entire 52 stores, and what would Food look like?

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Richard Dufresne - *Loblaw Companies Ltd - CFO*

Like I said, you can imagine, Patricia, our bigger square footage are in Food, so the bulk of that would be, in square footage, I'd say, would be in Food.

Patricia Baker - *Scotiabank - Analyst*

Okay. Excellent.

Then sticking with Food, but moving to a different banner. We look at -- you've had -- I'm not talking about your fresh food test, but just the performance of the food items and putting the PC private label into Shoppers and switching up that part of the store, has that been accretive to comps quarter-over-quarter?

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

It has marginally, although it is showing -- in Shoppers front of store -- although it is showing a tremendous promise. And we're still in that transition period. We're coming to the end of that transition period.

And the best way I can describe it is first you have to migrate a Simply Food branded product to a President's Choice branded product. You have to get it into the stores, then you have to determine what the sales trajectory is likely to be, and then you have to order for that sales trajectory, and then you have to start to promote.

What's been happening to us through the first part of this year is that when we bring the President's Choice and no name branded product into these categories, it tends to perform significantly better than we anticipated and so we're burning out of stock very quickly. And then we have to go through what is quite a long order cycle to get that product in, in the right way.

So it is a focus of ours. We think it's going to be a very nice part of incremental sales momentum for the Food business at Shoppers, helpful to margin, as well.

Most importantly, we're getting such a positive response from our customers. They are really delighted to have access to this stuff in Shoppers now.

Patricia Baker - *Scotiabank - Analyst*

That's useful, Galen. Now I'm assuming, from what you talked about and your use of the word promise, that sometime in FY16 you have a better sense of that balance and the ordering and keeping the availability on the shelf. Is that fair?

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

I'd say we're well on our way now. It has been a little internal source of frustration for us for the last number of months. So there is quite a bit of focus. And we feel a lot better now.

Patricia Baker - *Scotiabank - Analyst*

Okay. And thirdly, if I may, the discussion around center of store, and you indicated that you're getting some inflation there. Where are we really with the CPG companies? Have they really taken the pricing that you would have expected associated with the dollar, or you think that's to come some time in the back half?

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

Well, remember, a lot of this stuff gets negotiated, cost of goods get negotiated at the beginning of the year. You obviously have inter-year cost increases. We focus very, very hard on what's real cost inflation versus straight up US dollars.

It's not up to us as retailers to help cover the dollar deflation for the US CPG companies. So these are tough conversations. But where there are credible reasons to take cost increases, we're certainly open to that, and that is starting to happen and it's showing up.

I think the most important point here is that it's nowhere near the kind of inflation that we've been seeing on the fresh foods side and we're not able to pass through the full amount. So it's helpful in the way inflation is for retail, but not as much as one might think.

Patricia Baker - *Scotiabank - Analyst*

Thank you so much for that. I'll pass it on to someone else now.

Operator

Michael Van Aelst, TD Securities.

Michael Van Aelst - *TD Securities - Analyst*

Thank you. I just wanted to touch on the loyalty card, the PC Plus program, and you're getting up to almost 10 million members. That's pretty incredible in such a short period of time. You're almost at where Shoppers is.

Can you talk about the impact it's having on the basket and traffic, and maybe on your ability to redirect more of your budget towards one-to-one promotions rather than flyer promotions?

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

Yes. So we're building this muscle quickly. I think one of the consequences of the program growing so fast is that it's got a bigger impact on the way that we try and run the business, and I'd say we're not yet experts at it.

But we are seeing really encouraging numbers, the numbers that you would expect coming from a loyalty program. We are seeing a higher level of loyalty, an increase in the number of shopping trips from the people who are highly engaged in the program. We are seeing disproportionately high adoption rates on the customized coupons.

This is something that is very attractive as we market it to the vendors who help support the value of the coupons. So we are very, very optimistic about the role that this customized program is going to play in increasing the amount of promotional spend through loyalty.

So it's different for our merchants, and I think they are probably not as confident, at the moment, as they will be in coming months in migrating dollars from a straight up flyer into this loyalty program But we are seeing really strong signs of success.

By the way, it's incredibly helpful for us that we now have Shoppers Drug Mart in the family, because they have a much higher level of conviction around the ultimate impact. And they're actually already seeing it with the launch of My Rewards on Optimum. They're seeing coupon redemption rates through the digital format about 50% higher than what they would have been seeing on the printed version, and that's really very much in line with expectations.

Michael Van Aelst - *TD Securities - Analyst*

Okay. Great. And separately, on the synergies, to get from the almost CAD200 million level to the CAD300 million level by the end of year three, can you talk about the big buckets remaining to get there?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Like I said, as we mentioned, Michael, GNFR is in full stride now. So that's going to be a bucket that's going to generate growth.

We're starting to invest in our stores. There's a program on HABBA. Obviously, there's our food offering in Shoppers that we're working on. So those are the initiatives that will help us get to that number, but where we are today, I think we can say with confidence that we should hit our target of CAD300 million by 2016.

Michael Van Aelst - *TD Securities - Analyst*

Is there anything more related to head office restructuring or supply chain or anything like that?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

We're definitely looking at our organizational structure, and that's also part of it.

Michael Van Aelst - *TD Securities - Analyst*

Thank you.

Operator

Peter Sklar, BMO Capital Markets.

Peter Sklar - *BMO Capital Markets - Analyst*

Thank you. I just want to talk about Shoppers for a minute.

In your disclosure for the quarter on Shoppers, you said that obviously the comps were strong in both the pharmacy and the front end. You indicated the gross margin was up 90 basis points, but you also indicated you'd ex'ed out synergies, that the operating income was down year-over-year.

So there seemed to be some things brewing on the SG&A line. Maybe there's certain initiatives that you're investing in that are a bit of a drag at this point. I'm just wondering if my thinking is correct on that, and if so, you could elaborate what's going on in the SG&A?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

We've been talking since the beginning of the year of our budget for Shoppers that earnings would be down year-over-year, as we mentioned. And in SG&A, for sure like some of our adherence program are in there. There are some expenses associated with Delta.

But I think as Galen mentioned in his remarks, it's clear that when you look at SG&A for Shoppers, it's a bit different than ours. It's closely linked to the growth in scripts. So that's a relationship, when you're growing the scripts at the rate that they are growing, that we need to monitor. And so therefore, that's on a revenue basis and in terms of rate, it affects SG&A. So that's what's happening on the Shoppers side.

Peter Sklar - *BMO Capital Markets - Analyst*

And sorry, Richard, the first explanation you gave, I didn't understand what you were talking about?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

I was talking about in our budget, when we were talking about some of the reasons why Shoppers would be down this year, it was the adherence program expense that we launched, I guess late last year. And we also talked about the rollout of Delta, which is our new pharmacy system which is just beginning. So those are additional expenses that are in our figures that are now falling into the bottom line.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. And just one other area I wanted to touch on. In your financial services, you mentioned that, I guess in terms of credit cards, you're spending more on loyalty, and as well, you're spending more on customer acquisition costs. You seem to be investing more into obtaining and retaining credit card holders.

I'm just wondering what that reflects? Are you trying to be more aggressive in your credit card business in terms of customer retention? Or is that just a landscape that's more competitive?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

The story on financial services, largely driven by the price of gas that happened last year. Essentially, our growth in receivables has been slowing. People have been pumping the same amount of gas in their cars, but it's been costing less.

So the amount of receivables has slowed. And so therefore, the net interest margin that you apply on that amount of receivables in dollars is falling, less dollars. And also the interchange fee drop has kicked in, in April, and so that's also affecting the top line. And therefore, I guess when you look, the revenue falling and the loyalty expense, that's affecting the results. So the bank is working hard at actions to try to mitigate these impacts and we'll see how they will fare over the next few quarters.

Peter Sklar - *BMO Capital Markets - Analyst*

Right. Okay. Thank you.

Operator

Vishal Shreedhar, National Bank.

Vishal Shreedhar - *National Bank Financial - Analyst*

Hello. Thanks for taking my questions. Just in terms of the deleveraging, you noted now will be done in 2015, does that mean we should expect share repurchases in 2015, as well? And if so, how should we model that?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Vishal, we will first finish our deleveraging and then we'll get back to you.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. And just looking forward past 2015, is 2% to 3% kind of the way we should think about the NCID program long-term?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Same answer, Vishal. Let us finish deleveraging and we will get back to you on that one.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. Just moving on into pharmacy, and you commented that there was a few unexpected changes related to drug reform that you didn't anticipate when you were making your budget. Given that these drug reforms are unpredictable at times from these governments, how do you decide when you make these investments, such as in the patient contact center or your adherence initiatives? And how do you model that to ensure that you are going to achieve your targeted return on capital assumptions?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

We do models, like on any initiative, like building a new store. So the adherence center was the same type of modeling.

In terms of drug reform, there is known drug reform that we're able to budget year in, year out. And that's the one we budgeted. But the Ontario and Quebec drug reform or health care reform, we didn't know when we did our budget. So those developments happened during that year, and so therefore, we couldn't plan for them. But that didn't change our outlook.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. In terms of -- just taking a step back, in terms of drug reform, is it becoming more unpredictable or is it relatively predictable as you go on from year to year, just in terms of how you invest, given that these changes can come seemingly from unpredicted angles?

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

Yes, I mean, look, you can imagine, we spend an extraordinary amount of time trying to anticipate, trying to forecast. Where we've had a lot of success over the last 24 months as an industry is working with the provincial health care ministries to emphasize how important and how helpful to all of us some predictability will be.

And there is a distinction. So when we say drug reform, actually the transparency and the visibility and the consistency around drug reform really has been there and there's been no surprise. What's happened in Quebec and Ontario in the last number of months has been more focused on healthcare reform. So relating to payments for services and that sort of thing, as opposed to specifically around branded and generic drugs.

So we're embarking on the same kind of conversations with the governments on predictability, transparency and so on and so forth. And I think that message is landing. I think they understand.

But they also have their own budgets to meet. And not surprisingly, these two healthcare reform changes surfaced just around budget time, as they were working to balance their books and they came after the industry, and they've done it in a number of other places, too. So we do our best.

As Richard pointed out, we're not changing our outlook. We're not revising our budget internally as a result of these things. It's our job to mitigate them, and we're doing everything we can to do that.

Vishal Shreedhar - *National Bank Financial - Analyst*

Thanks for that color. And just a quick one here, in terms of Shoppers results, front store and pharmacy on the sales side seemed very strong. Wondering if there is any transient items that drove those in the quarter or if it's just ongoing base business strength?

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

It's a little bit of both. I'd say we benefited from the Target closures probably a little bit more than we expected. We did have a very good allergy season, and we've had a pretty good sunscreen season. And those are three pretty meaningful drivers when it comes to the front of store performance in that business.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. Thanks a lot.

Operator

David Hartley, Credit Suisse.

David Hartley - *Credit Suisse - Analyst*

Hello. Thanks a lot.

Just quickly on -- you're investing a lot right now, and I guess those investments run through your cost lines. SG&A was up 2%, I believe, in the quarter. What is the cadence of these investments as we round into 2016?

And how should we see that being financed or costed through your SG&A or even your gross margins? Are we going to see some material improvements ahead of all this reform and other foreseen events? Or should we expect a kind of similar rate of growth in these costs as we move into 2016?

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

So maybe you can -- so are you asking that question specifically with regards to the Shoppers Drug Mart business? Because in total, our SG&A is in pretty good shape. And our SG& A improvement is pretty significant, in our judgment, on the Food side of the business. So maybe you could just clarify?

David Hartley - *Credit Suisse - Analyst*

Well, I actually was for the entire business. In your pharmacy business, yes, you're investing into some new systems, some new programs, et cetera. And yes, I do see the efficiencies and so on. I'm just wondering, when do these investments start dropping off such that your rate of growth even improves better, your efficiencies improve better as we move into 2016?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

So David, I guess the best way to answer this question is look at our total CapEx that we allocate to the business. So you've heard us, like we announced that we spent about CAD1.2 billion this year. We're working on our number for next year, but we have an objective to bring that number down from where it is now.

And that's how we ensure, along with being very ruthless in terms of return on capital and all these projects, that we'll generate a return for investors. So it's as simple as that. So we'll make sure the dollars we allocate to each of the businesses will be in areas where the probability of hitting our estimated return is as high as possible.

David Hartley - *Credit Suisse - Analyst*

So are we talking about the denominator falling, but not necessarily the numerator rising, or is it a combination of both?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

It's going to be a combination of both. Because obviously, what hits the income statement is ultimately depreciation.

And what has been the biggest impact on our depreciation over the last few years has been our IT, because IT depreciates over a much shorter time period versus our long-term assets, such as stores. And since we're coming to the end of our SAP deployment, and we said to the market that our IT expenses are actually going to be dropping, so you should see an improvement in D&A over the next few years that will fall to the bottom line.

David Hartley - *Credit Suisse - Analyst*

Okay. So your cash flow return on investment should see even better improvements, would it not?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Yes.

David Hartley - *Credit Suisse - Analyst*

Okay. Excellent. That's it for me.

Oh, one other question, just on some of your new retail initiatives in grocery land, the box and Click and Collect. I notice that you've expanded the Click and Collect pilot a little bit and one of your competitors has entered into the fray. Could you maybe talk about your latest thinking on that, the success and challenges with these initiatives and where you see it going?

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

Well listen, I think we certainly feel that Click and Collect is our favored e-commerce strategy or proposition for the Canadian consumer. And we've been expanding, yes, in a measured way, which is an indication that we feel pretty good about the early pilots. And we'll continue to move forward as long as we feel that offer is meeting customer needs and that we're able to deliver it at ever increasing volume.

I think the fact that Walmart announced a similar mechanism for delivering fresh food e-commerce to consumers, that's a good thing. I think the more people who are doing Click and Collect who have incumbent retail assets, the better, so we welcome it. Obviously we think our proposition is a little stronger. But e-commerce is going to be an important part of the way that retailers do business in grocery and in drug over the coming years and we're well-positioned.

David Hartley - *Credit Suisse - Analyst*

Just as a follow-up on that, and then I'll exit. You mentioned that it's a good thing. We've seen the experience in the UK and elsewhere, still early days there, really, as well, where profit margins are under the microscope, if not down from such an initiative, which may include non-click and collect grocery delivered business.

But I wouldn't mind your commentary on that and how you see that affecting profit margins in the industry. And do you have to win by market share gains or is this a win-win all the way around?

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

Well, I think, David, we'll have to chat about that one off-line. It's a much longer conversation.

I think the UK is not a useful comparator in this case. And it's so early to tell exactly what the impact of this business is going to have on our margin. But suffice to say, we have a path forward that we think makes sense for the business. If we didn't, we wouldn't be making those investments.

David Hartley - *Credit Suisse - Analyst*

Fair enough. Thanks. I'll look forward to the conversation. Thanks.

Operator

Chris Li, Bank of America.

Chris Li - *BofA Merrill Lynch - Analyst*

Good morning. Obviously, the weaker Canadian dollar is top of mind again. Can you just maybe remind us what percentage of your cost of goods sold is exposed to the US dollar either directly through imports or through the US CPG companies?

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

We'll have to get back to you with some numbers on that. Maybe a little bit of extra color you'll find helpful is the US dollar impact travels most quickly in the produce business, because you price product, or you cost product, almost on a daily basis. What's happening right now, as you would expect, is we're shifting. And that would be 80% sourced from the US. So highly, highly exposed to the US dollar.

Right now we're in the Canadian growing season. So we've shifted a huge amount of purchases out of US dollars into Canadian dollars, and that is having a pretty material impact on the inflation rate. So it's bringing the inflation rate down.

So through the balance of the summer, we're going to continue to see that pressure. Then when we flip back into US purchases, we don't really know what the impact is going to be. But it's reasonable to suggest that it might pop up again.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. That's helpful. And just in terms of SAP implementation, by my estimates, there are roughly about 350 of the franchise stores to do before you're completed. Is the correct?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

I think we're over 720 stores now fully on SAP, so we're well on our way to be completed by year-end.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. And just maybe, Galen, if you can provide, I know it's probably early, but the food pilot launch you had on the Shoppers, I think in Regina a few months ago, is there any data points or any insight you can share with us of how that's going so far?

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

Look, I think it's going as expected. So we're seeing some really, really terrific results on the top line. We're seeing some very interesting, and in some cases, very promising results in terms of the margin.

And the real task that stands before us in terms of enabling a more extensive rollout is making sure that we can operate them such that we can appropriately manage costs. So managing that level of fresh product in a pharmacy format, getting shrink at the right levels, these are all things that need to be worked on carefully before we accelerate that platform.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. That's great.

And my last question is in your original 2015 outlook back in February, I think you threw out a number that for Shoppers, the operating income is going to be down roughly CAD30 million because of the initiatives and store closures. Are you still tracking in line with that number so far year-to-date?

Richard Dufresne - *Loblaw Companies Ltd - CFO*

Yes.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. That sound good. Thanks.

Operator

Keith Howlett, Desjardins.

Keith Howlett - *Desjardins Securities - Analyst*

Yes, I wanted to speak about your conventional food store strategy in Western Canada, where I think you've opened a Loblaw's store in Vancouver and a number of YIG stores in the Prairies. Can you just speak as to what your plan or outlook there is?

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

Yes. I think our plan and outlook is positive. So we'll continue to invest in that market.

Remember, we already have a pretty substantial network there that used to go by the name of Extra Foods. Over the last five or six years, we've been converting one portion of that network to No Frills. That's been a really big success for us. And now we're in the process of converting the remainder of that network, where appropriate, to the YIG.

And where we see opportunities for appropriate located sites, that we're building new stores there, too. So there's population growth there, and so you would expect us to pursue that with our retail network.

Keith Howlett - *Desjardins Securities - Analyst*

Just in terms of Alberta, which I guess is the first to experience the pain in the Canadian economy, what do you see there? Do you think your discount stores would be gaining share, or is it hard to say?

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

I think you asked the question, or somebody did, on the call last quarter. We don't see a major consumer shift taking place in Alberta, at this stage. We expect it, but there's nothing showing up in any measure that we see inside our business there just yet.

If you were going to ask me to speculate, in a context of a more meaningful consumer downturn there, I think our business is actually disproportionately better positioned, because we have such a high penetration of discount there.

Keith Howlett - *Desjardins Securities - Analyst*

I wonder if you'd just speak on the healthcare reforms that you referenced. There's the dispensing fee issue in Quebec and the professional allowance issue. Are there other issues that are potentially going to affect your business?

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

As Richard said, there is still a lot of fog in there at the moment. I know that the province is working their way through the specifics. The pharmacy organization there is working hard, and we are staying close to it to make sure that we understand the impact to our business with as much clarity as possible.

I think the thing to take away from this is we're not adjusting our outlook for the business beyond our budget based on what's happened in the last few months. So we see a way to mitigate, we believe, at this point.

Keith Howlett - *Desjardins Securities - Analyst*

And on the Ontario side, is there anything of concern particularly there?

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

No, same answer.

Keith Howlett - *Desjardins Securities - Analyst*

Thank you.

Operator

Thank you. There are no further questions at this time. I will now turn the call back over to Sophia. Please go ahead.

Sophia Bisoukis - *Loblaw Companies Ltd - IR*

Great. Thank you, Michelle. And thank you, everyone, for joining us today.

If you have any further questions, please do not hesitate to contact our Investor Relations team. Michelle? Thank you.

Operator

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