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PRESENTATION

Operator

Good morning. My name is Michelle. I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited second quarter 2014 results conference call.

(Operator Instructions)

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

Janet Craig *- Loblaw Companies Limited - SVP, IR*

Thanks, Michelle, and good morning. And welcome to the Loblaw Companies Limited second quarter 2014 results webcast and conference call. I am joined this morning by Galen Weston, President and Executive Chairman, Richard Dufresne, Chief Financial Officer, Sarah Davis, Chief Administrative Officer, and Domenic Pilla, President, Shoppers Drug Mart. Before we begin today's call, I want to remind you that the discussion will include forward-looking statements, such as the Company's beliefs and expectations regarding certain aspects of the financial performance in 2014 and future years, and the Company's plans and projections with respect to Shoppers Drug Mart Corporation which the Company has acquired.

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 securities 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 is required by law.

Certain non-GAAP measures may be discussed or referred to today. Please refer to our annual report and other materials filed with the Canadian securities regulators from time to time, for a reconciliation of each of these measures to the most direct comparable GAAP financial measures. An archive of this conference call will be available on our website. We also have some support material in the form of two slides that have been e-mailed to you, and I think posted to our website. They do not directly support the speaker's remarks, so you do not need to follow them as we speak. I will now turn the call over to Galen.

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

Good morning, everyone. This morning we announced our financial and operating performance for the second quarter of 2014, with strong same-store sales growth in both our supermarket and pharmacy businesses. We saw solid contributions from President Choice Financial and Choice properties. We continue to [surface] efficiencies, and recorded synergies related to the Shopper's acquisition for the first time. All told, on a consolidated basis, revenue is up 37%. Adjusted EBITDA rose 54%, and adjusted operating income grew 65%.

The core Loblaw retail business excluding Shoppers performed within our target operating model this quarter, with positive same-store sales growth, stable gross margin, significant efficiencies and solid earnings. Retail sales growth for the second quarter excluding Shoppers was 1.6%, with same-store sales growth at 1.8%. This was the 6th consecutive quarter of positive same-store sales, the result of a continued focus on our strategy of investing in the customer proposition led by Fresh. In a competitive market, industry square footage grew 3%, while Loblaw square footage grew about 1%. Despite growing significantly less than the market, we maintained market share in tonnage and dollars, grew basket, and increased sales productivity.

Inflation contributed to sales performance this quarter, however, it was a slight drag on retail gross margin which came in at 22.1%. Margins have been relatively stable, but significant inflation in the cost of produce and meat had a negative impact, as we did not fully pass on the cost increase. This investment in price allowed us to remain competitive in the market, which in turn supported our sales momentum. We continued to deliver significant efficiencies in the quarter, realizing 45 basis points of efficiencies between labor and supply chain. Year-to-date, we have delivered CAD36 million in savings, or 37 basis points from these two areas.

In the quarter, we made some investments in our retail business that offset these efficiencies, and Sarah will go through this in more detail in her remarks. Excluding this investment and other notable items, our adjusted retail EBIT excluding Shoppers increased slightly. We expect to see stable to improving trends here, as we extract further efficiencies from our business. One of these opportunities is SAP. We currently have 19 distribution centers and over 300 stores converted to SAP, with the final two DCs to be completed within the next month.

We are averaging approximately 20 stores bi-weekly, and we are on track for all the corporate retail network to be completed this year. With the first SAP store starting to lap a full year in operation, we are seeing positive indicators coming from improvements in availability, inventory, and NPS scores. By the end of this year, we expect to provide you with some tangible metrics of the benefits of our SAP implementation. Overall, our supermarket business performed well, and believe -- and we believe that we have the appropriate competitive positioning in the market.

Turning to Shoppers, sales increased 2.8% from the prior year. Our continued focus on the customer resulted in front store same-store sales growth of 2.4%. Higher baskets and traffic drove the sales increase, despite a very competitive environment and a delay in the allergy season. In the pharmacy business, same-store sales grew by 2.5%, the first time that Rx has outgrown front store since 2010. This is a result of our growing competitiveness, as well as increased stability and predictability on the pharmacy side of the business.

Scripts grew over 4%, with the strength coming from Ontario and the west, while average prescription value declined slightly as expected due to the deflationary impact of drug reform. This was another solid quarter for the Shoppers team, and the business is tracking to plan. Shoppers did see increased adjusted EBIT including the benefit of CAD10 million in synergies. Excluding this benefit, Shoppers EBIT would have declined year-over-year, but in line with their recent trends.

Our broader strategy with respect to the Shoppers Drug Mart acquisition extends far beyond the synergies we will realize. As the Canadian retail landscape continues to unfold, we will not only keep pace with the market, we will lead it. In a little over 100 days since the Shoppers acquisition closed, we have made significant progress. Our new management structure is in place, the Competition Bureau driven divestitures are on track for completion, with about half of the divestitures sales announced this week. The degree of collaboration and progress across the organizations has been very encouraging.

A very public example of this, was our Hero item launch on day one after closing. It exceeded all operational targets and sales expectations. Most importantly, we recorded CAD8 million in net synergies this quarter, with an annual run rate of CAD35 million as we exit Q2. We continue to expect to record CAD100 million in synergies by the end of the first quarter in 2015.

When thinking about the customer initiatives we have underway, and how we differentiate our offer to the customer, our loyalty programs stand out as one of our greatest strengths. Shoppers Optimum has over 10 million active members, and PC Plus continues to grow with over 6 million members. Optimum is a very successful and finely-tuned customer sales and retention tool, with over a decade of data and insights on how to drive and impact customer behavior. At Loblaw, with over 40% of our sales on PC Plus less than a year after the national launch, the results are very encouraging. Our PC Plus customers make more trips, shop bigger baskets, and shop across more categories. In line with our expectations, we are seeing a significant sales lift from our most loyal customers. Interestingly, we are also seeing a material increase in trips and basket from our less loyal customers, which if sustained over time will add additional leverage to the program.

Before I close, I wanted to touch on our cash flow and the balance sheet. The free cash flow potential for our business is substantial. In Q2, we generated CAD801 million in free cash flow, and CAD381 million year-to-date. Over the next 21 months, we have committed to our rating agencies to reduce our debt by CAD1.5 billion. Our adjusted debt stands at CAD10.7 billion, down CAD350 million since the close of the Shoppers deal. Once we are at the appropriate leverage targets, we will start to look more actively at other ways to return capital to shareholders through dividends and share repurchase.

In closing, I am pleased with the results of our second quarter. Our supermarket business is tracking within our target model in a challenging and competitive environment, and our first quarter with Shoppers was a solid one. SAP is on track, and our realization of synergies from the acquisition is underway. Looking forward, I am confident in our long-term potential. The retail landscape remains intensely competitive, but I firmly believe that by executing against our strategy and managing our business in a measured fashion, we will have superior long-term returns.

And before I turn the call over to Sarah, I want to thank her for the tremendous contribution as our CFO over the last four years. In that time, Loblaw has made significant progress, as well as having a lot of change, and Sarah has been a guiding force and a steady hand throughout. I can think of no better person than to take on the portfolio of CAO. And I also want to say welcome to Richard Dufresne, whom you all know as the CFO of George Weston. I look forward to partnering with him in his new role at Loblaw, where I know he will be a driving force. I will now turn the call over to Sarah.

Sarah Davis - *Loblaw Companies Ltd - CFO*

Thank you, Galen, and good morning. Overall, we are pleased with our second quarter performance. On a consolidated basis, we reported revenue of CAD10.3 billion in the quarter. Loblaw excluding the impact of Shoppers Drug Mart achieved revenue of CAD7.7 billion. This represents an increase of 2.4% driven by same-store sales growth of 1.8%. Loblaw adjusted EBITDA was CAD799 million in the second quarter, and we [reported] adjusted net earnings of CAD301 million or CAD0.75 per share. This is an increase of 17.2%, compared to CAD0.64 per share in the prior year.

On a GAAP basis, Loblaw reported a net operating loss of CAD456 million this quarter. There are some key differences between this and our adjusted net earnings of CAD301 million, including the following non-cash items. First, we recorded a CAD622 million charge to the cost of inventory sold, related to the fair value increment on the acquired Shoppers inventory. The remaining CAD176 million of the total CAD798 million increment will be recognized over the remainder of 2014 as the inventory is sold.

Secondly, we recorded CAD190 million charge for the cost of inventory sold, and a corresponding reduction in inventory. This relates to the roll-out of SAP, and the visibility we now have to the costing information at SKU level. This has allowed us to re-measure the value of our inventory using a much more precise method. And thirdly, CAD125 million of amortization was recognized in operating income. This relates to CAD6 billion of definite life intangible assets that were recorded as part of the acquisition of Shoppers. These assets will be amortized over next 10 years at approximately CAD550 million annually, and will continue to be excluded from our adjusted operating results.

Looking at our retail business excluding Shoppers, revenue grew 1.6%. Our internal inflation was in line with CPI in the quarter. We saw moderate growth in food, retail apparel and gas, partially offset by marginal declines in drugstore, GM and wholesale apparel sales. Our real estate square footage increased by 0.8%, compared to last year. Excluding the two inventory charges that I mentioned earlier, adjusted retail gross margin for Loblaw excluding Shoppers was 22.1%.

The 20 basis point decline in gross profit percentage was primarily a result of inflationary pressure on costs that were not entirely passed through to price, and higher shrink due to our increased assortment in fresh. Our adjusted retail SG&A expense as a percent of sales, increased approximately 20 basis points to 18.4%. SG&A was impacted by approximately 20 basis points or CAD14 million, related to the transition of certain stores to more cost-effective and efficient operating terms under collective agreements, and a 15 basis point or CAD11 million gain from financial instruments realized in the prior year. Excluding these two items, SG&A would have declined by approximately 20 basis points to 18.2% of sales. This decline came from efficiencies in labor and supply chain, partially offset by an investment in our franchise business.

Moving on to Shoppers, we were pleased with the solid sales growth achieved in both front of store and pharmacy. Front store sales grew 3%, led by food and cosmetics. Pharmacy sales grew 2.5%, driven by prescription growth of 4.1%. This is partially offset by an average prescription value decline of 1.7%, from further reductions in generic prescription reimbursement rates.

During the second quarter of 2014, two new drugstores were opened, and five smaller pharmacy format stores were closed. Year-over-year retail selling square footage increased 1.8%. Shoppers adjusted gross profit dollars grew 1.9%, driven by growth in sales and synergies, offset by reduced margins in the front of store as the result of promotional activity. Shoppers SG&A excluding depreciation and amortization grew 2.3%, primarily driven by higher level store level expenses in occupancy and labor.

Shoppers' adjusted EBIT grew by CAD4 million or 1.9% to CAD219 million. As Galen mentioned, this includes CAD10 million in gross synergies during the quarter. Excluding synergies, Shoppers adjusted EBIT would have decreased by CAD6 million. When combined with Q1 2014 results prior to the acquisition, year-to-date adjusted EBIT at Shoppers is down CAD4 million or 1%, and this is in line with historical trends in 2012 and 2013.

Now let me move to PC Financial. In the second quarter, PC Financial saw continued growth in its credit card portfolio. Revenue increased CAD44 million to CAD192 million. Reported earnings before income tax grew CAD8 million to CAD26 million, driven by higher revenue and a change in the reporting calendar. This was partially offset by higher operating costs as the result of an increase in active customers, higher loyalty program costs, and higher credit losses from increased average credit card receivable balances. Credit card receivables grew 10.9% in the quarter.

As reported on Monday, Choice properties' results were slightly ahead of their IPO prospective forecast. When we spoke in Q1, we indicated there would be certain accounting alignments as a result of the Shoppers acquisition. These alignments included adjustments to make the 2013 reported results comparable to those that will be reported in 2014. We have provided these amended historical results in the release in Addendum B. We remain committed and on track to achieve CAD100 million in net synergies in year one, and to achieve CAD300 million in net synergies in year three. The majority of our first year synergies will come from cost of goods sold, with the balance in expense areas like goods not for resale.

In the second quarter, we realized gross synergies of approximately CAD10 million reflected in Shoppers Drug Mart results. This was partially offset by CAD2 million in cost to achieve those synergies, which are reported in the Loblaw retail excluding Shoppers results. At the end of Q2, we reported CAD13.8 billion in total debt, or CAD10.7 billion in adjusted debt. Our reported net interest expense was CAD150 million in the quarter, or CAD128 million for the purpose of our adjusted operating results, as we excluded CAD14 million in financing costs associated with the repayment of the CAD1.6 billion of our CAD3.5 billion term loan facility, and an CAD8 million fair value adjustment related to the trust unit liability for the change in fair value of trust units held by third-parties. Our commitment to the rating agency is to reduce our debt by about CAD1.5 billion over the next 21 months. We remain committed to this plan, and as of the end of the second quarter we have reduced our debt by CAD350 million.

Moving on to an update of our divestitures. We have received approval from the Competition Bureau for 13 of the 27 divestitures. The process with respect to the remaining assets is continuing, and subject to Competition Bureau approval we expect to complete all of the transactions by the end of Q3. We continue to expect that the financial impact of the divestitures will be immaterial.

In anticipation of some modeling questions, I would like to draw your attention to a few points. For FY14, we expect approximately CAD1.5 billion in depreciation and amortization, approximately CAD400 million of which is related to acquisition of the intangibles of Shoppers Drug Mart, and this will be excluded from our adjusted operating results. Interest expense and other financing charges in second quarter were CAD150 million, and we continue to expect approximately CAD575 million in interest expense for the full year, with CAD192 million in Q3, and CAD151 million in Q4.

Before I turn the call over to Janet for Q&A, I wanted to have a chance to say a few words. I have thoroughly enjoyed my time as CFO at Loblaw, but I am looking forward to my new role of delivering on some of these efficiencies I have been talking about for the last few years. And with that, I will now hand the call back to Janet for Q&A.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Sarah. And Michelle, we are ready to take on questions.

QUESTIONS AND ANSWERS

Operator

(Operator instructions)

Our first question comes from Patricia Baker of Scotiabank.

Patricia Baker - *Scotiabank - Analyst*

Okay, that was fast. I just pressed star one two seconds ago. Just a couple of things. Number one, Sarah, maybe you did answer this in your discussion about modeling there, but with respect to that CAD190 million associated with the inventory system and the better costing at SKU level for the inventory, is that the last adjustment there? Does that cover the entire -- entirety of the corporate stores?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Yes, it does. It is an estimate based on the stores we have converted that would apply to all the stores.

Patricia Baker - *Scotiabank - Analyst*

Okay. So if there would be -- if there is any adjustment there, it would be pretty minor?

Sarah Davis - *Loblaw Companies Ltd - CFO*

That's right.

Patricia Baker - *Scotiabank - Analyst*

Okay. And then secondly, just looking at the Choice quarter and listening to the conference call, I just have a broader question. I noted that they, or you have a store in development to open I think in 2015, maybe 120,000, 130,000 square foot Real Canadian Superstore in British Columbia. And I guess, Richard or Galen, I just want to ask a broader question about what you are thinking about the retail landscape in Canada, and how from a square footage basis Loblaw will be addressing this? Because for all intents and purposes, one of the drivers behind buying Shoppers Drug Mart was having access to smaller boxes which is where the industry is going. So will we see very many more of these larger boxes coming on the landscape? And what is there specifically about British Columbia, or wherever you are opening those stores, that make those the appropriate box for the market?

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

Yes. So we will be reducing the size of all our stores. I think we have talked about that a number of times. The operating sort of model going forward for the Real Canadian Superstore in western Canada, we would size it at about 90,000 feet. So it may be that what John was talking about on the call yesterday was the total retail square footage of the shopping center that he is building in Surrey, because 120,000 would be outside of the traditional model going forward for the superstore. We are also reducing the size of our new conventional stores as appropriate, so very much in line with what is happening in the industry. What we do think is a big opportunity with Choice Properties however, is to work with them to take that large store space, and turn it in to more productive property by bringing other retailers in or other complementary services.

Patricia Baker - *Scotiabank - Analyst*

Okay, that's very helpful. Thank you very much, Galen.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Patricia. Next caller, please?

Operator

Next question comes from Irene Nattel of RBC Capital Markets. Please go ahead.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks, and good morning, everyone. Just looking at the strong same-store sales performance notably on the food side, very impressive that you were able to pass through as much of that inflation as you did. Can you talk a little bit about how you are seeing consumers respond to the higher price points on -- notably in fresh and in meat? And whether you are seeing any push back?

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

Yes. So, I mean, I think there is really two stories inside inflation consistent with Q1. The first is that there is still deflation in the dry grocery side of the store. And that is really a function of the aggressive new square footage, and the competition coming from other formats. On the fresh side, we have talked about different structural reasons that we have inflation in fresh from the Canadian dollar, to issues with the cattle herd and so on and so forth. But what we are seeing is a really strong response to our investment in more assortment and better fresh presentation, and a mix shift that is taking place that we think may be a more sustained shift in consumer preference.

They are just buying more fresh food. We have put these juice bars across 50 stores in the Inspire formats, and the market stores over the last number of months. This is orange juice, but it's fresh squeezed, and it is quite a few dollars more than the typical carton of Tropicana, and yet the adoption rate is very, very high. So customers appear to be trading up in fresh for what they perceive to be significant improvement in quality.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. And you are seeing this across the country, and across your formats?

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

Yes. I mean, it's most pronounced in the Inspire formats as you can imagine, given the level of investment we have made in upgrading the quality. But we are also seeing that in our superstore formats where the assortment is growing in fresh, particularly around multicultural, new generation, or first generation Canadians tend to buy us, they are shopping towards the fresh side of the store as well. And we are even seeing some of that happening in No Frills, although we think we can do better. We think there is still opportunity to improve the depth and breadth and consistency of fresh in the discount business.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you. And another question if I might, just looking at the outlook section of the release, overall I would say the tone sounded slightly more optimistic, both around the competitive environment, but also around drug in your commentary that you expect deflationary pressures to moderate. So just wondering whether my reading is correct, and if you could just expand a little bit?

Domenic Pilla - *Loblaw Companies Ltd - President, Shoppers Drug Mart*

Irene, it is Dominic. And where we are very encouraged on the drug side, is the work that we have done and the progress we have made with the Council of Federation, and the working group that has been set up to work collaboratively across Canada. We have been at the table and are quite pleased with their thinking, which is responding to the individual provinces' pressures of getting savings and their responsibility to do that. But more and more, further dialogue on how we can avoid unintended consequences like drug shortages, and how we can leverage pharmacy in order to provide better health outcomes for Canadian patients, and therefore reduce overall healthcare spend, not just the spend in generic drugs.

And that balance and that dialogue, and the transparency and rigors and discipline that has come with that is very encouraging for us. And we are seeing two things, a reduced emphasis on generic drug pricing, and a renewed emphasis on investment in pharmacy and expanded scope of practice and new services that generates new revenue for us, with that resulting in better patient outcomes, and lower overall healthcare costs. And that work is very encouraging to us.

Irene Nattel - *RBC Capital Markets - Analyst*

That's really helpful. Thank you, Dominic. And perhaps Galen, if you could just address your view of the competitive intensity at this moment?

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

Yes, I mean, it remains on the food side extremely competitive. But the outlook I think is rational in my view, based on how the market has been competing over the last few months in the face of the declining Canadian dollar. That is a good signal in my mind, but the biggest driver of the positive tone is the slowing of the growth of new square footage. And that is happening as we have always said in the back half of this year, very much on track, maybe even a little better than we had imagined.

And our outlook for 2015 is equally positive. But to be clear, there is a difference between the outlook being easier than it has been in the past, and the outlook being fundamentally better. It is still going to be very tough. We are still going to have population growth, growing slower than new square footage growth. It is just going to be less meaningful than in the last two years.

Irene Nattel - *RBC Capital Markets - Analyst*

Understood. Thank you.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Irene. Next caller, please?

Operator

The next question comes from Michael Van Aelst. Please go ahead.

Michael Van Aelst - *TD Securities - Analyst*

Thanks. So just looking at the food same-store sales trends. They have been pretty solid over the last three quarters, and it has been boosted by inflation. But I wanted to focus a bit more on the tonnage side. And it is -- you did mention that it was going down. But can you provide us with some more details on your strategy of letting sales in some of the lower margin categories kind of evaporate, while focusing on growing your high margin categories like fresh?

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

Yes. Yes. I mean, look, the starting point is we believe that fresh is a major source of competitive advantage for us. We have seen the customer respond very well to the investments that we have made in fresh. We will continue to do that, and that will drive a mix shift that underneath it all, should largely be positive for margin. However, the deflationary pressure in the center of the store or the dry grocery side continues. So this is a conscious effort. And we think it is part of the reason that our outlook around margin as we go forward is stable.

Michael Van Aelst - *TD Securities - Analyst*

In the past you have talked about the tonnage going down though, because some of the high weight products like bottled water and pop and that, you weren't promoting as aggressively, whereas you are getting improved mix in the shift towards fresh. Is that why tonnage is going down?

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

Yes. So, I mean, our tonnage share is flat, which we think given the amount of new square footage that has been going into the market from our competitors relative to us, which is about 3 to 1, that is a very good result. In terms of overall tonnage in the marketplace, it is down. But it is not something that we feel we should be chasing in absolute terms. It is really about proceeding carefully, and making sure that we are playing to our strengths. If that drives healthy sales growth, despite the fact that tonnage may not be as robust as it has been in the past, and that is absolutely fine with us.

Michael Van Aelst - *TD Securities - Analyst*

And moving on to the Inspire concept, can you update us on to how many you have now, and roughly where are they geographically, which provinces? And then, where do you see the Company exiting 2014 and 2015 as far as numbers for Inspire?

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

Yes. So we have Inspire stores now across the country. We have 20 which is I think a pretty good result, given that we opened Maple Leaf Gardens just three years ago, probably three new ones, four new ones, and the rest are upgrades and renovations. They are more heavily weighted in Ontario and Quebec, with one out west in Vancouver. And at this stage, we are very optimistic about the potential for that platform.

How many stores are we going to have? I think it's a little bit early to tell. We are going to move on an accelerated basis. But it is also going to be governed by how well the stores perform. Is it 50? It's probably more than 50. At this stage, it's too early to say whether it's over 100.

Michael Van Aelst - *TD Securities - Analyst*

All right. Thank you. I'll leave it at that.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Mike. Next caller, please?

Operator

The next question comes from Vishal Shreedhar of National Bank. Please go ahead.

Vishal Shreedhar - *National Bank Financial - Analyst*

Hello, thanks for taking my question. I have one on inflation, which you may or may not be able to help me with. But looking on the future, as commodity prices start to fade, and as we cycle the FX, and some of the quantity specific issues in meats, how should we think about the impact going forward? Should we think it will flip back to this kind of low inflation environment? And how should we think about the impact on gross margin?

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

Yes, so it's hard to predict what is going to happen with inflation in the next 18 to 24 months, particularly around some of the protein, some of the specific proteins, maybe as much as 18 months of continued strong inflation in beef for example. But to answer your question, once it stabilizes, it would be great to see a little bit of inflation.

I mean, we would be very much thinking along the same lines as the Bank of Canada, and I think that would be good for us, it would be good for the industry. And given the outlook as far as the competitive environment, I think there is probably a better chance of that in the next two years or three years than there has been in the past three years. But it really depends on how the consumer responds, and how competitive people end up ultimately being.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. And just changing topics here to Joe Fresh, there have been several announcements -- call it over the last several quarters, including international expansions, new management announcements. And the press release I think noted today that wholesale sales in Joe Fresh were down significantly. I was just hoping you could help us better understand the thought behind Joe Fresh, kind of where you are going, maybe indications on CapEx, profitability sales? Anything that can help us better understand the thought behind that business?

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

Yes. And so, our view is we have successfully built the Joe Fresh brand in Canada, from a zero to one of the top apparel brands in the country in a relatively short period of time. And so, there is a potential opportunity of some significance, if we were able to establish it as a relevant global brand. We think the fact that we have a very compelling combination of style and price has the potential to travel, and we have very significant levels of interest from international partners to help us do that in a fiscally responsible way. And that means with little earnings risk and a little capital investment.

And the announcements of the partnerships in the Middle East and Korea are good examples of that. There could be some incremental announcements in other parts of the world over the coming months. So at this stage, we think that we can manage the growth and explore the opportunity without any material impact in terms of capital pressure or P&L pressure on the Loblaw business, and we would report to you if that were going to change at any stage moving forward.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. So the implication of that comment, that this -- the decline in the wholesale sales that you have seen in this quarter, they didn't really have an impact on P&L standpoint?

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

Yes. So sorry, I didn't answer the last part of that question. So that is the decline in the JC Penney business. And we are -- we have been happy with that business from a P&L perspective, and it would be our expectation over time that we would balance off those declines, as we accelerated the growth with the international wholesale business.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. And just one last one here, the 25 basis points of franchisee investment, I was just hoping to get some clarification of what that represents, and what percentage -- on what line do we take that number on, that 25 basis points?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Okay. So basically the franchise business in Loblaw, it is not consolidated in to the financial results. So basically, the investment would come through SG&A, either through support of the business. And the reason that we have an increase in Q3, is that we have done a lot of franchise investments. So we are up from last year to this year. We are up about 28 stores in franchise, as we have flipped from -- some are new, and some are flips from other banners. So we have done some flips in Quebec in the Provigo banner to franchise them. That was always our plan. And with each franchise flip, there is a small investment. So it is just coming in Q3, and it is showing up in SG&A.

Vishal Shreedhar - *National Bank Financial - Analyst*

Got it. Okay. Thank you.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Vishal. Next caller, please?

Operator

Thank you. The next question comes from Perry Caicco of CIBC World Markets. Please go ahead.

Perry Caicco - *CIBC World Markets - Analyst*

Yes, thanks. I just wondered if you could clarify what we should expect for the rest of this year? I think the outlook said that you expect your financial operating performance to be in line with 2013 trends. And I think previously you had said that you would like to grow operating income. So should we think about the core business as basically flat to last year?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Hello, Perry. So basically, the way that I think people should think about it is, when you look at Loblaw on its own in 2013, the adjusted operating income had growth of about 2.6%. When you look at Shoppers on its own, its performance in 2013 on an adjusted basis, it was down about 1.8%. After two quarters this year, so in 2014, Loblaw is up about 1.2%, and Shoppers excluding synergies is down about 1%. So what we are saying is, based on the trend for last year, the trends we are seeing so far this year, we expect the businesses to perform basically the way that they have. So that would be slight increases in Loblaw, and slight decreases in Shoppers. All of this is excluding any impact of synergies, which would be layered on top.

Perry Caicco - *CIBC World Markets - Analyst*

Okay, thanks. And then specific to Shoppers, as you mentioned the operating income a little bit down from last year. And I think we all understand that the gross margin has been pressured by drug reform and front store competition. Just so -- so as a standalone division outside of synergies, what should we reasonably expect for EBITDA growth at Shoppers, let's say, 2015 and out?

Domenic Pilla - *Loblaw Companies Ltd - President, Shoppers Drug Mart*

So Perry, it is Domenic. So two things. One is, we will see -- we are hoping to continue to work with the Council of Federation to see a diminished pressure on generics price for two reasons. One is less emphasis on that by the Council of Federation. And second of all, less significant molecules going from 25% to 18%, that the top 10 now in volume have already been deflated to 18%. So the next molecules are obviously smaller volume, and therefore will have a smaller impact on the pharmacy side.

We also are seeing good growth on the pharmacy side in terms of share and traction in terms of growth, and therefore our share growth and script growth is now outpacing the deflation, and we are seeing positive comps on the pharmacy side. On the front store, what we are going to hopefully achieve is a decline of the margin pressure related to personalization, and moving away from mass offers in order to drive traffic to more personalized offers. We have seen tremendous benefit from that in 2014 our first half, and we think that will accelerate in 2015 to the point where we will see stable margins going forward.

Perry Caicco - *CIBC World Markets - Analyst*

So would it be unreasonable to expect kind of a mid single-digit EBITDA increase out of Shoppers in 2015?

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

So Perry, why don't we give you a bit of a better sense of the outlook for the business in 2015, when we get closer to 2015.

Perry Caicco - *CIBC World Markets - Analyst*

All right. And then, back over to Loblaw's, just what should we expect from the SG&A line over the next few quarters? You are starting to get some efficiencies. So I am just wondering how we should think about that?

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

Well, let me -- I will begin by saying in light of the announcements we made last week, and Sarah's new responsibility around efficiencies, we expect our SG&A to improve and our admin cost to continue to improve. It is not going to be a straight line level of improvement. There will be some quarters where it might not be as aggressive as some might like, and in others it might be more substantial than we might like. But we have a very, very intense and specific focus on this particular line in the P&L, and we have a very clear view of where that money is going to come from. And ultimately, it is going to be, in addition to synergies, those are going to be the two biggest drivers of earnings expansion for the Company going forward for the next two or three years.

Perry Caicco - *CIBC World Markets - Analyst*

And is the bulk of the SG&A improvement, would it be fair to say that would be in labor efficiencies?

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

Well, remember, [ITU] and IT is 90 basis points, and a big part of that is just ramping down the spending and watching the depreciation roll off. So we have talked about that on a number of occasions. And then, when you think about central costs, we believe that there is still significant opportunity for us to reduce those central costs, a big chunk of which will be enabled by the complete implementation of SAP, and then the optimization of that. In terms of labor in the stores, we think that will be a benefit that will come out of SAP. Early indications at store levels suggest that it will in fact be a benefit. I think at this stage, we need to think carefully about what portion of that is going to come straight out of the store P&L, and what portion we might invest back in service.

Perry Caicco - *CIBC World Markets - Analyst*

And the central cost you would expect to see largely next year?

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

It's going to flow steadily, lumpy, but steadily over the next couple of years, as the SAP program starts to settle in to the business, and as we start to optimize it.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. Thank you.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Perry. Next caller, please?

Operator

The next question comes from Peter Sklar of BMO Capital Markets. Please go ahead.

Peter Sklar - *BMO Capital Markets - Analyst*

Just one question on price. So you had indicated that Loblaw had about 2.5% of retail price in the quarter, which is a good result. So going back to last fall, when you started facing these costs of grocery inflations in terms of proteins and the depreciation of the Canadian dollar, like where do you think you are at today in terms of -- after a couple, two, three quarters of being able to pass through those costs, do you think that you have recovered a meaningful amount? Or you have just recovered a fraction of those pressures? And how do you think that is going to unfold in the industry over the next few quarters, if the Canadian dollar and protein prices stabilize in around these areas?

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

Yes. I mean, the big shock around the Canadian dollar and protein prices really flowed through the industry in Q1, and I think by and large the marketplace has responded differently but largely rationally. In our case, we took some of the increase and the customer seems to have absorbed that, but we certainly didn't take all of the increase, and I am not sure that we will. Our focus is on creating a value added proposition in fresh for the customer, rather than simply raising prices. And again, early indications across the board suggest that when we put the right proposition in front of the customer, price is not the biggest determinant of what they choose to buy.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. Thank you.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Peter. Next caller, please?

Operator

The next question comes from Keith Howlett of Desjardins Securities. Please go ahead.

Keith Howlett - *Desjardins Securities - Analyst*

Yes, I was just wondering if you have -- what your capital budget for the year is going to be?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Hello, it's Sarah. It's about CAD1.3 billion to CAD1.4 billion, in that range.

Keith Howlett - *Desjardins Securities - Analyst*

And for the tax rate for the year, is it likely to be -- ?

Sarah Davis - *Loblaw Companies Ltd - CFO*

26% to 27%.

Keith Howlett - *Desjardins Securities - Analyst*

26% to 27%. And then, I just want to ask on the buydowns of labor agreements, is that something that we should anticipate would go on through 2015, 2016? Or are you sort of close to the end, or is it an ongoing thing?

Sarah Davis - *Loblaw Companies Ltd - CFO*

It is ongoing. I would say we will always have some that happen, but the bulk of them will be done this year though. And some of the ones that we saw in Q2, we pulled forward from later, having them later in the year. So that is why it is a little bit lumpy in Q2. But we will always have some on an annual basis.

Keith Howlett - *Desjardins Securities - Analyst*

Great. And then just finally, on the outlook in Quebec, with the success, I guess of the Le Marche -- Provigo Le Marche, do you anticipate that you will be moving more Loblaw banner stores to the Provigo Le Marche, or what is the thinking there?

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

That is certainly the intent. We are very pleased with the performance and the customer response to the Provigo Le Marche in Quebec, and really it's just a question of discipline in terms of approach. We don't have an ambition to blanket convert all of the remaining Loblaws to Provigo Le Marches. We are picking sites one at a time that are best suited to that offer, and it's working well.

And in fact, it's the same approach that we are taking across the rest of Canada, with some market store business, converting to Inspire where it makes sense. And really trying to understand what kind of economic demographic is really required to sustain the performance of those stores. And it has been promising, so far that we can actually push these stores into demographic areas that might be less obvious than our original business case. And that's good.

Keith Howlett - *Desjardins Securities - Analyst*

Great. Thank you.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Keith. Next caller, please?

Operator

The next question comes from Chris Li of Bank of America Merrill Lynch. Please go ahead.

Christopher Li - *BofA Merrill Lynch - Analyst*

Thanks. Just following up on Dominic's last comment about gross margin perhaps stabilizing in 2015. Over the longer term, do you think that is a sustainable target, given increasing competition from Amazon, especially in the higher margin categories like health and beauty?

Domenic Pilla - *Loblaw Companies Ltd - President, Shoppers Drug Mart*

Yes, we do think that it is, because of the quality of our Optimum program, the loyalty of our customers and our ability to drive personalized offers through great insights, and more and more we're seeing tremendous traction in that area. We also are wanting to evolve our value proposition to more of an omni-channel offering, leveraging social networks, leveraging mobile, and leveraging e-commerce, ourselves. Our experiment with [e-mural] has been terrific. The knowledge we have gained working, by working closely with our Loblaw colleagues on e-commerce and omnichannel is extremely encouraging. And clearly, we also have the opportunity to link with PC Plus and PC Financial, and therefore those are massive opportunities for us to continue to fine-tune our offer to our customers. And we think gives us a sustained competitive advantage in the omni-channel environment, and therefore we are very confident about that.

Christopher Li - *BofA Merrill Lynch - Analyst*

Okay. Thanks. And Dominic, maybe if can you maybe provide us an update on how the associate owners are doing early on with integration, what has been the feedback like, and are there any areas of concern?

Domenic Pilla - *Loblaw Companies Ltd - President, Shoppers Drug Mart*

No, no areas of concern. In fact, probably the area that is the most engaged, with regards to the combination of the two companies. First of all, they have had great performance which is a sign of engagement. We also measure the engagement with the associate themselves, with the store employee, and of course, the most important measure, we measure our customer service index, our net promoter scores, and those are all up in the second quarter relative to first quarter, and relative to the second quarter last year.

And so, that is encouraging for us and a real sign of their engagement. We think it has to do with the fact that we have reaffirmed our strategy of transforming our pharmacy from a product-centric to a patient-centric pharmacy, expand the scope of practice which really resonates with our franchisees who are all pharmacists. And of course, reaffirm the business model of a franchise model. And those two things, I think went a long ways to keep them engaged. But I have to say, I think the thing that engaged them the most is the excitement around corporate brands, and the possibility of bringing President's Choice products in to our format. And second of all, the enhanced food value proposition, where they see the resonance of that with their customers who are looking for that convergence of health and nutrition. And our ability to satisfy that demand has got them really excited, and something that we are really working hard to accelerate in the second half of this year into 2015.

Christopher Li - *BofA Merrill Lynch - Analyst*

Okay. And I guess, my final question, just one on free cash flow and debt repayment. Just first on free cash flow, I excluded the CAD620 million of the inventory recognition, I estimate the Company generate about CAD200 million of free cash flow this quarter. Do you expect this quarter, the run rate to pick up as you take on more synergies from Shoppers?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Okay. I don't think the impact is related to the inventory. They were non-cash, so they shouldn't -- you don't need to pull them out. So I would say year-to-date, we have got free cash flow of about CAD381 million.

Christopher Li - *BofA Merrill Lynch - Analyst*

Okay.

Sarah Davis - *Loblaw Companies Ltd - CFO*

Keeping in mind, that we didn't have Shoppers in Q1. So in Q2, we had CAD801 million of free cash flow. That is not necessarily representative of what we are going to do. But we are definitely on track to the commitments we have made on our debt repayment of the CAD1.5 billion over the next 21 months.

Christopher Li - *BofA Merrill Lynch - Analyst*

And of the CAD1.5 billon, am I correct that you have repaid about CAD350 million? So you are left with CAD1.2 billion.

Sarah Davis - *Loblaw Companies Ltd - CFO*

That's right.

Christopher Li - *BofA Merrill Lynch - Analyst*

And then, is it still your priority to take George Weston's stake back up to about 50%? Is that still one of your priorities?

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

Yes.

Christopher Li - *BofA Merrill Lynch - Analyst*

Okay. Thanks very much.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Chris. I think we have time for a couple more callers.

Operator

The next question comes from Kenric Tyghe of Raymond James.

Kenric Tyghe - *Raymond James - Analyst*

Thank you. Good morning. Galen, you have highlighted the success of PC Plus, and sort of lifting and shifting consumer behavior. And I think Sarah also highlighted the cost associated with those successes, and the lift in membership. Could you speak to or characterize your thinking as it relates to loyalty economics, both in quarter and through 2014, perhaps in absolute and context of the market terms?

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

Yes, so I think I understood the question, Kenric. Sp you are trying to understand how we are thinking about the cost associated with the successful rollout of PC Plus?

Kenric Tyghe - *Raymond James - Analyst*

Essentially, the -- I guess, the ROI on that, whether it is obviously on a financial speak necessarily, but just in terms of the shift in consumer behavior, and what that's worth to you versus the cost of that shift, and how you manage that going forward?

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

Yes, okay. So it goes back to the basic principles of launching a loyalty program. So in the first year, typically, you get an attractive sales uplift that pays for the incremental cost associated with the points. And then the challenge you have, in terms of challenging the economics as you move forward is, you don't grow your sales year on year on year, and yet your cost of loyalty continues year on year on year. And really there is two things that we are focused on.

The first is the design of the program, which I think we have described on a number of occasions doesn't have an underlying base cost associated with it. The vast majority of the points that are earned, are earned as a result of direct engagement. In other words, you earn more points if you behave differently, and you actually buy more things from our store. So that in itself is a natural hedge against the ongoing cost.

The second, which Dominic touched on and something the Shoppers Drug Mart business is really pushing ahead with at this point, is the technology-enabled personalization. So now you can really start to zero in on rewards, in a way that maximizes the leverage of the investment you make. So we believe that we are just at the threshold of loyalty programs that are going to be significantly more impactful because of that personalization, and therefore generate a more attractive return on the investment. Does that get at what you were looking for?

Kenric Tyghe - *Raymond James - Analyst*

Absolutely. Thanks, Galen. If I could switch up, just a quick followup for Dominic, some great color on the dynamics of the Council of federations and the generic and generic cycle. Dominic, the question to you on generics is, over what time period or to what extent do you see us tracking to US generic penetration in Canada? So it looks like that generic penetration overall or the increase year-on-year has slowed. I mean, do we track to the US here, by a way of sort of end game generic penetration, and what is your read-through in terms of those trends on generic penetration in the Canadian market?

Domenic Pilla - *Loblaw Companies Ltd - President, Shoppers Drug Mart*

Yes, so there is quite a wide gap, which continues to be an opportunity for the Canadian market. And it's certainly one of the things that we are discussing with the Council of Federation, and with the individual of both public and private payers, and we are getting attraction. But I would say the time frame is probably a three to five-year time frame to think about, in terms of approaching US levels, which are among the highest in the world. So still a fairly long time frame. But we are making progress in our discussions around substitution, therapy management, and other programs to assist in the additional usage of generics, where it makes appropriate sense from the health outcomes standpoint.

Kenric Tyghe - *Raymond James - Analyst*

Great. Thanks so much. I will leave it there.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, Kenric. We have time for one more caller.

Operator

Our last question will come from David Hartley of Credit Suisse. Please go ahead.

David Hartley - *Credit Suisse - Analyst*

Thank you very much. Just a question on some of the things that the Company is working on. First of all, could you give us an update on the piloting of new stores, whether it be the box or other type of click-and-collect type pilots you have ongoing? And where that's at, is it meeting your expectations, et cetera?.

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

Yes. So really I would say, three pilot programs of significance, one that has been in the market which we have been watching for around a year now which is the box. We are going to open one or two more boxes. We are pleased with the way that business is performing, but we are not yet in a place where we can draw any conclusions about its ultimate size or potential. We remain cautiously optimistic about what that format may be able to deliver for us.

The other two are click-and-collect. And then, what we call the enhanced food proposition of Shoppers Drug Mart. Click and collect, we have four stores in the GTA that are under construction right now to accommodate the pilot. So why don't we provide an update once we have that actually in flight. But we are enthusiastic. We think we have a good proposition. But the devil is in the detail in terms of your ability to execute it.

So we will have more to say on that probably in two or four or three quarters from now. And then the second is the -- the third is the enhanced food proposition. At Shoppers, we have four stores that are under construction, renovation at this time to accommodate that proposition. So you will see that over the coming months, and you will also start to see us feed in more President's Choice products into the Shoppers Drug Mart grocery assortment. And we can come back to you and talk about how that's performing when we have a little bit more data.

David Hartley - *Credit Suisse - Analyst*

Okay. Great, thanks. And just question on with Shoppers, they previously, I guess in their e-commerce initiatives had signed an agreement with The Rack, and maybe others, I don't recall. Just wondering how that has gone, and how that feeds in to some of the thinking around the omni channel presence that you want to have going forward?

Domenic Pilla - *Loblaw Companies Ltd - President, Shoppers Drug Mart*

Yes. So our partnerships with other participants and our loyalty program have gone really well. Beyond The Rack is one of the partnerships we have, and we continue to see accretive sales, both sides for them and for us, and redemption improvements on our loyalty program. And of course, we continue to have our partnership with RBC that has been very accretive.

And so, our partnerships are working really well. Our customers are responding well to that, and it certainly links with our omni channel strategy. What we are working through now as a combined Company is links with brands like Joe Fresh, links with enhanced food, and other value propositions brought to us from Loblaw companies which we think are tremendous opportunities.

David Hartley - *Credit Suisse - Analyst*

Okay. And just one other question if I may. Just a clarification on the synergies of CAD100 million, is that an achieved number during the 12 months or is that a run rate number?

Sarah Davis - *Loblaw Companies Ltd - CFO*

It's an achieved number.

David Hartley - *Credit Suisse - Analyst*

Great. Thank you very much.

Janet Craig - *Loblaw Companies Limited - SVP, IR*

Thanks, David, and it s the end of the call now, so we are just going to let you go. Thank you very much for your time. And if you have any other questions, please don't hesitate to contact the Investor Relations team. Thank you.

Operator

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