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L.TO - Q2 2016 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 2Q16 adjusted net earnings of CAD412m and adjusted diluted EPS of CAD1.01.



CORPORATE PARTICIPANTS

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Patricia Baker *Scotiabank - Analyst*

Kenric Tyghe *Raymond James - Analyst*

Jim Durran *Barclays Capital - Analyst*

Peter Sklar *BMO Capital Markets - Analyst*

David Hartley *Credit Suisse - Analyst*

Vishal Shreedhar *National Bank Financial - Analyst*

Keith Howlett *Desjardins Securities - Analyst*

Chris Li *BofA Merrill Lynch - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Loblaw Companies Limited second-quarter 2016 conference call. This conference is being recorded today, Wednesday, July 27, 2016. I'd now like to turn the conference over to Sophia Bisoukis. Please go ahead.

Sophia Bisoukis - *Loblaw Companies Limited - IR*

Thank you, Michelle, and good morning. Welcome to the Loblaw Companies Limited second-quarter 2016 results conference call. I'm joined 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 discussion will include forward-looking statements such as the Company's beliefs and expectations regarding certain aspects of financial performance in the 2016 and future years. These statements are based on certain assumptions that 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 a reconciliation of each of these measures to the most directly comparable GAAP financial measures. I will now turn the call over to Richard.



Richard Dufresne - Loblaw Companies Limited - CFO

Thank you, Sophia, and good morning, everyone. In the second quarter we continued to deliver against our financial plan, achieving positive same-store sales with stable gross margins. We delivered diluted adjusted earnings per share of CAD1.01, an increase of CAD0.17 per share, or 20.2% compared to the second quarter of 2015, and grew adjusted net earnings by 17.7% to CAD412 million. We continued to return capital to shareholders, buying back approximately 2 million shares.

Our food retail business achieved 1.7% same-store sales growth adjusted for the shift in the timing of Easter, while our internal food inflation for the quarter was slightly lower than the food CPI rate of 1.8%. Our drug retail business had another very strong quarter with same-store sales growth of 4%, also negatively impacted by 100 basis points due to the timing of Easter. Same-store pharmacy sales grew 3.6%.

Same-store sales growth in both food and drug retail contributed to total revenue in our retail segment of CAD10.5 billion, up to 1.7% compared to a year ago. Adjusted retail gross margin remained within our stable trading band and was 26.4% compared to 26.3% in the prior year. This excludes the impact of consolidating franchisees in Q2 of 2016. Adjusted retail gross margin increased by 10 basis points, reflecting the impact of incremental synergies, strong drug retail front store gross margin, offset by the promotional investment made in our food retail business to enhance our competitive position and sales initiative.

Our focus on cost reduction and operating leverage are generating positive results. Adjusted SG&A as a percentage of sales improved by 40 basis points, excluding the impact of consolidating franchisees. In 2015 we announced the closure of certain underperforming retail stores and this initiative, combined with a focus on improving efficiencies at the retail level, drove the SG&A improvement in the quarter.

Adjusted EBITDA was CAD924 million in the quarter, a 7.8% increase versus last year. And our consolidated EBITDA margin now stands at a 8.6%, an increase of 50 basis points versus last year.

I'm also pleased to report the achievement of another significant milestone. When we acquired Shoppers Drug Mart in 2014 we initiated a CAD380 million synergy program. As of the end of the second quarter, we achieved this target, three quarters ahead of schedule.

Looking ahead, we remain confident in both our strategy and business performance. Our long-term financial strategy continues to be based on positive sales growth and a focus on cost reductions and operating leverage. With a strong balance sheet and free cash flow, we will continue to invest in growth while also returning capital to shareholders. Thank you and I will now turn it over to Galen.

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

Thank you, Richard and good morning. In our second quarter we continued to execute against our long-standing strategic framework, delivering the best in food, the best in health and beauty, operational excellence and growth. The result was a good quarter with positive same-store sales, stable gross margin and earnings growth.

We had a strong quarter in drug retail led by cosmetics, health and beauty and OTC. Food continued to perform well and we have expanded our enhanced food offering into 12 additional GTA stores this year. Pharmacy same-store sales growth benefited from increases in both prescription count and average script values. In food retail same-store sales growth increased over the first quarter.

On our last call we talked about a measured and decisive plan to improve our sales performance. In the second quarter we began to see positive results, showing improvements in all key metrics, including increases in tonnage. We have lowered shelf prices, increased promotions, invested in value programs in specific categories and markets. We remain committed to growing sales in measured steps over the balance of the year as we actively work to put money back in the pockets of Canadians.

After two years of over CAD1 billion in cost increases from our largest suppliers and related higher retail prices across the country, we have asked this group to support us in our initiative to lower prices for our customers. Our focus on price and value is showing results. As we head towards the low-inflation retail environment, we remain focused on driving sales volume, achieving cost savings and surfacing operational efficiencies.

While food price investments and healthcare reform will moderate earnings, adjusted net earnings will continue to outpace revenue growth through efficiencies, allowing us to deliver on our financial plan.

Sophia Bisoukis - *Loblaw Companies Limited - IR*

Thank you. Galen. Michelle, we are now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Irene Nattel, RBC.

Irene Nattel - *RBC Capital Markets - Analyst*

Good morning, everyone. On the prior couple of calls you described performance in food as somewhat disappointing and noted in particular is that you were not satisfied with operating efficiency gains. It seems to me that you've seen some improvements on those funds this quarter. If you could please comment on that, where you stand and what the key sources of the operating efficiency gains might be, other than the store closures.

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

Yes, let me start by talking about our sales performance. We were disappointed both in our relative sales performance and our absolute sales performance. We use this trading band measure for determining whether we're comfortable with how we're doing. We fell outside of our trading band in sales, market share in some other metrics and so we took some action, as described in the first quarter.

What we are reporting today is that we're seeing traction. We also made the point that we weren't going slam the lever in a particular way but actually be very deliberate and build those sales plans in places specifically where we were not performing, and turn the sales trend by the time we got to the end of the year. We feel good about how that is tracking.

On the efficiency side, this is something that we've always said we're pleased with the efficiencies that were coming out. What we were concerned about was that it wasn't dropping to the bottom line. And that was due in part to some noise that was in the system and some other things that were going against us.

What we're starting to see in Q2 is the noise moving out of the system and that SG&A leverage showing up in the biggest parts of the business, the retail business and also the drug business. That is now dropping to the bottom line, so it's a good sign. I don't know that I would put that full amount into your model going forward over the long term, but certainly it's an indication that we can actually drop efficiencies to the bottom line.

Irene Nattel - *RBC Capital Markets - Analyst*

And that's very helpful. Could you give us a little bit more detail on what kind of noise was there that isn't there anymore?



Richard Dufresne - Loblaw Companies Limited - CFO

Rather the focus on the noise, why don't we focus about the benefits, which is what we're really trying to do now. The businesses themselves have put pressure on their operations to drive SG&A savings and we're starting to see it. Obviously it shows up a little bit more on the food side but it's also shows up in Shoppers and that. Like their sales performance is going well and so therefore it's benefiting them on a rate basis. Together both businesses are driving this SG&A leverage that we're seeing right now and it's coming from the business.

Irene Nattel - RBC Capital Markets - Analyst

That's great. That's very, very helpful. If we could shift gears a little bit and talk about consumer behavior. Obviously there is a lot of chatter out there around what consumers are doing, trading up, trading down, discount versus market. If you could provide us with a little bit more color around what you're seeing in terms of your stores.

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

Yes. Again, I think we commented in Q1 that we were beginning to see this material shift to value after having seen a number of quarters and really maybe a year and a half of customers trading up in mix. Our view is that was because we had successive years of inflation leading to high food prices and consumers were starting to feel the ceiling. A ceiling that was forcing to trade into different items and into different categories and different markets.

So we've been flagging this for a couple of quarters and also expressing our commitment not to be caught on the wrong side of this. We got a little bit behind in Q1 and thus the actions that we've taken through the balance of Q2. It is -- I go back to this point -- for us it's very deliberate and very focused in the areas where we see the customer being the most sensitive. And it wouldn't surprise you to know that would be in our market division and some of our higher-priced formats. Those would be the areas that we would be focusing on improving our value position.

Irene Nattel - RBC Capital Markets - Analyst

That's very helpful, thank you.

Operator

Mark Petrie, CIBC.

Mark Petrie - CIBC World Markets - Analyst

Good morning. I just wanted to follow up with regards to the Shoppers business specifically. Obviously strong gross margin performance. Wondering if you could give a bit more color in terms of the mix there. And then ex synergies, with that target achieved, how are you looking at expectations for earnings growth in the Shoppers business over the next 12 months?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

Yes, why don't I start with what's underpinning the strong performance at Shoppers. First and foremost, same story as you heard in previous quarters, the addition of a different type of food mix is helping to drive traffic, and doing so at a much improved margin. So imagine as customers are going in and they're buying full-priced President's Choice products and a wider food assortment instead of being drawn into by deeply discounted carbonated beverage. That contributes to traffic building with a much lower investment and that improves the margin.



We're also seeing really strong performance in some of the core categories in Shoppers Drug Mart like health and beauty, mass cosmetics. We may be continuing to benefit disproportionately from that target exit even though it was some time ago. That continues to be a source of strength. And then we've had a pretty good cold and flu season, pretty good allergy season. These are all things that contribute positively.

Our view is that there is a nice, although not enormous, structural tailwind in those stores because of this shift to convenience that's taking place in the consumer's mind. And so we think that there's likely to be continued reasonable performance in Shoppers front of store.

Richard Dufresne - *Loblaw Companies Limited - CFO*

And, Mark, the second part of your question. I want to give you our expectation of the growth of the Shoppers business. But just to give you some comments we made earlier, like we said at the beginning of this year that this would be the year when we would see the Shoppers business grow its earnings because we haven't seen that in a while. And I can confirm that year over year Shoppers, excluding synergies, is growing earnings.

And then it's a matter of attributing which portion of the synergies are attributable to Shoppers. And it's a big chunk of because they are benefiting from our purchasing power on a lot of the stuff that's sold in stores. So they get it disproportionate part of the synergy attributable to their business. This is growing very nicely right now.

Mark Petrie - *CIBC World Markets - Analyst*

And Galen, you highlighted your request to suppliers for lower costs. I wonder if you could give some initial comments in terms of the response, how those conversations are going. And when you think about the proceeds from that, I mean obviously returning value or passing that value to customers is important, but how do you balance that against other strategic initiatives and potential uses of those proceeds?

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

I won't comment on the process, on the ongoing conversations that were having with suppliers, other than to say it is our view that prices got to a point that were too high in the Canadian market. And it is in our joint best interest, as suppliers and retailers, to lower prices and lowering prices should drive volume.

We are seeing in the places that we are making those investments, and we've been doing it now for a couple of months, that the customer is very much looking for that kind of value. And they are responding more quickly than we perhaps would have expected, which confirms in our view, that specific thesis.

Really the way to think about this supplier ask, is us working together with them to make investments in volume. You can't succeed in a low-inflation environment unless you're moving units in a food or mass retail business. And that is our focus. We feel well positioned and we feel that we have the financial capacity to do that and still deliver our financial plan.

Mark Petrie - *CIBC World Markets - Analyst*

And just following up on that, could you talk a bit about how you think about the business mix today with regards to regular price and promotion? And the outlook in terms of the balance between those two over the next year or two?

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

I think you know that we are a business that believes in a balanced approach to shelf prices and promotional volume. That hasn't changed, hasn't changed in years. It's partly the structure of our business with a big hard discount and discount superstore presence. It's also because we believe that's what the consumer wants. It is the best way of delivering real dollars of savings into their wallets.

I wouldn't expect a major change from a strategic perspective, as far as how and where we make the investments. Just making them with more intensity, increasing the level of investments across the board. And recognizing also that we have a terrific loyalty program. And that loyalty program is another powerful place for us to deliver value to the consumer, particularly those who are most loyal to our stores.

Mark Petrie - *CIBC World Markets - Analyst*

Okay, thank you very much.

Operator

Michael Van Aelst.

Michael Van Aelst - *TD Securities - Analyst*

Thank you. So with the food CPI slowing rapidly and Loblaw now seeing inflation below CPI for the first time in a while, is this a sign that -- obviously it is a sign of that you're investing in price. But are you just keeping pace with what others are doing in terms of Walmart's announcements and Empire's announcements? Or are you going further to try and boost your share?

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

Well, I don't know that it would be practically prudent of me to give you a specific detailed response to that. It doesn't get much more sensitive from a competitive point of view than that. Suffice to say, we think we're competitively a very potent organization.

We believe that we have formats that are uniquely well positioned in each of the core markets and that when we make investments, we will make them in places that will deliver a sustainable advantage versus our competitors. They have their own strategies, they have their own views and their own capacity to respond. But our view is that this is a period of time where the Loblaw business can excel.

Michael Van Aelst - *TD Securities - Analyst*

Okay. And how comfortable are you that this won't start a price war?

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

I don't know. But I can tell you in our case we are specifically focused on targeted deliberate investments in specific customers, specific banners and specific markets. And price wars are generally not something that we look forward to, but we will certainly be ready if the marketplace heats up.

Michael Van Aelst - *TD Securities - Analyst*

Okay. And the investments that you're making now in lower prices, is that spending some of the savings that you're asking from your suppliers in advance? Or will we see the full incremental go through after September?



Galen Weston - Loblaw Companies Limited - President & Executive Chairman

Again, I think that's a very difficult question for me to answer, Michael, because of the competitive sensitivity. Suffice to say, we are well down the journey of investing at this point and we have stated publicly that we will invest 100% of the proceeds that come from this supplier ask, back in the customer.

Michael Van Aelst - TD Securities - Analyst

Okay.

Richard Dufresne - Loblaw Companies Limited - CFO

Michael, yes, we've invested so far, but yes, we're delivering on our financial plan. We've been able to grow EBITDA margin despite the fact that we've made investments already. So we remain committed to delivering on our financial plan.

Michael Van Aelst - TD Securities - Analyst

Okay. The Easter impact on the drug side, can you separate it for us between the front of store and the drug?

Richard Dufresne - Loblaw Companies Limited - CFO

Obviously there's no impact of Easter on drug. People don't buy more drugs because of Easter. The whole impact is on front of store and it's about 200 basis points on front of store, which averages to 100 basis points on total Shoppers.

Michael Van Aelst - TD Securities - Analyst

Okay. And then finally, can you update us on the gas station sales status if possible? And as well on your Click and Collect customer adoption and the pace of roll-out that you're expecting this year?

Richard Dufresne - Loblaw Companies Limited - CFO

On gas there's nothing to comment on right now, the process is ongoing. We will report when we have something to report, but the process is ongoing right now.

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

And on Click and Collect, yes, it continues to be an area of focus for us and we continue to roll out stores. We expect to have somewhere close to 100 by the end of the year.

Michael Van Aelst - TD Securities - Analyst

Thank you and congratulations on the results.

Operator

Patricia Baker, Scotiabank.



Patricia Baker - Scotiabank - Analyst

Good morning and thank you for taking my questions. I have two. The first one may be another one that's too sensitive for you to answer but I'm going to ask anyway. On the first quarter call, when you talked about -- you pointed to a need to adjust pricing and it certainly was a discussion around a discount in order to catch up there. I think particularly in the Ontario market. And in your remarks today, Galen, you referenced a need in the market division to focus on improving your value position.

So the changes in pricing in the market division and investing there, has that commenced? And what we saw the investment in price in the second quarter, was it primarily in discount? Or was it across the board?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

I think it is. You are also scratching around sensitive areas. I think the distinction in some respects from Q1 in discount was we had a program, a big no-frills program that we typically run in the first quarter, that we didn't. We didn't plan appropriately for missing that event. When we focused on discount as the issue in Q1, that's really at the heart of what we were referring to.

The market business is a business that always has to watch its strategic act to discount. And as the customer gets more sensitive and starts shifting its trading into the discount price position, then one needs to look at the market business and understand how much to lower the gap. What I would say is that some work has been done across some of the more price-sensitive discount banners in the last number of months. And again, it has confirmed our thesis that those businesses need to be more competitive to thrive.

Patricia Baker - Scotiabank - Analyst

Would you say generally -- and this is something I'm hearing from a lot of food retailers, not just in Canada but also elsewhere -- that the gap that can be sustained between a discount banner and a conventional banner in 2016 and beyond, is a very different gap than what could've been sustained maybe five years ago or even three years ago. That the gap has to narrow. Just in general, not specifically Loblaw.

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

Look, I don't know how the world thinks about this. I won't comment on what's appropriate, again, around the world. There has been no change in our strategic view of what the gap needs to be between discount and market for three or four years. The task is making sure that you stay there and making sure that you're achieving it across as many platforms as possible and continuing to deliver the right financial performance.

Patricia Baker - Scotiabank - Analyst

Okay, fair enough. My second question is around -- you referenced that there was an expansion of the expanded food offering in the GTA area. I wasn't clear whether you were referencing that you'd added it to 12 more in the second quarter or that the year-over-year difference was a total of 12 incremental stores?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

It's 12 in the first half, 12 in the second half. And I'll just take a moment to remind everybody the difference between the food program, which is putting a different assortment led by private label President's Choice and no name into the everyday consumables departments in Shoppers Drug Mart. That is fully deployed across nearly 100% the Shoppers stores. That is the anchor of the strong food performance that's taking place in the Shoppers business.



The second initiative is what we call the enhanced initiative. And enhanced is where we're adding small complete fresh departments to key stores. And that's what's the incremental 12 that we're talking about. And that is a much smaller, lower impact program as far as the total Company is concerned, but a very exciting initiative in terms of the way that the consumer is responding to it, particularly in the urban market. And where we're most deployed at this point is in Toronto.

Patricia Baker - Scotiabank - Analyst

What's the total number, Galen?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

I think it's 17.

Patricia Baker - Scotiabank - Analyst

Thank you.

Operator

Kenric Tyghe, Raymond James.

Kenric Tyghe - Raymond James - Analyst

Thank you, good morning. Galen, it's time to gather a couple of themes here. It's been hard to miss a key mass competitor's step-up in its fresh focus campaigns. And I'm curious as to how your fresh performance and fresh tonnage has been trending, given their increased focus on fresh as a category, or perhaps even a refocusing on fresh as a category, and the immediate spend around their fresh capabilities. Certainly been a step up first quarter and even more pronounced in second quarter. I wanted you to speak to your -- how you feel about your performance, how your performance is trending relative to your expectations in fresh against that step change of that competitor.

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

Yes, again, I hate to comment on our perception of other competitors in the market. They're all executing their own strategies for sure. There is one particularly that has ramped up its commitment to fresh and we are paying attention. We are responding to it, based on our own analysis, in a way that we think is appropriate and effective.

The fresh business is hard. It's hard to execute consistently. You can make a lot of commitments to price and to shopping environment and in stock. The question is whether or not you can sustain it. But suffice to say, that organization gets better and better at this every day, but it doesn't change our confidence in our own platforms and our ability to compete with some of them.

Kenric Tyghe - Raymond James - Analyst

Thank you. And if I could switch gears quickly to the traffic question, Galen. Could you provide some color, or any further color, with respect to the puts and takes on the quarter? The number appeared essentially flat from what I could see.



Was it a case of gains in Western Canada perhaps offset by some modest losses elsewhere in the country? Or was it perhaps flatter across the country than we expected and there weren't the gains that one might have expected in Western Canada that was coming through? Or how should we look at that traffic number in the quarter, or be thinking about it, rather, in the quarter?

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

Fair question. We typically don't give a breakdown of areas of strength and areas of softness across the country. I would say there is a bit of a mix, there always is. In some key markets where we've invested we've seen some very promising changes in the trajectory. To a degree, perhaps that's being offset by softening in some other areas.

But the way we look at it is the underlying performance relative to the competition. And one of the things that we believe the market is likely to see over the next couple of quarters is a compression in the absolute sales dollar number. Why? Because inflation is coming down. So real volume growth or volume growth that translates into sales dollars in lower priced items, is actually going to be key to sustaining a positive sales growth performance in the coming months. And that is specifically what we are focused on. And that is specifically where in Q2 we have seen the most promising improvements.

Kenric Tyghe - *Raymond James - Analyst*

Great, thanks very much, Galen. I'll leave it there.

Operator

Jim Durran, Barclays.

Jim Durran - *Barclays Capital - Analyst*

I just thought I'd focus on the drugstore business for a second. There's been, obviously, the Quebec situation with respect to tendering, an uncertainty still. There's also been some chatter about the National Coalition reviewing their current reimbursement rates and the possibility of some change sometime late fall. I'm wondering if you can comment on that and whether you've done anything in terms of your outlook to try and incorporate that potential risk.

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

I think very deliberately when we comment on the outlook and the competitive environment, we talk about food prices and we talk about healthcare reform. It is something that continues to sit out there and we are always looking at it carefully and we are always planning for an impact. And we will be making our best efforts to accommodate for it in the context of our outlook.

Our job is to manage healthcare reform and price competitiveness and still deliver against our financial plan. There is nothing in our view of healthcare reform at this point that would threaten that. However, it remains a meaningful headwind to the organization but needs to be actively managed against, and managed with, every single day.

Jim Durran - *Barclays Capital - Analyst*

Thank you. And on the online business, as we're rolling it out, Richard had provided some general metrics on how the business of that online specific relative to the store had performed in the early days when you were talking about rolling it out. Can you let us know, like, is that relationship



still holding up? Like, is the average basket larger than a retail trip? Is the margin better because of mix? I think there was also a comment about fresh in terms of the basket being larger in the online traffic than it was in regular store traffic.

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

I think no meaningful change in some of those things that we've already shared. Perhaps what would be good is for us, at the right time, to provide all of you with a more comprehensive view of how that business is evolving. We're not there yet; it's still very, very early. And to draw any sustained conclusions when you have 67 pilot stores in the market would be premature. I wouldn't put too much stock in those early views, other than the fact that they're true.

Jim Durran - *Barclays Capital - Analyst*

Okay, thank you, I appreciate it.

Operator

Peter Sklar, BMO.

Peter Sklar - *BMO Capital Markets - Analyst*

I believe from your commentary that during the quarter you did invest in gross margin in terms of shelf pricing and promotional weights. But at the same time, if you look your gross margin improvement, if you just for the change in accounting policy, I believe your gross margin was a 10 basis points. So I'm wondering if you can reconcile, like, what are the tailwinds that are allowing you to offset these investments that you're making in margin?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Peter, very simply gross margin is up in the drug business and it's down in the food business.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. I wanted to ask a little bit about inflation. Inflation has decelerated quite considerably for you from Q1 to Q2. I'm wondering what you're seeing so far in Q3 and what your outlook is for the rest of the year? And in your plans, do you contemplate that we actually experience deflation with commodity prices no longer rising and Canadian dollar seems to found a level here.

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

Look I think that is an important question and you're going to need to come to your own conclusions about it. It's not just that our inflation rate has come down dramatically, the CPI has come down dramatically in food over the last number of months. We have been calling out for the last couple of quarters, as a change -- a meaningful change -- in the market conditions in Canadian food.

I commented in my remarks that we're in a low-inflation environment and we don't expect that to change. And that we have to adjust our trading plans to accommodate for that. The way you do that is you make sure that you are positioned to drive volume, because volume is the only thing that will make sure that your sales stay in positive territory.



Peter Sklar - *BMO Capital Markets - Analyst*

Okay. And lastly, can you comment on the motivations for wanting to sell the retail fueling business? I thought grocers typically like that business because it presented you with all kinds of cross-promotional opportunities.

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

Yes, I think very simply, we regularly review probably -- once every year or two -- what we would consider to be the non-core or peripheral assets. This is a big business with lots of elements, tentacles to it. There is a limit to which the management team can effectively succeed across all those different verticals.

In our last review we concluded that the gas business likely had more value to somebody else than to us. And that it was strategically less relevant, given where we were headed from a consumer perspective, than it has been in the past. You put those two things together and it's time to see if there's anybody out there who wants to pay an attractive price for the asset.

We've also said that it is only a very attractive price that is going to compel us to sell. Because we do like the business, we understand it. And it does play a secondary role on a number of our pads.

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes, Peter, the other thing I would add is like gas bars were helpful in building traffic. We acknowledge that and we like that and we want to do more. However, we don't need to own them to be able to achieve that objective. We feel if we find a good partner that wants to align with us, that it could be a win-win for both parties.

Peter Sklar - *BMO Capital Markets - Analyst*

Right. Okay, thank you.

Operator

David Hartley, Credit Suisse.

David Hartley - *Credit Suisse - Analyst*

Thank you, good morning. Want to ask you about your tax rate and depreciation going forward and how we should think about modeling that.

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes, David, on depreciation, talk with Sophia. They will guide you on where we're going to need it. Tax rate, we should be between 27%, 28% for the whole year. It was a bit higher due to timing in this quarter, but it will come back to normal for the rest of the year.

David Hartley - *Credit Suisse - Analyst*

Okay, perfect, thanks for that. And back to drugs for a minute. Market share in beauty for a number of years many of us who cover Shoppers Drug Mart talk about gains in market share. Could you give us a little bit of color in how the Shoppers business is doing in terms of market share gains and mass or prestige?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

Yes, I think it continues to do very well in both.

David Hartley - Credit Suisse - Analyst

So that means it's up?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

That means it's up.

David Hartley - Credit Suisse - Analyst

Okay. And financial services, another area of, I guess, some strength this quarter. What are the prospects there for that business? And strategically, how were you thinking about this business going forward as it contributes to the overall business of Loblaw?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

President's Choice Financial has been a fabulous asset over the last five or six years. It has over-performed our internal expectations pretty much every year over that timeframe. And so we like the asset, our customers very much like the asset, it complements some of the core business programs really well.

There is some change facing the financial services industry right now. The buzzword of the day is disruption from fin tax. So yes, we are looking very carefully at what kind of impact those new ventures are going to have, and whether it represents a threat or an opportunity. So we're on top of it.

David Hartley - Credit Suisse - Analyst

Okay, great. And last question, to come around to items on promotion. I believe that items on promotion remain elevated relative to a number of years ago. This is difficult and sensitive, but when I look at Loblaw and your balanced approach, how should I think about Loblaw in terms of its positioning with items on promotion? Whether it be in discount banners or your market banners?

Galen Weston - Loblaw Companies Limited - President & Executive Chairman

I think it's hard to generalize the portfolio. If I gave you -- and we sit on pretty every part of the continuum. We're a very meaningful high-low player at Shoppers Drug Mart. We're a slightly less intense high-low player in the market division, but very close.

Moving into the superstores they would attend far more to an EDLT with a complimentary flyer and promo program. ANd then no-frills is a really ideal mix of both, where it's got really, really aggressive shelf prices and also comes to market with hot, hot ads. The way that you deliver a compelling economic proposition is having high volume and low, low operating costs. So we run the gamut here and we don't expect the basic construct of any of our platforms to change materially.

David Hartley - *Credit Suisse - Analyst*

Okay, thanks a lot. I'll pass it on.

Operator

Vishal Shreedhar, National Bank.

Vishal Shreedhar - *National Bank Financial - Analyst*

Hi, thanks for taking my question. I have a simple question here. Perhaps not as easy to do, but efficiencies, obviously the synergies are coming in quicker than guided to initially. How much opportunity is left for efficiencies as you look at the business? I'm not talking about the next year, I'm talking about the next couple of years. And how significant are those efficiencies to achieve your business plan as you start investing more so in price?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Vishal, obviously we're in a business whose top line is not growing fast. If you want to be driving operating leverage we need to be focused on efficiencies. I would say that will remain a sharp focus for our organization for the years to come.

Vishal Shreedhar - *National Bank Financial - Analyst*

So is a fair way to characterize it that the runway is still significant? The reason why I ask is I think you still run the headquarters of Shoppers at Loblaw separately.

Richard Dufresne - *Loblaw Companies Limited - CFO*

We different have lots of ideas.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay, thanks for that. That's it.

Operator

(Operator Instructions)

Keith Howlett, Desjardins.

Keith Howlett - *Desjardins Securities - Analyst*

Yes, I had a question on the loyalty programs at Loblaw and Shoppers Drug Mart and what your current thinking is about keeping them separate, complying, et cetera.



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

I don't know, Keith, whether you asked this question last time, but we get asked this question fairly often. Clearly two big loyalty programs, deep customer databases with a lot of cross-shopping in between the two databases. So there is certainly inherent value and we need to figure out precisely the right way to extract that value.

We have a team who is working on precisely that challenge at the moment. We will announce any kind of changes at the right time. At this point we don't have anything to comment on.

Keith Howlett - *Desjardins Securities - Analyst*

I rely on Kenric to ask that question, but he didn't this time. (laughter) In terms of the store closures, I'm sure you may not want to share it, but are you able to indicate when you closed the stores that you announced. Do you pick up much of the volume at the rest of the network or does most of it disappear?

Richard Dufresne - *Loblaw Companies Limited - CFO*

We don't typically put two stores very close. So we capture some but we suspect that others are probably capturing a bigger share of that.

Keith Howlett - *Desjardins Securities - Analyst*

Great. And then finally on the JoeFresh business. You've exited, I know, the most stand-alone retail. What are your plans going forward? I think you need a new President there now, but are you in all the categories you want to be in? Or what's the outlook for more shelf space, more categories, et cetera?

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

I'm glad you asked the question, actually, because we're really pleased with what the new team at JoeFresh has achieved over the last two years. It has been, I think I would describe a soup-to-nuts overhaul of the branding, the sourcing processes, the merchandising, the marketing and the store program. It has come with a retrenchment in some respects, as far as our international ambitions.

But that was always part of the case scenario. We go out there, see if there was a viable stand-alone business in the US. We've concluded at this point that there isn't. So we shut the stores and we've come back.

Throughout that time the JoeFresh business continues to outperform significantly the rest of the comparable apparel market which we feel great about. And there are still a number of international channels, Mexico, the Philippines, places that we're seeing some interesting growth opportunity.

Although they are wholesale agreements with no capital and no meaningful incremental risk. But the upside of growing the volume base for JoeFresh which has a really compelling net benefit to the base business here in Canada.

As far as new categories, we continue test new categories with the brand. We have a cosmetics business now. We're well-positioned at Shoppers Drug Mart. We have a costume jewelry business at Shoppers. We ventured into shoes and are looking to see how that performs.

So I don't think we'll ever be finished. We just continue to look at things and see if the customer likes them. If they do, we push into the category; if not, we shift our focus and attention elsewhere.

Yes, our President is moving to a different role in the group. But we have a superb team, a creative team and an operations team. And we have the utmost confidence in their ability to continue to build on the success that they're responsible for over the last two years.



Keith Howlett - *Desjardins Securities - Analyst*

Thank you.

Operator

Chris Li, Bank of America.

Chris Li - *BofA Merrill Lynch - Analyst*

Hi, good morning. A couple questions. First is you're obviously executing well on your cost reduction initiatives. It sounds like, from your answers on the call, that if the sales environment becomes more challenging, there are certain cost levers that you can pull harder to make sure that you keep your margins stable and still grow earnings. Is that a fair characterization?

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

Yes, that's a very good characterization.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay, that's good. And I apologize if this is a bit of a technical question, I might've asked this in previous calls, but going on the drug reforms, if tendering does get implemented on a larger scale in Quebec, can you remind us on a high-level basis, how does that impact your Shoppers pharmacy business? If you can walk us through some of the steps or how that impacts your profitability from (multiple speakers).

Richard Dufresne - *Loblaw Companies Limited - CFO*

Chris, the law has been adopted. We have no idea what they are going to do with it. So we can't really comment. The only thing I'd say is that our exporters, the Quebec market is relatively small across Canada. So it will impact somewhat less as a percentage of the business. That's the only comment I'll make right now.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. Last question is -- I know you can't comment much on the gas station proceeds -- but is a fair to assume, given your data is where you want to be and there's really no big acquisitions to make that the potential use of proceeds would most likely be for capital return?

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

Yes, the balanced capital return strategy is at the core of how we think about all of our cash flow. This would be part of that and we would think about in the same terms.

Chris Li - *BofA Merrill Lynch - Analyst*

Great, thanks.

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

Chris, can you do me a favor and just ask a question, just a simple question about synergies? How we feel maybe about the achievement of our synergies? (laughter)

Chris Li - *BofA Merrill Lynch - Analyst*

Sure, Galen, how do you feel about your achievement of your synergies? (laughter)

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

Thank you. You'll understand why in a second. We feel obviously good to deliver the synergies that we set out ahead of plan. But what I really wanted to do was take a moment to publicly recognize the organization.

It is not an easy thing to do to bring two businesses together and to try and extract costs. That essentially means business processes have to change, people have to do things in a fundamentally different way.

The fact that the synergy team and the rest of the businesses have achieved this with virtually no disruption to the basic trading and the customer experience in our business, and in some cases materially enhancing that, that is that is a terrific accomplishment. Some extraordinary people have been working very, very hard across this business to achieve it. And I just wanted to take a moment to publicly recognize them. Thanks for asking the question.

Chris Li - *BofA Merrill Lynch - Analyst*

My pleasure. Thanks. (laughter)

Sophia Bisoukis - *Loblaw Companies Limited - IR*

Great, thank you. And thanks, everyone, for joining us today. We look forward to speaking with you again to discuss our third-quarter 2016 in results shall be held on Wednesday, November 16, 2016. Have a good day.

Operator

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

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