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EDITED TRANSCRIPT

L.TO - Q4 2016 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 4Q16 total sales of CAD11.1b and adjusted diluted net EPS of CAD0.97.



FEBRUARY 23, 2017 / 3:00PM, L.TO - Q4 2016 Loblaw Companies Ltd Earnings Call

CORPORATE PARTICIPANTS

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Richard Dufresne *Loblaw Companies Limited - CFO*

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CONFERENCE CALL PARTICIPANTS

Irene Nattel *RBC Capital Markets - Analyst*

Jim Durran *Barclays Capital - Analyst*

Michael Van Aelst *TD Securities - Analyst*

Mark Petrie *CIBC World Markets - Analyst*

Kenric Tyghe *Raymond James - Analyst*

Patricia Baker *Scotiabank - Analyst*

Vishal Shreedhar *National Bank Financial - Analyst*

Peter Sklar *BMO Capital Markets - Analyst*

Tal Wooley *Eight Capital - Analyst*

Keith Howlett *Desjardins Securities - Analyst*

Chris Li *BofA Merrill Lynch - Analyst*

PRESENTATION

Operator

Good day and welcome to the Loblaw Companies Limited fourth quarter 2016 conference call. At this time, I'd like to turn the call over to Sophia Bisoukis, Head of Investor Relations. Please go ahead.

Sophia Bisoukis - Loblaw Companies Limited - Head of IR

Thank you and good morning. Welcome to the Loblaw Companies Limited fourth quarter 2016 results conference call. I'm joined by Galen Weston, Chairman and Chief Executive Officer; and Richard Dufresne, Chief Financial Officer.

Before we begin today's call, I would like 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 2016 and future years. These statements are based on certain assumptions and reflect management's current expectations and they are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from our expectations.

These risks and uncertainties are discussed in the Company's materials filed with the Canadian Regulators from time-to-time. Any forward-looking statements speak only as of the date they are made, and the Company discloses 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 direct comparable GAAP financial measures. I will now turn the call over to Richard.



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Richard Dufresne - Loblaw Companies Limited - CFO

Thank you, Sophia, and good morning, everyone. In the fourth quarter, we continued to deliver against our financial plan achieving positive same-store sales with stable gross margins in the highly competitive and deflationary retail environment. We delivered adjusted diluted net earnings per share of CAD0.97, an increase of CAD0.10 per share or 11.5% compared to the fourth quarter of 2015.

We also continued to return capital to shareholders buying back 2.8 million shares at a cost of CAD200 million. Our food retail business achieved 1.1% same-store sales growth, as we moved into a deflationary price environment for the full quarter. Food retail same-store sales benefited by approximately 1% due to the impact of an extra selling day due to the timing of New Year's day. Our internal rate of deflation was slightly lower than the CPI rate of 2.3%.

Positive trends for same-store sales in drug retail continued this quarter with total comparable sales of 3.4%, which also benefited from the timing of New Year's day by approximately 0.6%. Front store same-store sale grew by 4.1%; pharmacy same-store sales grew 2.5%. With positive same-store sales growth in both food and drug retail, total sales were CAD11.1 billion, up 2.4% from last year.

Adjusted retail gross margin excluding the impact of consolidating franchises, remained within the stable trading band at 26.4%, 20 basis points lower than a year ago. Promotional investment to support sales initiatives in our food retail business were partially offset by improved drug retail margins due to strong front store performance.

SG&A as a percentage of sales excluding the consolidation of franchises improved 40 basis points. Improvement in SG&A included lower store support cost, the impact of store closures, foreign exchange and were partially offset by higher retail store cost as operational efficiencies achieved in stores were more than offset by an increase in financial support to franchises. Our adjusted EBITDA was CAD956 million, an increase of CAD75 million or 8.5% and margin stood at 8.6%, an increase of 50 basis points from the same period in the prior year.

Looking ahead, we continue to remain confident in both, our strategy and financial plan. In 2017, this will translate into positive same-store sales growth for the year and stable gross margins in the retail segment, despite the current deflationary environment and the continuing negative pressure of healthcare reform. We expect to further improve our efficiencies in 2017 though not at the same level experienced in 2016. We will continue to grow adjusted net earnings and plan to invest CAD1.3 billion in capital expenditures, of which CAD1 billion will be in retail. We will also continue to allocate a significant portion of free cash flow to share repurchases.

Turning to Q1 of 2017, we expect same-store sales to be negatively impacted by the shift of New Year's day in the first quarter of 2017, resulting in one less selling day. In addition, Easter will shift in the second quarter in 2017 compared to the first quarter in 2016. At this point, I'll turn it over to Galen.

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Thank you, Richard. Good morning, everyone. We continued to successfully execute against our strategic framework, delivering the best in food, best in health and beauty, operational excellence and growth. We delivered another strong quarter of financial progress within our model, delivering stable gross margins, operating leverage and earnings growth.

Our drug business continued to perform well. Front store same-store sales growth of 4.1% was supported by solid increases across all major categories, led by OTC and cosmetics. Our pharmacy business grew at 2.5% with strong script growth offsetting our Rx deflation.

In our food retail business, we saw a deflationary market in the fourth quarter as we continued to invest to drive volume in our grocery business. As a result, we saw slightly more internal deflation than CPI. However, tonnage volume and share increased, and average basket grew. Excluding gas and the extra selling day this year, we had slightly positive same-store sales. We achieved this while maintaining stable gross margins across our retail businesses, supported by shrink improvement and strong front store performance at Shoppers.



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Once again, we generated strong earnings growth through operating leverage, driven by improvements in SG&A rate, reflecting the continued progress of our efficiency and cost reduction initiatives. Overall, I'm pleased with the performance against our financial plan in the quarter and for the full year. Looking back at the year, we delivered against our milestones. We steadily grew our tonnage throughout the year, more than making up for a slow start to the year. Our synergies goal of CAD300 million in savings was achieved ahead of time. We surfaced operating efficiencies through the year and are still working hard to extract further costs from our business. We announced a share buyback program a year ago and in 2016, we returned a significant portion of our free cash flow to our shareholders through the repurchase of 10.3 million shares.

Looking forward to 2017, Loblaw will remain focused on its strategic framework and financial plan. We expect to maintain a stable trading environment, surface efficiencies to increase operating leverage, grow earnings, and continue to return capital to shareholders. Before we move to question-and-answer, I'd like to take a minute to congratulate and welcome Sarah Davis to her new role. As you know, Sarah has previously served as a Chief Administrative Office and Chief Financial Officer. As I continue in my role of Chief Executive Officer, I'm excited to have Sarah step in and take over the day-to-day responsibilities as President of Loblaw Companies Limited.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And we'll take our first question from Irene Nattel from RBC.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks, and good morning, everyone. I was wondering if we could start by talking about the outlook for SG&A and operating leverage, as we move through 2017, and what key initiatives you might have in place?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Essentially, as I mentioned in my comments, we're still working hard to improve SG&A in 2017, albeit we won't be able to deliver the same rate improvement that we've seen in 2016, like you saw 40 bps more or less throughout the year. And while we'd love to be able to achieve that going forward, I think it's not realistic. So, you should expect something a little bit lower but we've got a number of initiatives that will contribute to us adding those figures.

Irene Nattel - *RBC Capital Markets - Analyst*

Just moving on to the trends, are you seeing any shift in consumer buying patterns in response to the lower price related to deflation?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Yes, they're buying more low-priced product. I think, the short answer is we're lowering prices; customers are responding to those lower prices; we're seeing it in our shelf investment; we're seeing it in our promotional investment. And we're pleased; we think we're making the right decisions to invest in the right categories.



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Irene Nattel - RBC Capital Markets - Analyst

And in terms of the loyalty, I believe that earlier you'd indicated that 2017 could be an important year as we look at the Optimum and PC Plus programs. Wondering if there's anything you could -- any updates you can provide at this point?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

No.

Irene Nattel - RBC Capital Markets - Analyst

Okay.

Galen Weston - Loblaw Companies Limited - Chairman & CEO

But, we're working on it. Sorry. So, we're working on it. We're working hard to figure out what the future for PC Plus and Optimum is. And when we're ready to talk about it, we'll make sure that we give you the full story.

Irene Nattel - RBC Capital Markets - Analyst

Should we be expecting it in 2017, or more of a 2018 event?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Why don't we comment on it a little bit later when we get closer?

Irene Nattel - RBC Capital Markets - Analyst

Okay, great. Thank you so much.

Operator

And we'll take our next question from Jim Durran with Barclays.

Jim Durran - Barclays Capital - Analyst

Can you just give us some idea on the deflation side? Like, where're the big buckets of deflation; is it still sort of meats year-over-year; how much of it is still maybe some FX? And if you're expecting positive comps for the year, is that based on an assumption that deflation will abate and turn to inflation as we creep through the year?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Yes. So, I mean, we're watching deflation carefully. I mean, the current CPI rates are low, and that does create an increasingly difficult operating environment. We continue to invest decisively and deliberately.



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As I said before, we're satisfied with the results that we're getting where we're making the investments. Fresh continues to be the place where the investments are most aggressive and where you see the most significant deflation. Meat has been called out before. Bakery is a place where we continue to see an increasing level of investment.

Look, the key in periods like this is to continue to drive volume. And we are pleased with the way our volume is moving in response to the investments. And then, you have to effectively manage cost. I think that suits the way that the Loblaw business model is structured. And as we have said before, we think we are well able to deliver our financial plan in this environment.

As far as what's going to happen to deflation or inflation over the balance of the year, I think it's premature to comment. Although it's fair to say that the first half of 2016 was the peak inflationary period; and the back half of 2016, you started to see the inflation rate slow rapidly. So, I mean, I think you can make your own judgments about that.

Jim Durran - *Barclays Capital - Analyst*

Would you say that you gained tonnage share or are you holding tonnage share at this point?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

On the fourth quarter, we feel pretty good about our share results.

Jim Durran - *Barclays Capital - Analyst*

And last thing, just on online, where are you at in terms of number of locations in Canada that you are offering online? And there has been a number of changes obviously in the competitive domain. What's your stance heading into 2017? Are you expecting to add more locations or are you are sitting back and sort of assessing where you are at?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Yes. So, we are doing both. We are continuously assessing where we are at. We've got 100 locations, we would expect to continue to roll out Click & Collect across the country. I won't comment on exactly how many. I think I have said, that's the assessment we are trying to do that we push the button and really, really accelerate the full deployment or do we progressive at the pace of the market, and we haven't made a decision on that just yet.

Jim Durran - *Barclays Capital - Analyst*

And any consideration about home delivery at this point?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Well, yes, lots of consideration about home delivery and lots of consideration about all of the different delivery mechanisms for grocery online. Certainly, our view is today that Click & Collect is in the best interest of the customer and that the Canadian consumer's responding really well to the service.

Is home delivery going to be a part of it? You've got a few people experimenting; we will watch that closely. We might experiment. But at this point, I don't think anybody has reached a conclusion that is the best path forward for grocery.



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Operator

And we will take our next question from Michael Van Aelst with TD Securities.

Michael Van Aelst - TD Securities - Analyst

Thank you. Just continuing briefly on the Click & Collect question, are you seeing any change in the economics on your part as others roll out Click & Collect of their own?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

No.

Michael Van Aelst - TD Securities - Analyst

So, on the Shoppers side, in 2016, grocery seemed to be the bigger driver of the front store sales. Although it pulled along other categories as well. What would you expect to be the driver of front store in 2017?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

I think it will be a balanced performance across the full front store package. Think about the role of food. We did our full sort of deployment of President's Choice, the revised planograms as part of the coming together of Shoppers and Loblaw. So, we saw a huge boom in 2015, the first part of 2016.

We are starting to lap that, still very, very pleased with the performance of food in Shoppers Drug Mart, very pleased with the performance of cosmetics, both in enhanced beauty part of the store and actually in mass cosmetics. And so, we think it will continue, not quite at the rate perhaps of last year but still it will be an accretive part of the sales formula for the business.

Michael Van Aelst - TD Securities - Analyst

And how does that the fresh rollout fit in there?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Yes. So, again, I think, we've commented, very, very pleased with the deployment of our fresh convenience offer in the urban markets. We continue to aggressively expand that in the right urban locations. You will see more of it showing up in key markets over the balance of 2017. And we are still working our way through the right combination of assortment and pricing for the suburban proposition.

Michael Van Aelst - TD Securities - Analyst

Okay. And I know you talked about on the SG&A side, I know you talked about progress in 2017 but not as good as 2016, where do you see Loblaw's stance in terms of simplifying its operations, what inning would you be in at this point?



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Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Well, there is a lot of debate around that on the management team. I'd say we're about a third of the way there. But the way to think about SG&A leverage is, and I've comment on this before, we're not trying to chase a huge number in a short period of time. What we're trying to do is continuously and relentlessly improve the cost structure of the business.

We want to do it through simplification, through the improvement of business processes, it involves pretty much every line of the P&L that we're working on, we focus on the SG&A line, but there's also elements of it that show up and margin shrink is a great example of that. Store labor is the place that we're focusing.

And so, I'd say, we still got some pretty significant runway, but it's going to unfold in a stable, significant way quarter-after-quarter, year-after-year in keeping with this concept of stable trading. It's almost as if we want stable SG&A leverage and improvement as well.

Michael Van Aelst - *TD Securities - Analyst*

And can you just clarify the difference between the lower store support costs and the higher retail store costs to support the franchisees?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Store support is more head office and retail store is in the store.

Operator

We'll take our next question from Mark Petrie with CIBC.

Mark Petrie - *CIBC World Markets - Analyst*

I wondered if you could just give us a bit more detail in terms of the CAD1 billion budget for CapEx on the retail business for 2017?

Richard Dufresne - *Loblaw Companies Limited - CFO*

It's more of the same as you've noticed over last few years, we've been shifting away from infrastructure investment and more into our retail network. So that's a trend that's continuing. And we've been at the CAD1 billion level in the retail for last two years, and that's a level we feel comfortable with.

Mark Petrie - *CIBC World Markets - Analyst*

And any sense or can you give us any sense in terms of the mix between your formats?

Richard Dufresne - *Loblaw Companies Limited - CFO*

No.

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Mark Petrie - CIBC World Markets - Analyst

Okay. And then, you mentioned that people are buying more lower priced product, and that's the root of the deflation. But, could you just give us a sense of whether that's continued trade down to the discount channel, if it's simply a matter of people opting for more lower priced product in terms of private label or lower quality goods, and then maybe a sense in terms of the mix in terms of promotional adoption?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Yes. I think, I'm not going to go through a breakdown of sort of each and every element. What you should take away is there's no sort of disproportionate place that this is actually happening. We're seeing customers trade down in support of the price investments, fairly equally across the broad portfolio. We've tonnage growth fairly equally distributed across the broad portfolio.

We're seeing take up on promo; we're seeing a response in more aggressive private label programs that tend to focus on lower priced goods; we're seeing it in our shelf investments. So, it's really what you would expect. Customers are coming into the stores; and where they see opportunities to save money, they're taking advantage of those opportunities.

Mark Petrie - CIBC World Markets - Analyst

I guess just lastly, in terms of the store portfolio, I'm assuming square footage growth for 2017 will remain materially below 1%, but maybe you could just confirm that. And then, do you have any plans to be moving some of your existing square footage between channels, so conventional to discount and so forth?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

No. I mean, look, both of our businesses are competitively positioned. We feel good about the role that they play strategically. And we're investing new square footage in support of that strategy. I mean, I think the only thing I would say is that our prototype new store in each of our formats continues to be smaller than it was five or six years ago.

Richard Dufresne - Loblaw Companies Limited - CFO

Yes. And we confirm our square footage growth will be sub 1% again this year.

Operator

And our next question comes from Kenric Tyghe with Raymond James.

Kenric Tyghe - Raymond James - Analyst

Galen, could you speak to how the enhanced beautyBOUTIQUE stores are performing relative to the more typical beautyBOUTIQUE and perhaps how the performance of those stores is impacting your thinking or plans around the enhanced beautyBOUTIQUE offering?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Yes. So, we are very happy with the way they are performing. And we see it as one of a number of exciting pillars for continued investment and growth in the front store proposition at Shoppers.



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Kenric Tyghe - *Raymond James - Analyst*

And just staying with beauty, a follow-up there, you've also, sort of with the enhanced beauty offering obviously introduced a number of, I guess so I characterize as super prestige brands, Chanel and the like. Could you provide some sort of color on how those brands have been performing and whether you believe you are actually taking share in that, the high end of the market?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

I don't know that I really want to provide too much color, but suffice to say, we are adding more doors in each of those brands with their full support and our full support. That should give you an indication that we have collective confidence in Shoppers Drug Mart beautyBOUTIQUEs as a distribution channel for those premium brands.

Operator

We will take our next question from Patricia Baker with Scotiabank.

Patricia Baker - *Scotiabank - Analyst*

My first question, I'm probably going to get a no but you might surprise me. If we look at that deflation number, which for the quarter was above 2.3%, and we recognize that there are a lot of products that are priced differently this year versus last year because of other extraneous things that are going on.

Of that number, how big of an impact was your planned price investments on that deflation? So, in other words, very well-planned deflation that you were looking for to have in your business by getting your pricing down to drive the volume and the tonnage?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Yes. I mean, look, I think, I'm not going to give you a breakdown; I am not going to give you too much direction. Although we have been working on this, as you well know, for pretty much four quarters, expecting it, planning for it and making decisive investments.

And so, I would say a meaningful portion of where we sit in terms of deflation is a function of proactive investment that's being made by us and being made by others in the marketplace. It continues to be rational, but it continues to be very intense.

I'll, if I may, just seize on the question to comment on our ongoing discussion about Street math. The Street math shows a pretty extraordinary tonnage growth in our business over the course of Q4, and it would over represent the real underlying tonnage growth in the business. We have it, we are happy with it, but I thought in a positive sense, I should also remark on the ineffectiveness of that measure as a representative of the true underlying volume growth in the business.

Patricia Baker - *Scotiabank - Analyst*

Okay. Galen, I thank you for two things. Thank you for using the word meaningful because that answered my question. And I thank you for addressing that Street math, (multiple speakers) incredibly erroneous. Okay.

I have another question and it is around comment that you just made when you were talking about Click & Collect. And I think what you said is that Click & Collect is best for the customer. And I am not necessarily disagreeing with that because I certainly think, definitely a Click & Collect model is what's best for the retailer because it's a more efficient model. Just share with us your thoughts on why you call that best for the customer?



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Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Yes. Look, this is sort of based on some extensive research that we've done as we determined what the right path forward was for our digital grocery strategy.

And if you are a country that has a lot of people in cars, driving from one place to another, being able to drive path to supermarket, drive to supermarket on your way home from dropping the kids off to school or picking the kids up from school, being able to pick the window to the tune of 15 or 20 minutes in order to pick up your groceries and have them put in your car, and then drive on to your next errand or what have you, has more resonance than the idea of waiting around in your house, being trapped in your house waiting for that particular delivery to arrive.

And when you look at other countries with this model, what you see is places where home delivery started as the channel for e-commerce, it tends to have the highest penetration. Where you see Click & Collect having been the starting channel, it tends to have the highest penetration. But when you look at what's been happening in some of these mature markets, there's a distinct shift even in the home delivery markets towards Click & Collect.

So, it is not so definitive in the eyes of the customer that I'm saying there will never be a home delivery channel for the Canadian consumer; just that on balance the customer sees a lot of convenience in it. And you're right, it is definitely in our interest as an incumbent store-based retailer for that to be the dominant channel for digital grocery in Canada.

Patricia Baker - *Scotiabank - Analyst*

Can you help us understand on the SG&A front and all the things that you're doing, can you just give you us one simple example, either you or Richard, on the simplification? So, talk to us about some process, some task that now as a result of trying to make the business simpler, and I know you're still in the early days of that, but just give us one example.

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Yes, okay. So, I'll give you an example, the product listing process. So, the product listing process would have 15 or 20 steps to it. And as a result of the implementation of the SAP and the optimization of SAP, will be pushing a number of steps down to somewhere closer to five or six.

But it's hard to understand what actually happens and how much complexity takes place in a listing process. But it gives you a sense of the quantum of simplification that improved processes and the right technical tools actually deliver for the business.

Patricia Baker - *Scotiabank - Analyst*

And when you look at something like that, would you have benchmarked what say best-of-class grocers, what their listing process, the steps that would have been involved?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Yes.

Operator

Our next question is from the Vishal Shreedhar with National Bank.



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Vishal Shreedhar - *National Bank Financial - Analyst*

Just on EBITDA growth in the quarter year over year, it was about 8% to 9%. However, I think I'm correct, there's about a CAD27 million benefit from franchise consolidation. So, if you take that out, it looks like the growth has considerably slowed from call it the prior quarter. Just wondering if you can give us some help on what the big items are that are causing that slowdown in growth?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Obviously, same-store performance was a bit -- is a bit slower but definitely we get a benefit from franchise consolidation, but like we still feel that we're growing our business at a very healthy rate.

Vishal Shreedhar - *National Bank Financial - Analyst*

So, I guess another way of asking the similar question is, is the price investment in the food side, is that accelerating or is that stableish?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Well, I'd say on an absolute rate basis, it continues to be at the same rate that it has been for the last number of quarters. That's intentional. Like, we're planning it that way.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. Return on invested capital, I know, Richard, you've remarked in the past that's a focus for you. Capital, CapEx of the CAD1 billion, a bit higher than I thought where it would be. I'm just wondering your thoughts on return on invested capital and what levers; is it predominantly SG&A that can be pulled to drive that higher?

Richard Dufresne - *Loblaw Companies Limited - CFO*

No, I think just the investment decisions we're making now, we're putting much more scrutiny in how we allocate capital in the business. We understand the projects that drive higher returns and we skew our decisions toward those projects. So, over time, you should see an increase in our return on investment capital just by the nature of the decision we make going forward.

Vishal Shreedhar - *National Bank Financial - Analyst*

And pharmacy reforms, have those stabilized, and do you have a good read on what's going to happen in 2017 or is the visibility generally low?

Richard Dufresne - *Loblaw Companies Limited - CFO*

We have some visibility and it's -- we have same visibility as we had at the beginning of 2016. So, we have some; we had a sense of the amount but you never know what's going to happen during the year and we're trying to offset it through the business.

Vishal Shreedhar - *National Bank Financial - Analyst*

Is Shoppers still growing? I don't know if pre-synergy is the way to say it anymore but is Shoppers still growing pre-synergy on EBITDA let's say?



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Richard Dufresne - Loblaw Companies Limited - CFO

It was in 2016. Yes.

Operator

Our next question is from Peter Sklar with BMO Capital Markets.

Peter Sklar - BMO Capital Markets - Analyst

So, you are well into your Q2 now and you and the industry should be seeing greater deflation than you saw in Q4, if for no other reason than that you are getting the stronger inflation comps, like Galen referred to. So, I am just wondering if you are discerning any change in behavior amongst yourself or your competitors as a result of this at heightened deflation trend you are experiencing?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Nothing outside the environment that we saw in Q4 and Q3. I mean, it continues to be intense. And as I said before, from our perspective, people continue to be trading rationally but very aggressively. Some people are investing in markets that we are investing less in. We are investing in markets that others are investing less in. So, there is a lot happening, but I wouldn't ascribe any macro trend that has emerged in Q1. We are still in the middle of Q1 for 2017 at this point.

Peter Sklar - BMO Capital Markets - Analyst

My next question is on store closures. I believe, in 2016, you closed on a gross basis, 32 stores. Now, as I recall, when you announced the restructuring in 2015, there were going to be 50 store closures. So, I am just wondering where the other 18 slipped to?

Richard Dufresne - Loblaw Companies Limited - CFO

There is no slippage, like we completed our store closures, I guess in Q2 of 2016 I guess the last month, and that's it. But, there was no slippage.

Peter Sklar - BMO Capital Markets - Analyst

So, how do I recognize 32 of the 50, Richard?

Richard Dufresne - Loblaw Companies Limited - CFO

I'll go back to my notes and get back to you, but like there was no slippage there.

Peter Sklar - BMO Capital Markets - Analyst

Okay. Lastly, in the MD&A, when you are talking about the retail business, there is a reference to you've increased financial support to franchisees. So, I am just wondering what is the issue with franchisee economics?



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Richard Dufresne - Loblaw Companies Limited - CFO

This is the way we manage our business. The franchisees are under long-term contracts and we have certain objectives to hit some retained earnings numbers. And so, there is a portion of their business that is not under their control, i.e. if we do price investments and we make the business more aggressive, it's not within their control.

So, we need to adjust their earnings and we true that up mostly in Q4 of each year. We do some early in the year but most of the true up happens in Q4. So, that's what we referred to specifically in the MD&A.

Operator

Our next question comes from the Tal Wooley with Eight Capital. And your line is open.

Tal Wooley - Eight Capital - Analyst

Richard, I just wanted to go back to your comments on return on invested capital. You said you are getting better at selecting the best returning projects going forward, and that's how you will drive improvement in that number. I was wondering if you can characterize, maybe just in terms of the types of projects that those are, if you could give us some examples of what are the best things that Loblaw can do to move that number right now?

Richard Dufresne - Loblaw Companies Limited - CFO

I guess renovation as we have determined, like we hit those figures easily like we have a base of sale in a store; we are doing a select program of investment in that store and we typically hit our returns. New stores are tougher, takes longer. So, there is more volatility on those returns.

So, by knowing which projects give us the highest and more reliable return, we can skew toward our decisions toward those projects to hit the numbers we are focused on. So that's an example of how we do it.

Tal Wooley - Eight Capital - Analyst

And then just talk briefly on deflation. I can understand, as we look into the back half of sort of a Street math thing to sort of say the comps get easier for inflation, in the second half. I guess could you speak more to what you think the absolute sort of price level might look like over the course of the year? Do you see any factors that make deflation more aggressive, as you move through the course of the year or do you think that holds steady or maybe even gets little bit better?

Galen Weston - Loblaw Companies Limited - Chairman & CEO

Yes. I would say, we are watching that very, very closely. That is an important question for us to answer. At this stage, we see no change in the trends, no change in the competitive environment that moves beyond our current view of what's going to happen.

We have called in our outlook that we see positive same-store sales growth for the full year. That should give you some sense of how we feel. Are there forces out there that could turn that on its side? Not that we see yet, but if they surface, we'll be sure to call it out.



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Tal Wooley - *Eight Capital - Analyst*

And then, just finally on the Click & Collect business, I'm wondering if you could just contrast for me how you're managing rolling that out. It's been primarily in your corporate-owned banners, but you have particularly in market -- in your market business, some franchise-owned banners that would probably benefit from that as well.

And so, I think of like Hamilton and Fortinos or something like that, where I don't believe that has been rolled out more aggressively. Are you going to be able over time to sort of offer that service in some of those core markets where you are maybe more running under a franchise business as opposed to corporate-owned business?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Do you live in Hamilton?

Tal Wooley - *Eight Capital - Analyst*

No.

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

No, I'm kidding. Okay. So, yes, we do. There's nothing about the franchise agreement that would prevent us from running an effective Click & Collect concept there.

Tal Wooley - *Eight Capital - Analyst*

And just, again, maybe to follow-up on that. The same thing too with Real Canadian Superstores versus No Frills, how are you thinking about managing that, because obviously they serve similar customer bases in similar markets?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

So, there's nothing that would prohibit us from doing a Click & Collect service in No Frills. You know that we have deployed it in a number of Real Canadian Superstores; we're seeing some really, really positive results in those deployments.

Just keep in mind that this adds cost to the store P&L in an absolute sense. No Frills is a hard discount business which trades on low margins, low assortment and very, very low operating costs. So, you've to be really, really careful about adding incremental overhead to those boxes, unless you're really certain that it is going to enhance the economic proposition as opposed to dilute it.

Operator

Our next question comes from Keith Howlett with Desjardins Securities.

Keith Howlett - *Desjardins Securities - Analyst*

I had a question on the gas bars, where that process currently is?



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Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Yes. That process continues, and we will report on it when we are ready.

Keith Howlett - *Desjardins Securities - Analyst*

And then, I had a question about online beauty, is Shoppers Drug Mart got any plans to go online or to expand its offerings or anything of that nature?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

So, we have a very compelling online beauty offer available through the beautyboutique.ca that's been up and running in market probably for about a year. We're now aggressively driving customer volume to that site. And so, you should expect to hear more about it, see more of it in 2017. Yes, it's an important pillar for our omni-channel strategy, and we feel pretty good about where it sits today.

Keith Howlett - *Desjardins Securities - Analyst*

And then just in terms of certain categories, are you noticing any visible shift, like people buying diapers online or are you identifying any categories that look particularly susceptible to online?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

No. I mean, I think the way to interpret our strategy is that in our core businesses -- our core businesses are drug and food and apparel, we expect to have a compelling omni-channel offer that takes advantage of our strategic assets and delivers our customers something really compelling. So, we sell diapers online today and we'll continue to build on that volume through our own platform.

Keith Howlett - *Desjardins Securities - Analyst*

And then just finally on the new conventional stores in Western Canada, I guess over the last three or so years, the CityMarket stores, how are those being received in the market?

Galen Weston - *Loblaw Companies Limited - Chairman & CEO*

Well, we're continuing to build more of them, so largely, feeling pretty positive.

Operator

Our next question is from Chris Li with Bank of America.

Chris Li - *BofA Merrill Lynch - Analyst*

Sorry. I got on call a bit late, but did you mention what is your targeted square footage growth for the year?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Sub 1%.



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Chris Li - BofA Merrill Lynch - Analyst

Sub 1%. And then, just on the free cash flow, just in your outlook, you mentioned you will be returning a significant portion of free cash flow to share repurchases. I just wanted to confirm, when you talk about free cash flow in terms of capital return, are you focusing on the retail free cash flow or is that on a consolidated free cash flow or is there no big difference between the two?

Richard Dufresne - Loblaw Companies Limited - CFO

No, there is a big difference at the retail free cash flow, and we are talking about free cash flow after dividends.

Chris Li - BofA Merrill Lynch - Analyst

On the retail segment that is generating the cash?

Richard Dufresne - Loblaw Companies Limited - CFO

Yes.

Operator

Our next question comes from Vishal Shreedhar with National Bank.

Vishal Shreedhar - National Bank Financial - Analyst

Hi. Sorry about that. Just a few quick follow-ups. On the segmented same-store sales growth for Shoppers Drug Mart, you gave us the day impact on consolidated. Is it the same in each of the two segments?

Richard Dufresne - Loblaw Companies Limited - CFO

It's a bit more in front of store; pharmacy is a bit less affected.

Operator

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

Sophia Bisoukis - Loblaw Companies Limited - Head of IR

Thank you to everyone for joining us today. If you have any further questions, you can contact our Investor Relations team. We look forward to speaking with you again to discuss our first-quarter 2017 results, which will be held on May 3, 2017. Have a good day.

Operator

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



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