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L.TO - Q1 2017 Loblaw Companies Ltd Earnings Call

EVENT DATE/TIME: MAY 03, 2017 / 2:00PM GMT

OVERVIEW:

Co. reported 1Q17 adjusted diluted EPS of CAD0.90.



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CORPORATE PARTICIPANTS

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Richard Dufresne *Loblaw Companies Limited - CFO and Member of Management Board*

Sophia Bisoukis *Loblaw Companies Limited - VP of IR*

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Irene Ora Nattel *RBC Capital Markets, LLC, Research Division - MD of Global Equity Research*

James Durran *Barclays PLC, Research Division - MD, Head of Canadian Equity Research, and Senior Analyst*

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Mark Petrie *CIBC World Markets Inc., Research Division - Research Analyst*

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Peter Sklar *BMO Capital Markets Equity Research - Analyst*

Tal Woolley *Eight Capital, Research Division - MD of Equity Research*

Vishal Shreedhar *National Bank Financial, Inc., Research Division - Analyst*

PRESENTATION

Operator

Good morning, my name is Christina, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited Q1 2017 Conference Call. (Operator Instructions) Thank you.

Sophia Bisoukis, you may begin your conference.

Sophia Bisoukis - *Loblaw Companies Limited - VP of IR*

Thank you, and good morning. Welcome to the Loblaw Companies Limited First Quarter 2017 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 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 2017 and future years. These statements are based on certain assumptions and reflect management's current expectations and they are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from our expectations. These risks and uncertainties are discussed in the company's materials filed with the Canadian regulators, from time to time. Any forward-looking statements speak only as of the date they are made. The company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than what is required by law. Certain non-GAAP financial measures may be discussed or referred to today. Please refer to our annual report and other materials filed with the Canadian securities regulators for reconciliation of each of these measures to the most directly comparable GAAP financial measures.

I will now turn the call over to Richard.



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Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

Thank you, Sophia, and good morning, everyone. In the first quarter, we continued to deliver against our financial plan amidst a competitive and deflationary retail environment. We delivered adjusted diluted net earnings per share of \$0.90, an increase of \$0.08 per share or 9.8% compared to the first quarter of 2016. We continue to return capital to shareholders, buying back 3.4 million shares at a cost of \$240 million and announced a 3.8% increase in our dividend. Same-store sales in our food retail business, excluding the impact of gas declined 2.1% as the deflationary environment that began in the fourth quarter continued in Q1. Adjusting for the impact of New Year's Day and the negative impact of Easter falling in Q2 this year, food retail same-store sales were flat.

Our internal -- our internal rate of inflation was in line with the CPI rate of negative 3.9%. Positive trends for same-store sales in drug retail continued this quarter with total same-store sales of 2.5%, adjusting for the impacts of New Year's and Easter. Front store same-store sales grew by 3.6% and pharmacy same-store sales grew 1.4%. With relatively flat same-store sales growth in food retail and positive same-store sales growth in drug retail, total retail sales were \$10.2 billion, up 0.1% from last year.

Adjusted retail gross margin, excluding the impact of consolidating franchises remained within the stable trading band at 27%, 10 basis points higher than a year ago. Improved drug retail margins were partially offset by the impact of food retail promotional investments to support sales initiatives.

SG&A as a percentage of sales, excluding the consolidation of franchises, improved 10 basis points from the same period in 2016. Improvement in SG&A included the impact of store closures and divestures, favorable changes in store support cost as well as the unfavorable impact of New Year's and Easter in both food and drug retail.

Our consolidated adjusted EBITDA was \$865 million, an increase of \$36 million or 4.3% and margin stood at 8.3%, an increase of 30 basis points from the same period in 2016.

Looking ahead, we continue to remain confident in both our strategy and financial plan. In 2017, we expect to deliver positive same-store sales growth for the year and stable gross margin in the retail segment despite the current deflationary environment and the continuing negative pressure of health care reform. We expect to further improve our efficiencies in 2017 though not at the same level experienced in 2016. We also plan to grow adjusted net earnings and allocate a significant portion of free cash flow to share repurchases.

At this point, I will turn it over to Galen.

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Thank you, Richard, and good morning, everyone. We were pleased with our performance in the first quarter of 2017. In a period of significant deflation, intense competition and continued pressures from health care reform, we delivered another solid quarter. The food retail business experienced a second consecutive quarter of deflation led by declines in produce prices. Against these headwinds, we grew our average basket, saw tonnage volume growth and share gains in both our discount and market banners. Adjusted for the impact of holidays and gas, our same-store sales were flat in the quarter as we continue to invest to deliver value to customers. While we expect deflation to moderate in the coming quarters, we see no signs of a competitive intensity easing. And as a result, we do not expect inflation to turn positive in 2017. So more than ever, we are leveraging customer data and analytics to better understand our customer and to drive our business forward. Targeted product offers delivered through PC Plus and Optimum programs to our loyalty customer base helps drive our basket growth in the quarter. For example, we are using our increasingly advanced analytics to expand our list of items with high punching power, products with higher penetration rate that also drive a larger overall basket, increasing ROI on our flyers.

Our drug retail business performed well, again, in this quarter. Holiday-adjusted pharmacy same-store sales grew and front store continued to deliver growth across all major categories. In the quarter, we continue to roll out our digital refill service, which is now operating in over a 1,000 pharmacies across our network. This initiative allows patients to manage their prescriptions online and subscribe for refill and pickup reminders.



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The advantages to our business are clear, but increased compliance also drives better patient outcomes and reduces the health care costs related to medication and hospital visits.

In January, we marked the expansion of click-and-collect to our 100 store, most recently we brought 4 Real Canadian Warehouse Club's online in Nova Scotia and New Brunswick. We now offer click-and-collect in 128 locations from coast-to-coast. Traffic continues to grow with strong repeat business, larger baskets and strength in fresh categories.

Food has been an important driver of growth for us at Shoppers Drug Mart. One of the most promising initiatives has been the success of fresh in our urban format stores. In these stores, fresh items are in about 25% of baskets and these stores consistently outperform their peers. In the quarter, we introduced our first enhanced food offering in Vancouver, with 11 more planned in the coming months.

Loblaw remains 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. As Richard highlighted, we maintained our share repurchase program in Q1. Additionally, we announced a dividend increase of 3.8%, which marks our sixth consecutive year of increasing our dividend.

Overall, in the first quarter, we generated strong earnings growth and I'm pleased with the performance against our strategy and our financial plan. We will now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Irene Nattel from RBC Capital Markets.

Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

If we could please start with the basket and the drivers of basket growth, just wondering whether above and beyond CPI inflation, you chose to invest a little -- you chose to invest a little bit more to help drive tonnage, and what your strategy is as we start to see deflation easing?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes, absolutely. So that's right, we continue to make specific and well-planned promotional investments across the business. As I commented in my remarks, we are using analytical data to make some of those better decisions. And what we are essentially seeing is an added item or 2 in the basket, and that's driving both sales and tonnage in the face of very moderate traffic declines.

Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

That's very helpful. And you also noted that you are seeing growth across both discount end market, can you talk a little bit about the trends that you are seeing in both please? And also, basket competition changes?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes, I mean, look, I think it's better and better merchandising strategies in both the businesses are translating into stronger results. We generally don't talk specifically about the difference between the 2 businesses. We try not to give out regional specifics either. Although it was a particularly strong quarter for the market division, although, I don't think that's representative of a broader trend.

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Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

That's great. And just one final one, if I might. The discussion -- your commentary around using better analytics. How much of that is related to the whole -- now that SAP, you got all that data and how should we be expecting you to continue to use a lot of this information that you now have to help drive the business on a go-forward basis?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes, so a lot of it is coming from higher quality data, most of it, in fact, and we are working hard to become even more analytically capable, even more analytically focused in terms of how we make merchandising decisions, how we make cost planning decisions, in labor, in our stores. So you should see that as an enabler, both of margin growth -- or margin improvement I should say and also cost improvements over time.

Operator

Your next question comes from Jim Durran from Barclays.

James Durran - Barclays PLC, Research Division - MD, Head of Canadian Equity Research, and Senior Analyst

I just wanted to go back to your deflation comments. Sequentially, you're talking about improvement in deflation rate. Are you expecting -- not expecting deflation to become inflation before the end of the year when you talk about 2017 being deflation overall?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

That's what I said, yes.

James Durran - Barclays PLC, Research Division - MD, Head of Canadian Equity Research, and Senior Analyst

Okay. A bit surprised by that, I guess, just based on where the FX trends are and where meat seems to be going. So are you suggesting that the price promotion environment is going to remain intense or get even more intense?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes.

James Durran - Barclays PLC, Research Division - MD, Head of Canadian Equity Research, and Senior Analyst

Helpful. With respect to your guidance, there has been a lot of noise obviously on drug reform. I was wondering if you would be open to sharing with us what kind of approach you have taken in your guidance to drug reform risk.

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes, so our -- I think we comment regularly on the cumulative negative impact of drug reform, it's sort of little pieces being added across the country, province by province. Nothing that we consider to be a major change, year-over-year the pressure is approximately the same. And as we commented before, we see our objective is to do other things inside the drugstore business and inside the rest of the portfolio to offset those predicted challenges



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or predictable challenges. I think what we are trying to communicate is that it's really not letting up and we don't expect it to let up anytime soon, but we believe it's manageable in the context of our overall financial plan.

James Durran - *Barclays PLC, Research Division - MD, Head of Canadian Equity Research, and Senior Analyst*

Great. One last question, just on the gas station sale. Any insight with respect to the potential use of the proceeds once they come in?

Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

I guess, it's only in Q3 that this will happen. So for now, like, we're just saying general corporate purposes.

Operator

(Operator Instructions) Your next question comes from Michael Van Aelst from TD Securities.

Michael Van Aelst - *TD Securities Equity Research - Research Analyst*

I just want to start by following up on the -- your promotional intensity comment. So what are you seeing in the market that made you to believe that promotional intensity is going to pick up to the -- in the latter half of the year that would prevent any inflation?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, I mean, I think -- I think the way to interpret my comments is there is a year-over-year cycling that's going to moderate the deflationary trend that we absolutely expect to see continue. Really what we are commenting on is that the notion of a shift into sort of a steady inflationary environment is going to be offset by what we see as a continued level of competitive intensity. We are continuing to invest, we're continuing to focus on driving tonnage. Our expectation is others will do the same thing. We believe that we have the cost opportunities and the promotional efficiency opportunities to perform from a financial perspective in that environment, that just is our view. It's hard to predict what's going to happen with inflation, but that's certainly our perspective.

Michael Van Aelst - *TD Securities Equity Research - Research Analyst*

Okay. And then on the SG&A trend. On an apples-to-apples basis down just over 1.5%, can you talk about some of the key buckets that are helping you out there and how much longer you can keep it declining?

Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

Yes, Mike, I guess, we are happy with our SG&A performance in Q1 obviously, but it's really difficult to drive an improvement in rate, when sales are negatively affected by deflation. And however, in our plan, we remain focused on driving SG&A savings. But as we said, like we expect those savings will be smaller in 2017 than they were in 2016, but they will continue. And so therefore, like as deflation continues, our focus is going to be more on dollars than on rate. But the initiatives are more of the same, like, we are looking at streamlining our processes, we have closed some stores a while back which we are still seeing some of the benefits. So all of these initiatives together will continue to drive improvement in SG&A and that remains our relentless focus for a while.



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Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. And then, traffic, you said it was down, it seems like other grocers are experiencing the same, but you got basket increasing. So is it -- you think the higher gas prices are affecting the amount of tonnage people are going to store? Or is it just you're better merchandising, which is allowing them to stock up more while they're there?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes, it's a great question. I'm not sure we really know the answer. This is a trend that's been evident over the last couple of quarters. And yes, we are definitely adding items to the basket that may be responsible for reducing the number of trips. It may also be because customers were shopping a little bit less last year -- or more frequently and spending a little bit less per basket last year because inflation was so high, and now they are buying more in -- in an existing -- in a visit. So I'm not sure we have a really clear idea, we are just really comfortable with our ability to merchandise that extra item and continue to get the right sales trajectory and tonnage trajectory.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

And then just, finally, on Financial Services. That was -- the revenue growth pace did slow quite a bit, and the EBITDA was the lowest you have seen in Q1 for the last 3 years. So was there higher spending in there? Is that type of loyalty, what's the driver of that?

Richard Dufresne - Loblaw Companies Limited - CFO and Member of Management Board

One of the driver, Michael, is obviously, the change and interchange rate, which are dropping. So that's affecting that business, but you have to consider that we are getting the offset in the food business. So -- but the plan for PC bank this year was contemplating slower growth driven by that.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. And there is no increase in loyalty spending or anything?

Richard Dufresne - Loblaw Companies Limited - CFO and Member of Management Board

No, that's in line -- that is in line.

Operator

Your next question comes from Vishal Shreedhar from National Bank.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

I just want to follow up on your comments about 2017 being in deflation. You may have already said this, but did your view change from Q1 or...

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Well, I don't think so. I mean, we always felt that the back half was going to improve. We still feel that the back half is going to improve. And we're just calling out we don't think it's going to move back in our view to sort of the more traditional 1% to 2% level of inflation.



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Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

Okay. So your view on the competitive intensity hasn't really changed from Q1 from when you last spoke with us?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

I don't think so. I mean, it's -- but it's pretty intense out there. And as we have been saying for a long time, our view is that we want to use our assets and our merchandising programs to drive tonnage. We've seen success in that and we intend to continue.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

Okay. Few quick ones here, on the dividend, up a little less than I thought, wondering if there was a dividend payout ratio you target, and in the future if we should reasonably expect dividends to grow with earnings?

Richard Dufresne - Loblaw Companies Limited - CFO and Member of Management Board

Yes, we are actually landing on that ratio now. And if you look at, with that increase, when we get to around 25%, which is where we wanted to be. So going forward, therefore, we should be able to increase our dividend more in line with our growth in net earnings.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

Okay. On pharmacy reform, the Ontario government indicated a pharma care program for people under 25. I'm wondering if that has any impact to Shoppers and if you see this kind of pharma care idea gaining steam across Canada?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes, so it's too early for us to tell precisely what the impact is going to be on the Shoppers business and the Loblaw drug business, still working our way through that. It certainly has the advantages from sort of coverage point of view of giving more people free coverage to drugs. But if you think about health care reform across all the provinces as a major focus, there is relentless pressure to reduce cost, and this is an example of health care reform, it's actually probably going to increase cost as far as the Ontario government is concerned. So that's probably going to put incremental pressure on other sort of parts of the reimbursement model. But again, it's too early for us to tell whether this represents a significant sort of shift. Our view probably is that it's within the norm that we have been expecting over the last few years.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

Okay. And you announced a few management changes recently. I'm wondering if there is any changes at the COO level. And if so, how those might be addressed?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO and Member of Management Board

Yes, so Sarah has made the decision not to replace the COO and she has flattened the leadership of her organization, which I think is a terrific thing and beyond that, we really don't have much to comment on.



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Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay. So who will be taking those responsibilities?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Those functions will report to Sarah.

Operator

Your next question comes from Mark Petrie from CIBC.

Mark Petrie - *CIBC World Markets Inc., Research Division - Research Analyst*

I just want to follow up on your comment about the market division doing well, but you don't think necessarily that's part of a broader trend. Are you just saying that you don't expect necessarily the shift to discount to slow down? Or are you talking about your performance within the market division not being a continuing trend?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, I mean, I'm still trying to distinguish between the performance that you may see in a particular part of the business in a quarter and I didn't want you to extrapolate that that meant there was a reversal in the shift to discount that is largely been happening across the country over the last number of years. And these things are driven in part by what the real estate capital program has been in prior years, what the competitive environment is in certain markets. So no change in the long-term trends.

Mark Petrie - *CIBC World Markets Inc., Research Division - Research Analyst*

And then, I guess, sort of related to that. Just on the square footage growth and capital allocation, could you just give a little bit more color in terms of food versus drug segments, and then within the food business, how you look at the allocation of capital between formats, be it market discounts, superstore going forward?

Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

Yes, not much changes there, like obviously, over the last few years we have been shifting our focus from infrastructure capital to store and each gets an amount of capital driven by the return that they are showing us on their projects. And so I'd say if you look, there has been some good announcement on the drug side, good announcement on the discount side, and maybe a little bit less on the market side. But that be -- that be a...

Mark Petrie - *CIBC World Markets Inc., Research Division - Research Analyst*

And how has the pace of conversions from market stores to discount formats trended over the last couple of years and what's your expectation for this year?



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Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

So primarily, what's been driving our conversions has been a conversion of an old banner in Western Canada called Extra Foods. The first wave of conversions was primarily into discount, the second wave of conversions was predominantly into the market division. So there might have been a slight over-emphasis on market in the last 18 months, but if you look at the network conversions in general, it's on balance, predominantly discount.

Mark Petrie - *CIBC World Markets Inc., Research Division - Research Analyst*

And then just coming back to the gross margin, do you expect that the gross margin will continue to have upside at Shoppers? And then, I guess, related to that how are the SG&A trends evolving within the Shoppers business as it relates to the cost to supply and service the food business within Shoppers?

Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

Gross margin at Shoppers should be more or less flat, like we bought the business last year, which has extremely high gross margin, but it's a really small business. So it actually moved the needle from a rate perspective, but we will be cycling that in Q3. So -- but other than that like -- our expectation is, both our food and drug business should be delivering stable gross margin. And on SG&A, I think I have been pretty straight forward as to what we expect like -- we continue to focus on driving cost out of our business, and that focus is not going to change. But we will not deliver the same improvements in 2017 that we delivered in 2016.

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

And specifically, on whether food in the front store in Shoppers drives increased SG&A, I would say, no.

Operator

Your next question comes from Peter Sklar from BMO Capital Markets.

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

In your write-up and in your discussion today, you indicated that, drug retail margins are improving? Or did improve during the quarter? And I'm just wondering is that in Shoppers or in the pharma's or in that business within the Loblaw footprint? And what are the drivers behind that improvement?

Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

It's in Shoppers, Peter, and as I was saying, a few improvements in the business, but there has been the QHR acquisition which I just mentioned that has an extremely high gross margin rate now, and while small -- the rate itself is such that it actually moves the needle on the total rate of Shoppers and we will cycle that in Q3 of this year.

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

Okay. And Galen, when you were talking about the fresh program at Shoppers, could you just elaborate a little bit. I think you said something that 25% of the baskets include fresh items. Was that correct in what you are saying?



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Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, that's right. So the way to think about what we call the enhanced food proposition at Shoppers, it's been performing really, really well in the stores where we've deployed it, specifically, in the urban markets in Toronto. And so we are continuously looking for incremental locations to add that proposition. In the last number of months we've started to shrink the amount of square footage that we need to deliver a compelling fresh food offering. That's giving us a path to more stores. The most meaningful thing to call out at this point with the enhanced food proposition at Shoppers is the decision to open in Vancouver, and as I said, we have opened 1 store. We plan to open a number more over the next number of months in Vancouver. So where it's working really well, is in the urban centers, and you should expect to see that turn up successively in different cities over time. What we haven't landed on still is, a really compelling proposition in the suburban markets, and we still are optimistic, but we are not rushing to roll those out.

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

Right. And in your -- in your enhanced fresh program within the Shoppers stores, how does the price position compare to a conventional market store?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Very comparable.

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

Okay. And Richard, lastly, I believe, there was -- how you have this quarter-to-quarter write-up and write-down in the value of the franchisee investment. I think this quarter was a write-up, can you give us an idea of the magnitude of that write-up?

Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

We don't give that detail, Peter. And that like -- that will -- there is -- it's a few million up and down every quarter based on which franchisee gets converted. So it's actually noiseless, so I don't want to comment on the actual number.

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

So it's not enough that it's going to impact the reported EPS?

Richard Dufresne - *Loblaw Companies Limited - CFO and Member of Management Board*

No.

Operator

Your next question comes from Keith Howlett from Desjardins.



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Keith Howlett - *Desjardins Securities Inc., Research Division - Consumer Products & Merchandising analyst*

Yes. So I had a question about the Atlantic Superstore in the Atlantic Canada. Sometimes in the AIF you classified it as a discount store, and sometimes you classify it, or more recently classify it as a conventional store. I'm just wondering what the -- what your strategic positioning is on the banner and where it might alter over the coming years?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes. So it's -- it sits in the market division. That's absolutely true. The retail format is modeled off the 50,000 to 80,000-foot market store that was developed in Ontario, about 20 years ago. But it operates, and has always operated at a much more competitive price position, and it continues to operate at a very competitive price position. From a market division point of view, it probably has the closest price index to Walmart of any of our market stores. So that's really the strategic positioning of the banner. It's a very price-sensitive market. So a fully differentiated market format wouldn't work, in our judgment, in the East. But the mix, the assortment and the core proposition is more aligned with the market division than it is the discount format, and so we think it's in the right place organizationally.

Keith Howlett - *Desjardins Securities Inc., Research Division - Consumer Products & Merchandising analyst*

And then, I had a question about the Wholesale Club, which seems to, at least some of them have gone under conversion to more of a targeted food service, and I realize it already was, but a more targeted food service offering. Just wondering where your plans for the Wholesale Club are?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, that's a good observation. We've absolutely shifted the proposition materially towards food service, particularly to restaurant. And look it's not a big business for us, it's predominantly anchored in the West. So we are continuing to make refinements to improve its performance. It's something that we are happy with, it's not something that we see as a major source of capital investment or format growth in the coming years.

Keith Howlett - *Desjardins Securities Inc., Research Division - Consumer Products & Merchandising analyst*

And then, I just wondered if you could comment about your ongoing plans to tie nutrition, counseling and programs together with the pharmacy business and what the agenda is or the timing there is?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, so I don't have too much to comment on at this point other than to say, there is a lot of very good work being done, and we are very optimistic about the potential for this sort of Live Life Well proposition that combines, both pharmacy, food, nutrition, counseling and other services as a source of medium and long-term growth. And we'll have more to share on this subject in the future.

Operator

Your next question comes from Tal Woolley from Eight Capital.

Tal Woolley - *Eight Capital, Research Division - MD of Equity Research*

Just wanted to ask, you've explained on prior calls, like click-and-collect is sort of the ideal model for your network and for your customers. So obviously, there have been some announcements in the past few months with respect to home delivery from both discount and market competitors? And just wondering how you sort of still see that model evolving over the next 12 to 18 months? Is that possible we would see you look at piloting home delivery sometime soon?



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Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, so we are really happy with the click-and-collect sort of progress that we are making, really very, very encouraged by the customer response, very encouraged by the way that they're shopping the stores, and really interested in the way that the penetration is growing in certain stores around click-and-collect. But there's been home delivery in different parts of the Canadian marketplace for a long time. In Ontario, Toronto area, Grocery Gateway since the very beginning, and with Longos, it's continued to operate. So is there going to be a home delivery channel for food in the e-commerce future? There may very well be. I'd say, at this stage, people are experimenting as opposed to making a broad-based commitment. And is it possible that you will see us experiment, never say never, but there has been no change in terms of our commitment to the click-and-collect proposition as the one that customers feel the most strongly about in Canada today.

Tal Woolley - *Eight Capital, Research Division - MD of Equity Research*

Okay. And then actually it's, just a similar question on the drug retail side, I have noticed that some of your warehouse competitors now, you can get a new prescription filled completely online, and not have to visit the store. And I guess, looking across the business, given the regulatory cost pressures, all that stuff, how ripe do you see the dispensing business for sort of online disruption going forward?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Well, again, probably a question better answered another day. But if you compare our natural assets, Shoppers Drug Mart, it's store network puts it within almost within 5 minutes of every Canadian. So the convenience proposition of going and picking up your prescription medication, especially, if you can order it in advance online, which we announced with this digital refill program is a very compelling convenience proposition. If you are a large box retailer who has far less convenient locations, then you might think differently about trying to enhance the customer proposition by delivering direct-to-home. So we are aggressively pursuing digital enhancements to our pharmacy strategy just like we are to our food strategy and just like we are to our apparel and beauty strategies. You'll see more of that from us, but at this stage, we don't see a -- an aggressive transition away from the core value proposition that is an extremely convenient set of pharmacies all across Canada.

Operator

Your next question comes from Kenric Tyghe from Raymond James.

Kenric Saen Tyghe - *Raymond James Ltd., Research Division - SVP*

Galen, could you perhaps step back for a minute and just speak to some of the key learnings from your food and Shoppers offering? And perhaps also just walk through what some of the challenges are that would need to be overcome in terms of that suburban fresh, I mean, we could probably all, has of a guess, as to what some of the more obvious ones are. But if you could perhaps also just walk through some of those and some of the wins and losses to date in terms of that food and Shoppers strategy?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes. So I think -- I think it is actually as obvious as you imagine it would be. So the Shoppers Drug Mart stores that are in the downtown course of the cities in Canada, they have very, very high population densities. There's a lot of foot traffic walking past them and they are -- they are terrific assets with space that we've been able to deploy against convenience food and fresh food. And so the customer lifestyle is very consistent with the offer, popping in on the way home from work, and grabbing a meal for dinner, or doing a fill-in shop, picking up your produce, your bananas, and so on and so forth. What we have been trying to do, is we have been trying to increase the size of the basket by having a broader food offering so that we can get the same number of trips or perhaps more that were previously being driven by aggressive investments in milk or aggressive investments in sort of traffic drivers, promo drivers. So what's happening is, customers are coming in, they are buying fresh fruits, the trips are



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increasing, and the margin is improving significantly, because the mix is improving. It's all leaning into that urban lifestyle pattern and very consistent, performance very consistent with what you'd intuitively expect. I think when you move out into the suburbs, the trade-off of going to a small store with less -- a less broad offer by driving 5 minutes versus driving 7 minutes to a bigger supermarket with the full weekly shop available to you is, I think ultimately what we are struggling with. And that's all about changing people's habits, changing their behavior, and we expect that to take longer, and in order to draw the customer, ultimately, you need to change the merchandising mix. You have to change the purpose that people would be stopping into a Shoppers to buy fresh food. Because that's all you are doing is are offering them a less complete full basket shop then why would they make that trade-off? If you start shifting the merchandising towards meal occasions and promoting for lunch or dinner, then you start to mimic what has happened in other parts of the world as these convenience food propositions have lifted off outside of the urban market. So we're working away. We are not -- we are not in any rush. We want to make sure that we have a proposition that really resonates with customers before we push the button and scale it up. So we'll keep you posted.

Kenric Saen Tyghe - *Raymond James Ltd., Research Division - SVP*

And then just perhaps a slightly different line. In terms of your use of data, which has been the more valuable of the currencies? Has understanding the Shoppers' customer been more valuable in terms of the food offering in Shoppers? Or has been understanding how people shop for food, in other words, using the PC Plus currency data been more valuable in terms of the Shoppers' currency or you really just try to understand both customers in terms of using both sets of data equally for the purposes of the food offering. I'm just trying to understand sort of how one has gone about sort of which of the currencies has been most valuable? Or they both been equally valuable and that's how you've managed to fine-tune the offering as you have between Optimum and PC Plus?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, I mean, look, I would say, a part of our strategy has been to operate these businesses with a certain degree of independence. So Shoppers continues to do what it's been doing for a long time and they lead the way in our judgment in terms of taking the customer insights that come from their loyalty program and using that to make really smart promotional investment decisions. So that confidence, that knowledge, that best practice has probably been the biggest asset that has come to the group and the timing was really good, because it was at the same time that we were ramping and scaling up PC Plus. So we could take those analytical insight learnings and methodologies and start to deploy them against the food proposition. And then I think the second thing both for Shoppers and PC Plus is the advanced nature of these recommendation engines, which is allowing us to deliver precision offers that have a very attractive return rate in a far more automated way than what was possible even in Shoppers just a couple of years ago. So it's the combination of getting the right offers, but being able to automate large parts of it, which allows you to do more and do it more efficiently than ever before.

Operator

Your next question comes from Irene Nattel from RBC Capital Markets.

Irene Ora Nattel - *RBC Capital Markets, LLC, Research Division - MD of Global Equity Research*

Just a couple of follow-up questions, if I may. On the click-and-collect, do you continue to get better visibility and a better notion of what the path to profitability with digital retail will be for you?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes, we do. And I mean, again, it's simple sort of economics of P&L. You need to have enough incremental sales coming from this with enough margin to offset that incremental investment in labor. And so as you get your penetration up, you -- and as you get the incremental sales that you need, you get the productivity in the system that makes it work. The second piece which you probably heard from others is that click-and-collect typically increases the loyalty, reduces the promiscuity of customers, and so you actually get more of their total food basket, which is what appears



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to be driving that all-important element of incrementality. So we are watching it very closely, and we see some very promising signs. Is this ever going to be a truly accretive part of the business? Probably not, but is it going to earn its cost of capital and more, could very well do so.

Irene Ora Nattel - *RBC Capital Markets, LLC, Research Division - MD of Global Equity Research*

That's great. And then just coming back to the whole issue of -- sort of how to address the urban customer. Clearly, the enhanced offering at Shoppers is one element, but of course, the other element is this smaller footprint of fuller shop retail stores like the one you just opened in Montréal. And I'm wondering if you could just talk a little bit about what your view is on the future of the smaller food boxes? And your plans on sort of incremental rollout across the country?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO and Member of Management Board*

Yes. So there is absolutely a place for smaller food boxes. Our boxes are getting smaller across the board from superstores that used to be 150,000 feet now we're opening them in the West at 80,000 to 90,000 feet. You are seeing similar levels of sort of scaling down across every one of our formats. But I'll tell you the challenge with the food box is that its margin structure is such that it's hard to pay the escalating rents in the really high-density urban markets. So it's not as easy to have blanket coverage that -- that one might think. So we're dropping them in, in very specific locations where we can get the right real estate deal and where the customer traffic is as we would expect. The real advantage that we have in these urban markets is this incredible Shoppers Drug Mart network and the ability to put in just the right -- just the right mix. And what we are seeing is that, that fill-in shop or that sort of multi-stop during the week shop, that so many urban customers are shifting towards can be very, very effectively met by the proposition that we can squeeze into a Shoppers Drug Mart.

Operator

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

Sophia Bisoukis - *Loblaw Companies Limited - VP of IR*

Thank you, to everyone, for joining us today. If you have any further questions, you can contact our Investor Relations teams and we look forward speaking with you again to discuss our second quarter 2017 results, which will be held on July 26, 2017. Have a good day.

Operator

Thank you, ladies and gentlemen. This concludes the conference call for today. You may now disconnect your lines, and have a great day.

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