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L.TO - Q3 2017 Loblaw Companies Ltd Earnings Call

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NOVEMBER 15, 2017 / 3:00PM, L.TO - Q3 2017 Loblaw Companies Ltd Earnings Call

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PRESENTATION

Operator

Good morning, my name is Jamie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited Third Quarter Results Conference Call. (Operator Instructions)

Roy MacDonald, Vice President of Investor Relations, you may begin your conference.

Roy MacDonald

Great. Thanks very much Jamie, and welcome everybody. This morning we're presenting our third quarter 2017 results. I'm joined in the room here by Galen Weston, our Chairman and Chief Executive Officer; and Richard Dufresne, our Chief Financial Officer.

And before we begin today's call, I want to remind you that today's discussion will include forward-looking statements. As such the company's beliefs and expectations regarding certain aspects of its financial performance in 2017 and in future years. These statements are based on certain assumptions and reflect management's current expectations and 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. 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.

Also certain non-GAAP financial measures may be discussed or referred to today. Please refer to our annual reports and other materials filed with the Canadian Securities Regulators for a reconciliation of each of these measures to the most directly comparable GAAP financial measure.

Before I turn the call over to Richard, I would like to note that on October 31, Loblaw confirmed that it is aware of an industry-wide investigation by the Competition Bureau concerning a price-fixing scheme involved certain packaged bread products. The company is cooperating fully, court



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filings made by the Competition Bureau remains sealed while searches are completed. The company expects to be able to provide further comments after those filings are unsealed. As such, please note that we will provide no further comments at this time.

And with that, I'll turn the call over to Richard.

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

Thank you Roy, and good morning, everyone. We posted a solid quarter and performed well against our financial framework. As you all are aware, on July 17, we completed the sale of our gas bar business. I will highlight the impact of the disposition as I discuss our Q3 results.

In the quarter, on an adjusted consolidated basis, we grew revenue by 0.3%, EBITDA by 7.5%, net earnings by 7.2%, consolidated EPS grew by 10.3%.

(inaudible) and adjusted (inaudible) EPS grew by 13%.

In food retail, the market remained highly competitive and we saw a return to inflation with third quarter CPI at 0.3%. Our internal inflation was marginally higher than that.

Against this backdrop, we maintained a stable trading platform. We delivered same-store sales growth of 1.4% in food retail. In drug retail we had same-store growth of 3.3%, supported by front store same-store sales growth of 2.8% and pharmacy same-store sales growth of 3.9%.

Adjusted retail gross margin was essentially flat in the quarter. Gross margin, excluding the impact of the consolidation of franchises was up 50 basis points, however, adjusting for the impact of the low gross margins GAAP business on last year's results, we were essentially flat. Improvement in drug retail margins were offset by a slight decrease in food retail margin.

SG&A as a percentage of sales excluding the consolidation of franchises was 18.3%, worse by 10 basis point. Excluding the impact of gas bar's our retailer SG&A rate improved by 40 basis points. This improvement was driven by lower store support costs, primarily onetime in nature, and the favorable impact of foreign exchange in the quarter.

Free cash flow was \$340 million in the quarter and \$964 million year-to-date. In the quarter, we continued to return capital to shareholders, buying back 7.2 million shares at a total cost of \$485 million.

Our 2017 outlook remains unchanged. As we discussed on our second quarter call, we expect significant incremental external pressures on our business model in 2018. We have quantified \$190 million of incremental headwinds associated with minimum wage, and we expect additional healthcare reform to significantly impact our pharmacy business, but at this point we still do not know the magnitude of that impact. There is no single initiative that will offset the significant industry headwinds facing the company in 2018.

That said, we have made significant progress to mitigating these headwinds, but depending on how healthcare reform plays out, we expect we have not covered all of it. Until the full extent of healthcare reform becomes certain, the extent to which it will temper the company's adjusted net earnings growth beyond 2017 cannot be determined.

At this point, I'll turn over the call to Galen.

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

Thank you, Richard. We delivered solid results in the third quarter in an increasingly competitive market that returned to slight inflation in Q3, but saw sequential declines in August and September. Against this competitive backdrop, we were pleased with our results in food retail, which delivered tonnage, share, traffic and basket gains.



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Turning to our drug retail business, we continued our positive trend with same-store sales growth of 3.3%, with pharmacy growth of 3.9% and Front Store at 2.8%. Pharmacy grew as count growth outpaced declines in the average value of prescriptions. Front Store sales growth was led by strong performance in OTC and cosmetics.

In addition to delivering stable trading in line with our financial model, we are also advancing our business in exciting new ways. Last week, we announced the combination of shoppers Optimum and PC Plus to create PC Optimum, a single customer centric loyalty program launching February 1.

Today when Canadians are asked, which programs provide the best value, they rank our programs first and second. The combination will amplify that value, allowing members to earn and redeem more points across our entire network of stores.

This program will be foundational for our future that will give us rich data and a single customer view, as we aim to establish increasingly personalized and effective offers for our members.

Like loyalty, our e-commerce omnichannel strategy continues to unfold and build. Ultimately our goal is to serve customers how and where they want in our stores and through our digital businesses and services like click-and-collect.

Our click-and-collect business continues to expand. We currently cover about 30% of the Canadian population and we are opening a new location, almost every day.

For some Canadians, click-and-collect is the ultimate convenience, easy orders picked up on their terms. For others, home delivery will be the answer. To serve them better, today we announced that we will begin Instacart home deliveries on December 6 in Toronto, then Vancouver in January, expanding rapidly to new markets in 2018.

Fast, fresh home delivery of produce, ready-to-eat meals or a favorite PC product from our Loblaw's Real Canadian Superstore and TNT Stores is the perfect complement to our existing e-commerce service. And Instacart, new to the Canadian market, is a proven technology driven, on demand service already serving more than 150 American markets.

Harmonized loyalty, expanding click-and-collect, Instacart home delivery, each of these initiatives is a key ingredient in our strategy to compete and win in a rapidly changing and increasingly digital world. We now have over 600 data scientists, engineers and programmers dedicated to our omnichannel's future in food, healthcare, fashion beauty, loyalty and payments. We will continue to invest in the talent to execute per our plan.

We are pleased with the quarter. Our business strategy is clear. We're excited about our future. But given all of the headwinds, we expect 2018 will be a very difficult year.

Before I open the line for questions, I want to take a moment to thank Richard, who as you know will transition to George Weston Limited as President beginning January 1. In his place, we welcome [Darren Myers], who many of you have already had the chance to meet. We will remain very well served by the 2 of them, but I wanted to take a moment to appreciate them. Thank you.

Please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Mark Petrie with CIBC.



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Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

Galen, you called out the increasingly competitive market. Obviously, you guys showed great cost control in the quarter, but also a pickup in inflation and a higher inflation number than CPI. So can you just help us square up your approach on cost in a competitive environment with the external cost pressures, which will be ramping up in 2018? And then with the potential need to raise prices to help mitigate those cost pressures?

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

Yes, absolutely. I mean I commented a few times on this subject. Our objective is to take our cost out of the SG&A lines in our business so that we don't have to raise prices to our customers. The inflationary pressures that we're seeing for 2018 are significant across the board. We're working really hard, to make sure that we can take as many costs out as possible, so that we don't have to raise prices. We're starting to see this creep into inflation. And we don't see it though, sort of taking off, and we don't see it as a major enabler to help us offset these headwinds.

Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

Okay. That's helpful. And just with regards to the Instacart announcement? Could you just maybe help us understand why you preferred to partner with a third-party for home delivery as opposed to execute it internally? And then if you could give us some sense on the financial arrangements for that partnership, that will be helpful?

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

Yes. So our view is that nobody can quite predict the future as far as what customers are going to be looking for in terms of their omnichannel, sort of pickup delivery or experience. We believe very strongly in click-and-collect. We're investing in our own resources against it, as you know it's going very well. And -- but we recognize that our home delivery service is also part of the future. And a partnership allows us to deliver that proposition to the consumer, without having to take on the incremental capital investment of building it ourselves. And so you'll see us continue to do that. There'll be places, where we make our own strategic investments and then there'll be other places where we partner with folks, with long-term strategic partnerships. And that's what you're seeing with Instacart. I guess a little bit early to talk about the financial arrangements that we have with Instacart. But suffice to say, this is a premium service targeted at customers who are looking for the ultimate in convenience. And when we look at how Instacart continues to perform across the United States, it's a very compelling proposition, and something we're really looking forward to bringing to our customers.

Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

And so just a follow up, so they'll be picking the orders in your existing stores?

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

That's correct.

Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

And is there -- are you talking about the length of the contract that you signed with them?

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

No.



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Operator

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

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

I wanted to begin with, if you could just flesh out for us a little bit, how you're seeing this increasing competitive intensity play through in the marketplace? And where exactly is it coming from?

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

I feel like you ask that question every quarter and I think I provide the same sort of approximate answer. So we see it across the board. Look this is a highly competitive, intense market where you have a set of very strong competitors, who are very good at their core strengths. And you have new entrants, who are expanding more and more into everyday consumable categories. And you ask what geographies are performing well versus which aren't? We generally don't comment on that. Suffice to say, overall performance across the country is intense. We're happy with it. There are a few markets, where we are seeing outsized performance and there are a couple of markets, where we're seeing the competitors very strong and putting pressure on us. So it's a mixed bag.

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

Okay. So really it's just more of the same taking up a notch, is that a fair comment?

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

Very much so.

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

Okay. Just thinking through sort of the longer-term impact, Galen, of the evolving sort of -- the evolving consumer share of wallet with e-commerce taking a bigger bite, if you will, out of the wallet. How do you see the margin profile evolving? And do you see a way, that you can offset that margin headwind and continue to deliver earnings growth?

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

Yes, we do. I mean that is our job, and that is the construct of our long-term plan. And we see inside the P&L of the business and the balance sheet of the business, the opportunity to do that. A big part of it, is going to be accelerating the cost reductions required inside the business. We're happy with what we've done to date. We know we need to do more and we have a good line of sight to how we're actually going to do that. That should give us the space to make the investments that we need to compete in this emerging digital omnichannel world, while at the same time growing our earnings.

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

That is outstanding. And just one final question if I may. Can you talk a little bit about what's going on in Front Store over at shoppers? What you're seeing in terms of mix there? And sort of what's going on, on the promotional side?



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

Yes, so the Front Store business, the Shopper Drug Mart continues to be a real source of strength for us. Our control brand business has -- continues to perform. Our everyday consumables, nonperishable foods, continues to perform. Our perishable foods proposition in both Toronto and Vancouver continues to perform really well. So does -- so is prestige beauty, and we're investing more and more in our prestige beauty sites across the country. So there aren't any particular points of weakness across the front of stores. It's a great network. Really well positioned for those customers, who are looking for convenience every day assortment, complemented by pharmacies. It's really good.

Operator

Your next question comes from Tal Woolley with Eight Capital.

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

Just on the pharmacy business. CIHR just put up a recent annual report, when you look at some of the spending data for prescription drugs, it's clear that a lot of drugs that aren't dispensed in the traditional retail setting are what's driving the growth in the market, and you're flagging some concerns about prescription drug reform again. Is the company looking at ways to try to take advantage of where the growth is on drug spending? Would you ever look at moving into infusion clinics or acquiring your way into that market, longer term to try to offset some of the pressure you're seeing elsewhere?

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

Yes, absolutely. So you're talking about the growth in what we call specialty pharmacy, which are sort of long-term therapeutics that are -- have a high sort of dollar value attached to them. This is an area of strategic focus for us. We don't necessary -- we do not feel that operating the clinics themselves is the best way for us to sort of prosper in these categories. We do have a comprehensive strategy and we're quite pleased with the results to date.

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

Okay. Will that be a bigger piece of the puzzle, going forward?

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

Yes, given that -- specialty, from a -- in a unit perspective is very small, but from a dollar value perspective it's very big. It is where the innovation is coming in therapies and it is growing quickly. And we expect to secure our share of that growth.

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

Okay. And just on cannabis, you've been clear about wanting to get involved in dispensing on the medical side, but from what we've seen in the legalization rollout was, there really hasn't been much of a carve out yet for retail pharmacy to play a role. And the license producers are certainly interested in keeping their direct to consumer model for medical. Alberta and BC have still not rolled out private retail, would you consider using some of your assets in those markets to pursue recreational, once the market opens up?



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

Yes. So look, we've been quite clear about our interest in the marijuana business, with a particular focus on medical. We think that pharmacy distribution could be a very important and effective part of the medical marijuana universe. The regulatory framework that exists today is evolving rapidly. And we don't know exactly where it's going to land and so our strategy continues to evolve. And there really isn't more for us to comment on, at this point. And we obviously will when things settle and they will settle one province at a time, and we'll have a strategy for each province.

Operator

Your next question comes from Michael Van Aelst with TD Securities.

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

I just want to clarify a few things on Instacart. Can you just explain how the delivery order process will work? Will the customer go through your site and then get transferred over to Instacart once they say they want delivery? Or does it go in directly through the Instacart site?

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

Yes. So we will launch with -- on the Instacart marketplace, of which we'll be the anchor tenant. And so the customer will go to Instacart, they will shop the assortment available through Instacart and they will have the product delivered by an Instacart service representative. And we will make sure on our website that customers have awareness and access to that sort of convenient delivery model, and they'll be transferred to that shopping site.

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

And does Instacart -- I don't believe this is fully exclusive in Canada, is it?

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

No, not fully exclusive. But we will be there. They are launching with us. Their relationship with us, that has brought them to Canada. They have a couple of retail relationships that include all of North America and they will be part of the marketplace too. And grocery is the anchor, and we will be the anchor grocer.

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

Could you explain how it would -- how this system, the Instacart system will decide whether the order comes from Loblaw stores or from the other buyer stores?

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

Yes. So if you go on the Instacart website, you'll see that you start by picking the retailer.



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Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. All right. And then as far as the same-store sales is concerned on the food side, it seems like traffic was up for the first time this year. Have you gotten more promotional? Is that also part of your explanation, why food margins were down a little bit? Can you just explain, what's going on there?

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

Yes, I mean look, no notable change. We just continue to execute our strategy. We continue to merchandise as effectively as possible. We think we're getting better and better at it. And we are seeing that momentum slowly build. And I think that's an indication of why we had some strong results this quarter. But I wouldn't call that out as a meaningful change in trend.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. And on the click-and-collect, you mentioned you cover 30% of the population now, do you have a target penetration that you want to hit?

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

We do have our target penetration, not one that we're disclosing at the moment.

Operator

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

Peter Sklar - BMO Capital Markets Equity Research - Analyst

Galen, back to e-commerce, I believe you, yourself and other members of management, used to talk about the strategy that Loblaw wanted to be out -- first out of the gate in terms of gross e-commerce with your click-and-collect program, because you wanted to condition Canadians to click-and-collect because you thought that was more efficient model. Now obviously the market, at least in part, is migrating to home delivery now including yourselves. So has this -- how does this impact your view of the long-term economics of grocery e-commerce for Loblaw?

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

Well I mean, again, I think we've said that we're big believers in click-and-collect. We continue to be big believers. We see excellent results in our click-and-collect stores and we continue to roll them out. Ultimately the customer determines the channel by which they want to make use of our service, or those services of any other retail. We feel that our responsibility is to make sure that we have the available services for those customers. At this stage, the future remains difficult to predict. I think what you should take away from the announcement today is that, we're committed to being where the customer wants us to be and we will find interesting, creative and financially sensible ways of meeting that need.

Peter Sklar - BMO Capital Markets Equity Research - Analyst

But in Loblaw's plans, given that you're in click-and-collect and home delivery, is there a roadmap to profitability for grocery e-commerce?

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

Yes.



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

And how long does it take to get there?

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

Well, I mean again, it's a fair question, but we don't really want to answer. But I think you can take from our commitment to continue to expand click-and-collect that we feel comfortable about the economics that is embedded in them.

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

Okay. I have a question on your grocery inflation, which sounds like it was about 0.5%. That 0.5%, you think that's reflective just of the general inflationary backdrop? Or were there things specific to Loblaw that may have impacted that, like mix or price investment?

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

Well the biggest determinant of sort of the underlying inflation performance in the industry is how it cycles over the previous year. So you can get a reasonable indication that we're going to land in and about where we are, based on where we were around this time last year, as you cycle through. It is very difficult to predict inflation. And we have a view of it. Our view of it is that it's not going to return to the very significant inflationary era of 24 months ago. But -- and so what we see is as good a proxy as any for right now, as good a proxy as any for what we see looking forward.

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

Okay, and then just lastly on this recent ask, you've had of your suppliers related to the DC charge. Can you talk a little bit about the reaction you've gotten from suppliers? Have you gotten an earful from them? Or has it been pretty muted? Just how is that unfolding?

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

Well we don't want to get into details, but this is one of many initiatives that we've put in place to deal with the headwinds we're facing. And so far so good.

Operator

Your next question comes from Patricia Baker with Scotia Bank.

Patricia A. Baker - *Scotiabank Global Banking and Markets, Research Division - Analyst*

I actually have 3 questions. My first one, first of all thank you for hosting the call on the merging of the loyalty, the 2 loyalty programs last week, I think it was -- that was quite useful. But we all spent a lot of time on that call discussing the mechanics, and we didn't really get around to discussing what the benefits will be beyond sort of revenue and customer gains for Loblaw, because merging the loyalty, if I recall back when you made the acquisition with Shoppers, it was called there was a potential longer term synergy targets. Can you talk about, what the benefits are beyond, maybe, financially? And what cost savings there might be associated with merging the 2 programs?



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

Yes, so high level, these programs are becoming ever more digital and they require a level of investment to stay current and dynamic, and to meet the opportunities and the demands that we get from our customers. And so running 2 separate technology platform means that you have to invest about twice as much. So there's a saving in terms of the ongoing operational investment that comes from that. There's an enormous benefit, as you went through in some level of detail with the team last week, on being able to see in a unified fashion, how the customer is trading across our entire network. And that gives us an incremental level of visibility into what the opportunities are to help the customer understand the strength of our different value propositions. And so if a customer can earn more by shopping in our collective network, then we think the customer will shop more in our collective network. And that will give us an opportunity to save money. The third is really the analytical horsepower that comes with that level of information on your everyday consumable behavior. And we can take that insight as we have been doing, really well with Shoppers for the last decade and PC Plus for the last 4 or 5 years, to make better promotional decisions, to make better assortment decisions inside our core bricks and mortar business. So those are the 3 principal benefits we see looking forward.

Patricia A. Baker - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Okay and I just want to double check something that I've always believed about the Shoppers Optimum program and it certainly have been discussed when Shoppers was a stand-alone company. And that was the notion that the typical Optimum customer liked to redeem for -- in cosmetics, in the higher-margin cosmetics department and treat it to the points as an ability to be able to gift themselves. Has that kind of trend continued with the Optimum program?

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

Yes. So there are 2 types of redemption on the gifting side. People like to use points to redeem for gifts for themselves. And then they also like to redeem points for gifts for others over the course of the holidays. Interestingly, when you dive deep into the Optimum program and the PC Plus program, similar patterns emerge. So there's a group of customers who like to earn points and redeem them for indulgence. And then there are a group of customers who are oriented toward everyday value and using those points to reduce the spend that they have in their monthly budget. It's a little bit more skewed to the budget side in food versus pharmacy, but both are strong. You have budget customers in Shoppers significant number of them as in food. And so what we are doing is, we're bringing a program to market that allows indulgence to continue in both Loblaw and Shoppers and also amps up the value proposition for those looking for immediate discounts.

Patricia A. Baker - *Scotiabank Global Banking and Markets, Research Division - Analyst*

You in the closing of your opening remarks, Galen, you thanked Richard and Darren and that brings to mind the fact that coming January '18, there's going to be some key executives moving, in particular Richard. And then couple that with the recent round of the restructuring and the elimination of 500 positions. I understand you've put in place a new organizational structure, would you care to talk about that? And maybe let everybody know who's in charge of what?

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

Yes, okay. I'd be happy to do that. So we have Darren, who will be the incoming CFO; you have Sarah who is our President, has been since January. Underneath Sarah there really are 3 new positions. The first position is the Chief Customer Officer. And that role will combine sort of our new product initiatives, our marketing, our loyalty, our digital strategies. Then you have what we call our CAO, Chief Administrative Officer, which is supply chain IT, cost reduction and a portfolio support services in there. And then you have the Chief Operating Officer, who will have all of the retail divisions. And that will include shoppers, it will include market, it will include discount, and it will include Joe Fresh. That is essentially the organizational structure moving forward. I'll allow Sarah another time to talk a little bit more about the rationale behind that organization model. It was her initiative, and I think sets us up to be very well served from a management capability perspective looking forward.



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Patricia A. Baker - Scotiabank Global Banking and Markets, Research Division - Analyst

Okay, I look forward to hearing from Sarah on that. And then a last question, I guess I'll give to Richard, maybe my last Loblaw financial question for you Richard. And I think maybe you won't give me the answer, but could you help us by providing the gross margin, the retail gross margin for Q4 last year X gas so that when we monitor that Holy Grail of the stable gross margin pattern, we know what we're looking for?

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

I don't have that on top of mind, but I'm sure Roy can provide it to you after the call.

Operator

Your next question comes from Vishal Shreedhar with National Bank.

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

Just a few easy ones here. On Instacart, do they charge -- are they going to charge their own prices? Or they'll charge the Loblaw prices?

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

So the pricing model for Instacart hasn't landed yet. So there's a number of different patterns that you see in the U.S. and we'll be very transparent about that in our sort of media release and ultimately, when we launch the product. But this is a premium service, and the idea is to make sure that it properly reflects the cost of delivering the service. And that's the way we intend to move forward.

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

Okay, but you get to see the customer and the loyalty, et cetera?

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

Yes, we do.

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

Okay. I just want to get some -- a quick one here for Richard, on the SG&A line, you highlighted benefits from lower store cost and FX, I was hoping you could quantify that for us? And maybe explain what the lower store costs are, if that continues going forward?

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

So the point I want to make on SG&A has to be quite clear, we're really happy with our SG&A performance, but like 40 basis points in one quarter is too big. So we've got a number of significant positive events that are not likely to recur. So therefore we have improved our rate slightly versus last year, but as you can imagine because we have not been inflating our top line much, it's difficult to lower the rates. So you should not assume that the rate we've experienced in Q4 is going to continue in Q3, so it's going to continue in Q4 and Q1 of next year or so. We're continuing to drive SG&A down, but not at the pace that we delivered on this quarter.



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

Okay. So the -- another way of saying it is the FX and the lower store support costs, largely transient, although a portion of that may persist?

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

We've got some benefit that will persist, but not to the tune of 40 basis points.

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

You gave us some color on the store closures. And I know you're probably not going to get into details of what and where they are. But in terms of square footage growth for 2018, should we think this will offset these store closures, will also offset the growth plans? Or how should we think about that?

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

We have not been growing square footage that much, like to the tune of 4% to 5%. This is not having a significant impact for this year.

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

Okay. And just may be a top level perspective here for Galen, again looking at 2018 you called out the difficult year there. But management is continuing to invest seemingly at an elevated rate. You got your -- you've got so many initiatives going on, the click-and-collect, the delivery, I don't know the extent to which your investing or if there is any planogram changes on that. But then you have your exiting businesses, PC Financial, gas bar, that will hit 2018 as well. So as you look at all these costs and you look ahead of you and you are exiting businesses and you are continuing to invest, what's management's orientation here, as they try to balance the desire for growth with the desire to invest, maybe some high level color on that?

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

Yes, so our long-term view is that we can invest for growth and make sure that the company is as strong as it needs to be in this rapidly changing environment. But we can take significant incremental cost out of the business and that will allow us to deliver against long-term financial outlook that delivers value for shareholders. In a given year, we're not going to hold ourselves to a very specific number, if we think that it causes a compromise in our long-term strategic plan. In 2018, the headwinds that landed midway through the year, more significant -- potentially more significant than anything that the organization has experienced before, and so we are making our best efforts to balance the books. And when we get more information about the quantum of those headwinds, we'll be able to provide you with more visibility into what 2018 looks like. What we're calling out and did in the second quarter is that 2018 is shaping up to be a difficult year, but we are very encouraged by the progress that we've made to offset those headwinds.

Operator

Your next question comes from Jim Durran with Barclays.

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

I just want to go back to e-commerce for a second, with respect to Shoppers Drug Mart, like what role do you see those stores playing on the grocery side of e-comm?



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

So probably more to come on that. But at the outset of our Shoppers-Loblaw's combination, we certainly saw the real estate footprint that exist in Shoppers Drug Mart complemented by the real estate footprint offered through the Loblaw network, as something that could have significant, strategic relevance and advantage in an e-commerce world. So I would say it's too early to know, exactly, how we might apply those advantages to our strategy. But it is certainly something that the organization is thinking about. And we will experiment with deployments in the future to see exactly how real that advantage could be.

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

With respect to your percent of population that you've got click-and-collect exposure to now, would you be able to tell us, what percent of what you deem to be the urban population, that same footprint is addressing?

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

It's significant.

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

Okay. And with respect to Instacart, will you have any say over what is charged to the customer in terms of handling and shipping fees? Or is that an Instacart independent decision?

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

The service fee is an Instacart pricing decision. And then ultimately, the retail price, this is something that we work together with them on. This is a financial trade-off and there is lots of room to sort of modify the cost structure, depending on the consumer appetite for the service. And so we will monitor it closely and we'll make the necessary adjustments.

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

Okay, and my last question just on the headcount reduction. Do you expect to have a net benefit in the fourth quarter? Or is that going to be a 2018 impact.

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

We're going to see a slight benefit in Q4.

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

And then the store closures is late Q1 in terms of impact?

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

It's going to start in Q1 and it's going to spread over the year as the store close.



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Operator

Your next question comes from Keith Howlett with Desjardins Securities.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

Some questions on drug reform. With respect to the Council of the Federation, is there a framework for the reforms? In other words, is there a reduction in the reimbursement rate on specific drugs? Or is it some broader umbrella framework of listing fees or something?

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

At this stage, I think it's too early to comment. That will ultimately be the decision of the Council of Federation and can be different by province. So we are extrapolating, what we think the impact could be based on what we've seen in Québec. But as to how each of the provinces chooses to sort of enact their policy changes, we're just waiting to hear from them.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

And then with respect to the federal government, that's reviewing the branded drug pricing framework, do you have any comments there? Or are you actively engaged in discussions on that, on those federal reforms?

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

No. We can't comment on that.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

And then I just had a question on the health and wellness theme, and just if you can provide us some high level guidance on your initiatives to sort of combined nutrition and drugs and exercise and all of things that are your assets -- where are you going with that initiative?

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

Yes. So I think the way we describe it, is that's a triangle between pharmacy, health record, the nutritional health record that we see as people shop in our stores, and then nutritional record comes from guiding stars. And then the acquisition of QHR, which is an EMR company that has GP-based medical records. So that is sort of the anchor of our strategy and we are busily working our way to connect those assets in such a way that we can bring products and services to market. That will help customers more effectively and actively manage their health and their sustained wellness. And stay tuned what we have coming, it's going to be quite exciting.

Operator

(Operator Instructions) Your next question comes from Chris Li with Macquarie.



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Christopher Li - *Macquarie Research - Research Analyst*

Galen, if you look into your crystal ball and if at some point over the long term, Amazon decides to sell prescription drugs in Canada, how do you think Shoppers Drug Mart is positioned to protect their market share? Are there any structural differences that you see in the Canadian pharmacy space versus the U.S., which makes it as a less of a or potential long-term threat?

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

No. I think it's too early to answer that question. I don't think anybody even knows how Amazon is going to sort of pursue this ambition or strategy in the U.S. Suffice to say that Canada and the U.S. are fundamentally different in terms of their pharmacy markets. And so it will be difficult to judge until they make a decision, if and when they make a decision to look at Canada. We have a long-term strategy, an outlook on what the sort of digital pharmacy space is ultimately going to look like. It's a core market for us. And we are actively investing to make sure that we secure the most innovative and strategic position in the Canadian marketplace.

Christopher Li - *Macquarie Research - Research Analyst*

Okay, that's great. And then with respect to Shoppers, can you give us an update on timing on rolling out SAP across the Shoppers store network?

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

We're working on that. Store network is going to be the last part that we will get to. I think we need to do a master data, we need to do the DC first, so that's going to come and we'll get back to you on that one.

Christopher Li - *Macquarie Research - Research Analyst*

Okay, that's great. And Richard, just maybe one for you as well, I know in the past you have always said \$1 billion of retail CapEx over the long term is a reasonable level. Is that still sort of the case of your view of longer-term in terms of your CapEx outlook?

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

Right now, that is still the case.

Operator

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

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

Great. Thanks very much, Jamie. Thank you, everybody for your time this morning. You can follow up with me afterwards for any questions you have. And please mark your calendars for February 22, when we will be discussing our full year 2017 results. Have a great day.

Operator

This concludes today's conference call. You may now disconnect.



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