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L.TO - Q2 2019 Loblaw Companies Ltd Earnings Call

EVENT DATE/TIME: JULY 24, 2019 / 2:00PM GMT

OVERVIEW:

Co. reported 2Q19 fully-diluted EPS of CAD1.01.



JULY 24, 2019 / 2:00PM, L.TO - Q2 2019 Loblaw Companies Ltd Earnings Call

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PRESENTATION

Operator

Good morning. My name is Julienne, and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited Second Quarter Results Conference Call. (Operator Instructions) Thank you. Roy MacDonald, VP, Investor Relations, you may begin your conference.

Roy MacDonald - Loblaw Companies Limited - VP of IR

Thank you, Julienne, and good morning, everybody. Welcome to the Loblaw Companies Limited Second Quarter 2019 Conference Call. I'm joined this morning by Galen Weston, our Executive Chairman; Sarah Davis, our President; and Darren Myers, our Chief Financial Officer. And before we could begin the call, I want to remind you that today's discussion will include forward-looking statements, such as the company's beliefs and expectations regarding certain aspects of its financial performance in 2019 and in future years. These statements are based on 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. So please refer to our annual report and other materials filed with the Canadian securities regulators for a reconciliation of each of these measures to the most directly comparable GAAP financial measure.

And with that, I would like to now turn the call over to Darren.



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Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Thank you, Roy, and good morning, everyone. In the second quarter, we continue to deliver on our financial plan. Revenue grew by 2.9%, adjusted EBITDA normalized for IFRS 16 increased 5.4% and normalized adjusted earnings per share increased by 7.1%.

Our same-store sales in Drug retail grew 4%, our strongest quarter in 3 years. Front store same-store sales grew 3.3% and pharmacy same-store sales grew 4.8%. For front store, we delivered positive comp growth in all categories led by OTC, food and cosmetics. Pharmacy was also strong with 3.7% prescription growth.

Moving to food. Our Food retail same-store sales grew 0.6% in the quarter. Our CPI equivalent internal inflation metric was in line with CPI of 3.6%. We drove basket growth, however, we saw a decline in traffic. We remain focused on stable trading, maintaining approximately flat gross margin and growing our sales generally in line with the market. While we delivered on our financial targets in the quarter, our Food retail same-store sales were lower than expected.

As we have mentioned in the past, we are evolving as a company to use data to make better promotional decisions focused on driving profitable growth. In the quarter, although our margin improved, we found consumers more sensitive to some of these adjustments. Our development of expertise and data-driven insights is a journey and we have made and will continue to make focused and deliberate actions to correct this as we continue to adjust our models.

In the quarter, total retail gross margin was 29.9%. Excluding the consolidation of franchises, retail gross margin declined by 10 basis points. Retail gross margin improved in the quarter for food but was more than offset by a decline in Drug retail.

Retail SG&A as a percentage of sales of 19.6% included \$290 million benefit related to IFRS 16. Excluding this benefit and the impact of franchise consolidation, retail SG&A improved year-over-year by 30 basis points. Our SG&A performances -- performance benefited from our process efficiency initiatives and lapping of some prior year unfavorable FX. PC Financial revenue grew by 17.4% driven by growth in our credit card portfolio and continued higher year-over-year sales at The Mobile Shop.

Adjusted EBITDA declined \$5 million compared to last year as the impact of revenue growth was more than offset by the termination of our daily banking services and increased investments in the business. Adjusted consolidated EBITDA margin was 10.6% in the quarter. Normalized for the impact of IFRS 16 and the consolidation of franchise, the margin improved by 10 basis points.

In the quarter, fully diluted earnings per share were \$1.01. On a comparable basis to last year and after excluding \$0.04 per share from the incremental depreciation to the spin out of Choice, fully diluted earnings per share for the quarter were \$1.05, an increase of approximately 7.1%. IFRS net earnings available to shareholders and continuing ops declined by \$7 million year-over-year, which included the incremental depreciation of \$15 million resulting from the Choice spin out.

Free cash flow was \$333 million this quarter. And in the quarter, we repurchased 3.6 million common shares at a total cost of \$250 million. Reflecting on our second quarter, we are pleased with our continued progress in delivering process and efficiency gains, supported by a culture of operational excellence. These savings are offsetting cost pressures and enabling us to invest in our growth areas for the future. Although our Drug retail business performed very well in the quarter, our same-store sales performance in Food retail was lower than expected. We are making very targeted and measured adjustments, which will continue over the coming quarters to improve our sales performance in Food retail. Additionally, the timing of the Thanksgiving holiday period this year will negatively impact fully diluted earnings per share and same-store sales performance in Q3 by approximately \$0.03 and 1%, respectively, with an offsetting benefit in the fourth quarter.

I will now turn the call over to Sarah to provide additional color.



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Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Good morning, everyone. During the quarter, we executed well against many aspects of our strategy. Process and efficiency initiatives improved SG&A rates and delivered improvements in our financial performance. We continue to build our expertise in data, improving food margins and realizing the benefits of personalization and curated customer offers. We made good progress on our strategic initiatives. We increased PC Optimum penetration rates, improved e-commerce sales and service metrics and we ended the quarter with some very well-received advertising programs, including PC Eat Together, the return of our famous, No Frills Hauler campaign and discount, and the introduction of a new program, welcoming food lovers to unite at our various market division banners. Our online videos have been viewed more than 100 million times.

However, as Darren highlighted, we slipped outside of our stable trading range on same-store sales comps in our food business. We are not content with that performance. We have already taken steps to address this result and are confident in our ability to make measured and targeted investments to bring our performance back in line with our stable trading framework over time. The highlight of our quarter was the performance at Shoppers Drug Mart where we had our best comps in 3 years.

While inclement weather and a slow start to the summer were not great for apparel or home and entertainment sales, it provided for a very strong cough, cold and allergy season. In addition, we continue to refine and improve our food offerings at Shoppers, especially in the urban locations. Our enhanced food offering is now available in more than a 100 stores and in most major markets. This is paying off driving traffic and basket gains with very strong comp sales. Cosmetics also had a very strong quarter. We completed a milestone -- major milestone consolidating our mass and prestige beauty businesses online at shoppersdrugmart.ca/beauty. We are very pleased with the resulting growth in e-commerce sales.

Our newly formed center of excellence beauty team continues to gain traction across the omni-channel touch points. Based on the success of featuring our own in-store beauty experts, we have officially launched our Shoppers' Beauty Pros. We are seeing stronger engagement on our social media platforms, especially with our important Millennial and Generation Z customer base. Shoppers achieved another important milestone this quarter. Our rollout of a digital pharmacy system is proceeding smoothly with the system now operating in more than 50% of our pharmacies. This provides an important platform for the future. With the digitization of our pharmacies, we are achieving reductions in the time taken to process prescriptions, improved bill performance and the ability to offer auto refill functionality on our HealthWATCH platform and ePrescribing. And most importantly, the system enables our pharmacist to spend more time engaging with customers. Customers remain our central focus. Data-driven insights allow us to delight them with smart assortments, promotions and rewards. Process and efficiencies allow us to employ technology and invest in building a better business to serve customers today and in the future.

I'll now pass turn the call over to Galen.

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

Thank you, Sarah. In Q2, we delivered on our financial framework and continued to invest in innovation. While we were particularly pleased with the Shoppers Drug Mart performance and many signs of strength in that business, we were not satisfied with our supermarket sales slipping outside our stable trading range. The team is now making the appropriate adjustments to bring food sales back into balance. Our commitment to data-driven insights and process and efficiency has not changed. We are making excellent progress against all 3 growth pillars; everyday digital retail, Payments & Rewards and Connected Healthcare. We remain in a disciplined investment phase as we focus on shareholder value creation over the long term.

I'd now like to open the floor for questions.

Roy MacDonald - Loblaw Companies Limited - VP of IR

Thank you, Galen. Julianne, could I ask you to introduce the Q&A process please? And I'd like to remind everybody to please limit your question to a single subject area and feel free to jump back in the queue.



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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

My single subject will be not surprisingly same-store sales. Can you talk a little bit more about sort of how the sort of sluggishness manifest itself? Was it categories? Was it banners? Was it products? Can you really see the link between sort of some of the promotional activity and the lack of sales? Can you just give us more color please?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Okay. Irene, it's Sarah. I'll start. So I think what you will realize that, as we talked about, part of our strategy in data-driven insight was to bring a little more mass into our sales in food in order to -- and we've created a few algorithms in order to drive a higher margin. So what happens with when you ask people to develop algorithms focused on profitability and increased margins is, that's exactly what you get. And what happens with that and when you bring it into terms of what happens in-store, it actually does bring down the promotional intensity. So you end up with fewer items on promotion in your flyer and that does have an impact on sales. So in terms of where, let's say, it's more focused on the market division, which is where we mentioned last year, we really did start. And we have done some promotional changes in the discount business as well, but I'm not going to get into specifics about categories or regions. There is not 1 certain category or 1 region that this has been -- really is across both divisions, more focused on the market division and across the company.

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

And in your opening remarks -- Sarah, and in your opening remarks, you said you're tweaking the algorithms, which is understandable. And you said something about over time. So how should we be thinking about the cadence, if you will, of potential acceleration in top line as we move through the back half of this year and into next year?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

I think you should think that we're not going to do a knee-jerk reaction. So you're not going to see a radical change in Q3 and we're still pretty committed, actually, we're very committed to our strategy of using data-driven insights in order to improve our gross margins. But what you should know is that we know exactly where we need to make these targeted investments. We've already started to make the investments. We know the categories, we know the banners and we've already started to do that. It's just not something that we would feel would be prudent from a competitive perspective to talk to you about where exactly we're going to do this.

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

Fair enough. So if I could sort of -- what I'm hearing you say is in this balance of top line and margin, perhaps it went a little bit too far in one direction and the objective is to sort of stabilize that, but net-net, still within the financial framework.

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Yes, and I think, Darren can add some color, but when you think about financial framework, that's exactly what we're trying to do. We're trying to invest in data-driven insights as well as in process and efficiencies in order to invest in our growth areas that we've been talking about digital retail



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and Payments & Rewards and Connected Health and still deliver on our financial framework over time, but that doesn't mean in every quarter, in every moment, but it's -- that's the guideline that we're working with.

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Yes, Irene, I just add. I mean, I think you have it right, it's a balance equation and we've been going for smart tonnage, as Sarah said, and it's just about getting that right balance. We're not trying to be the high-growth company. We're trying to be measured in our approach. So expect to see some improvements as we go, but this won't swing from one side to the other.

Operator

Your next question comes from Mark Petrie from CIBC.

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

I'm also just going to follow up on the whole same-store sales topic. I guess, given that it is broad based, what gives you the confidence that it's a matter of tweaking the balance on promotions as opposed to something more broad, either in the competitive environment or sort of how consumers are responding to your broader value proposition and some of your marketing?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Well, I mean, I think, we know exactly what we did. And what we did was we focused on going for margin improvements. And in the excitement of seeing margin improvements in certain categories, as we started to implement some of the algorithms, people were overzealous as we all enjoyed the additional margins that we were seeing and so we know what we did. So we know what we can do in order to change it. And so we are -- we're not doing a broad based, we are actually focused on a few areas that we do want to change as well. So it's not a broad based everywhere, it's a targeted investment.

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

And Mark, I'll just add also. I mean we're changing how we operate the company. So we're in a learn as we go and keep making adjustments as we look at new ways to run the company in a better, more efficient way that's better for customers.

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

And I mean, certainly, your loyalty and data tools give you more options in terms of how you want to approach these measured and targeted investments, but does that change the relative level of investment needed to drive improved tonnage than it might have 5 years ago or something like that? Or is it pretty consistent?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

No, absolutely. I think with the additional data and the loyalty, we understand where we need to make the adjustments much differently than we would have 5 years ago where we would have gone with a mass offering across businesses. So I think it does allow for fine tuning, which is clearly less expensive.



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

And then it seems like in recent months, we've seen evidence of inflation in categories outside of the fresh categories that I guess have been the primary drivers of inflation over the last several periods. So from your perspective, is that a catch up in related to the severe cost inflation you faced over last 1.5 years or more of a reflection of specific cost of goods increases? And does that relate at all to sort of the dynamics around the promotional investment and balancing tonnage?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Mark, it's -- I mean, we're seeing inflation really still across the board, still highest in fresh and in vegetables, in particular. I still think it's from -- impact on through cost increases from our suppliers. I don't think that's changing as we look at the second half. I mean, if you look at the first half, we've been in the 3s from an inflation point of view. In the second half, we will be lapping inflation from last year. So we do think that will moderate as the year continues here.

Operator

Your next question comes from Patricia Baker from Scotiabank.

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

I'll apologize up front and I'm going to stick with the same topic. And I've heard everything that you said so far, Darren and Sarah, with respect to the fact that you are changing how you operate the company using data-driven insights. Darren, in your opening remarks, you said that this is a journey and sort of that indicated that you're evolving with -- evolving how you approach the business with the data. And I guess, you made it sound to me like you're on a learning curve and it's probably pretty early in the learning curve and you haven't, as an organization, really figured out how to use the data insights in a way that really lets you balance the margin and the top line as effectively as you might want, but this is not the first quarter that you've been using the data to drive your promotions, et cetera. So is there something particular in here? How long -- can you just clarify for us, how long have you been -- actually been applying data-driven insights to your promotional programs, et cetera? And then, just further on that very point, I mean, how quickly do you, as an organization, get indications on how certain things that you're changing are working? And how, I mean, quickly can you adjust for that? Does it take a whole quarter to figure out how going for margin hurt your sales? Just a little bit more color and clarification there so that I have a better sense of what you're really talking about.

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Okay. So I'll go first. So we would have started I would say in Q1 of 2018 with this where we said we're using data-driven insights. We're prepared to lose some bad tonnage and we started in certain categories in our market division. And as we saw positive results and we were excited by the improvements in the margin we were seeing, we continued into other categories. I would say from any type of where you would have seen a total company result, you would have seen it in Q3 of 2018 where we really were starting to see the margin improvement. And then we continued from there with some elements of that being brought into the discount division as well. And so we definitely saw -- so to your next question of when do you actually start to realize these things. So because we were comfortable with our sales performance and the improvements in our margin, which was allowing us to invest in the future, we continued adding new categories on as well. I would have said in Q1 of this year, 2019, we weren't as pleased with our sales as then either. And we did start to make some changes. But I would so -- I would say through Q2, we started to see a determination that there were other things happening in terms of the terrible start to the spring in terms of the right-hand side as well. And I think the other thing that happened is that with the increase in inflation, it's had a -- the consumers are a little bit more sensitive as well. So if you only have \$100 to spend in a week and you're seeing some inflation and you're seeing some change in promotional activities, it had an adverse effect. So it's a combination of events that would have brought that. So when you think about what we've been doing, we are because of the algorithms or writing, it does result in a reduction in the number of loss leaders we would have in our flyer for example. And what happens with that is not only because you have fewer loss leaders, you do lose some tonnage, but what that does do is it opens it up to the rest of the market and so that's also what we're seeing. So hopefully that provides a little bit of color. I don't know, Darren, if you have anything you want to add to that?

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Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

No. Actually, well said, Sarah. Nothing to add.

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

No, I think that does add a lot of color and it is particularly interesting. And you made -- the latter point that you made, Sarah, it does open it up to the rest of the market, I guess, it's really important kind of in the context of using data in analytics correctly, et cetera, et cetera, to recognize that you don't operate in a vacuum. There's always going to be that other part of the market. There is 2 other things that you said that I found interesting. I really do understand your point and you've been hammering at home and working effectively towards it for quite some time and that is the notion of bad tonnage. When we looked at what happened in Q2, the decline in the tonnage in Q2, I guess, it would be fair to say that that represented some loss of good tonnage as well as bad tonnage. And then you referenced that you were disappointed with the Q1 same-store sales, but we did have a deterioration in the same-store sales from Q1 to Q2 and that sounded interesting that you talked about the loss leader. And I think earlier in an answer to Irene's question, you mentioned that market division is where you were seeing a fair bit of impact with less promotional impact on the flyer. And I guess, in the context of a consumer being a little bit more sensitive, I guess, the market division is where you got to be a bit more careful. I guess, going forward with respect to having the right promotional activity to attract the traffic of the customer. Am I wrong there?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Yes. No, I think that's right. And I think to your point about did we lose bad tonnage and good tonnage, we did lose some tonnage we didn't want to lose and that's why we're making some adjustments and that would be in the areas that we know that we want to make those changes, that's where we're making the adjustments. We're okay with some of the tonnage we lost and we're not okay with other parts.

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

Okay. Fair enough. And then a very simple question. On -- at Shoppers Drug Mart, with this very strong showing there, it was nice to see that. Can you tell us whether you had a positive traffic and basket in the front end?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Yes, we did.

Operator

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

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

So on this food same-store sales, you called out weather and the everyday low pricing on the right-hand side of the store. Can you quantify the impacts of those 2 this quarter?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Probably not weather overall, but right-hand side was call it about 60 basis points.



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Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. All right. And then, if you look at your numbers versus your peers, your inflation seems to be trending higher than your peers and your gross margin is a bit -- is better than your peers and your OpEx is growing slower than peers. So I mean, clearly, you can see why you may have lost some limitational tonnage, but as you tweak your sales or tweak your strategies, are you -- are we going to see a reversal in some of those, the kind of performance relative to peers on those line items?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Well, I mean, I think we're all -- we're trying to keep a balance. So yes, taking -- making some investments will have an impact on gross margin. Will it? I don't know what our peers are doing. So it's hard to know how we'll compare to them. But I would say on the other lines, it shouldn't have an impact. We will continue on the other parts of the strategy for sure.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. And when you talk about kind of tweaking the algorithms, can you give us a sense as to like the bandwidth from how sensitive they are? So are you making -- did you make bigger changes this quarter, which caused a bigger falloff in your tonnage? Or whether a small change that consumers were that much more sensitive to and you really got to try and land this on the head of a needle?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Aelst, a good question. I would say we've continued to do the algorithms. So there would have been a little bit more that we did, but I think adding to it would have been the impact of the consumer as well and so. And then as I said, we are doing it in targeted areas that we are making the investments.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. So the reason why you think it's going to reverse over time or normalize over an extended period of time is because you don't want to have a knee-jerk reaction that might cause a competitive reaction. Is that fair?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Yes, that's -- well, that's part of it. I would say definitely the big reason would be that we're happy with our strategy. We actually like what we've seen. We're -- we like our overall sales performance. It is in line with what we want to do in terms of our financial framework. The fact that it came from Shoppers and not the food business this quarter, that's the benefit of having a big enterprise, but we do want to do some tweaking in order to bring those food sales up, but we like the strategy we've got. We're happy with the work we've done on data-driven insights and we're happy with the work we've done on process and efficiencies and it has allowed us to put some pretty significant investments into our future. So that would be the reason that we are not doing anything radical.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

And just a quick question on the drug side. Now that you've lapped the, I guess, drug reforms and you're showing some strong top line growth on -- at Shoppers, are we starting to see EBITDA growth on the drug side again?



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Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Yes, I mean, we're seeing growth in the profitability within Shoppers now. So we've lapped the large drug reforms, you said, that they were -- for the rest of the year, we're seeing normalized levels of drug reform.

Operator

Your next question comes from Jim Durran from Barclays.

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

I do want to shift the conversation to another line item on the income statement, but I do have one question. With respect to all of this changing in terms of your price stance, how frequently do you assess price perception by the consumer across your banners? And are you confident that the perceived relative pricing that you bring to them is still seen as compelling value?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Yes, we look at a lot of metrics. So we would look at sales, relative sales, market share in terms of tonnage share as well as price perception every single week in all of our banners across the business.

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

You do the price perception through a consumer research study at some point?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

We do it a couple of ways. We do it through our own pricing. So we actual have actual data on pricing across the industry and we also do it from industry groups that we look at it as well as we use panels, so we would use all elements.

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

Okay. That's helpful. So just want to shift to...

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

The other piece that we do have -- sorry, the other piece we do have now is we have customer feedback that comes in every single day. And so if there is any changes, I mean, customers don't always tell you if they're not happy, but we get a lot of feedback on all the elements of our stores. So we would use that data as well.

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

Sounds great. Just on SG&A, you've obviously had some good benefits out of SG&A cost containment. Just interested in understanding as we now move into the second half, sounds like there is hope that price adjustment is going to help comp store sales perhaps may not benefit gross margin as much. And so I'm just trying to get a handle on how much we can rely on SG&A expense rate to help the EBITDA margin in the second half of the year?



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Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Jim, from SG&A performance, as you said, it's been quite strong, so 30 basis points both Q1 and Q2. I think it's important to note within that, this quarter, there was some FX and co, may be a third of the benefit came from FX, which was from last year. So as we look forward, we're still investing in the business that will hit the SG&A. I'd probably -- I'm not going to give you a guidance, but I wouldn't rely on something as large as 30 basis points each quarter, but it's a line item we'll continue to focus on. We'll continue to push hard on process efficiencies, but we're also investing in the business.

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

And the investments you're making right now like what kind of payback timeframe will those initiatives have?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Look, they vary greatly depending on which form they're in, but they generally -- they're very IRR accretive. Paybacks can be as short as 6 months, can be as long as 2 to 3 years on some items. So it really depends on the item and the nature of it.

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

So we shouldn't necessarily view that incremental investment as a big push with a meaningful payback in a 12-month time frame?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

No, I believe, this is more long -- these things are longer term in nature. So they're moving us over the longer term. I mean, some items surely are impacting shorter term, but generally, these are for longer term investments.

Operator

Your next question comes from Vishal Shreedhar from National Bank.

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

Off the top, I thought I heard management's, I know, as Galen say that Loblaw delivered on its financial framework in the quarter. I may have heard that wrong, but I thought the financial framework was more high single-digit EPS growth rate. So has something changed in the financial framework? Did I hear it wrong? Whether you're talking about something different?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

I think it's for our own terms of purposes within the framework, 7%. I mean, it's a range that we gave of 8% to 10%. And I think when you look at all the metrics, we're pretty much there, Vishal.

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

Okay.



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Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

And I think the other things that we highlighted was that in Q2, we would be having -- in 2018, we didn't deliver on the financial framework because of many of the headwinds related to drug reform and minimum wage, et cetera, and what we said was, we would be lapping that in Q2. So that's -- so the 7% was right in line with what we expected.

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

And actually, it's a good clarification, Sarah. Just for color for the full year, with our investments, we certainly did not expect or say we would be at the financial -- long-term financial framework this year.

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

Okay. Given that -- given my perception was that you exceeded your margin expectations in this quarter due to your adjustments between sale and margins -- sales and margin. So is that a fair comment? Management's exceeded its internal plan on margin dollars in food?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

I'm not going to get into the details of that plan. I mean, we're pleased with the margin performance in the quarter though.

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

Okay. So as we look forward and you have to make adjustments to get the sales back, so you'll be investing more in price. And then like how should investors think about that in terms of how it translates to the bottom line? Is it fair to say then that because of these investments in price that you'll be making to get the sales line back that will place incremental pressure on the earnings trajectory relative to what we saw in Q2 if we just extend that trend forward?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Yes, I mean, I think the way to think about it, we delivered 7% EPS growth this quarter. We're going to have a Thanksgiving impact, and we are saying, we will invest more in price that will be done in a measured way over time. It's not going to be a big knee-jerk, as Sarah said. So for all intensive purpose, I'm not going to provide guidance, but those are both pressures to a -- our performance in Q2.

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

I think what the other point we would say is we have not changed our outlook for the full year and so that would be another point that you should consider.

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

On the -- I'm going to switch gears just completely here. This is an IFRS 16 question, so I apologize, but in the cash flow statement, I only care about this because it matters for the free cash flow calculation. But in the cash flow statement, the cash rent paid on leased liabilities so the principal component was \$248 million this quarter. Last quarter, it was \$183 million. Is that -- it's a little bit more lumpy than I thought. How should -- is that lumpy because of timing or should that be consistent through the year? How should we think about that?



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Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Probably best is to take that one off line and we'll have that right in front of me at this time, but let's just take that one off line, Vishal.

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

Okay. The -- in Q4, and Sarah, I think you had mentioned something about general merchandise and Hi-Lo strategy and how that was impacting sales? Is that issue behind us?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

No, not entirely. We've had other things compounded. So I would say the weather hasn't been great. I hate to blame sales on weather, but I also took -- but it helped us on the pharmacy business. So yes, there was -- so we would say GM still this has been a great place, but we are working through that.

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

So that Hi-Lo pricing issue that you were working through, changing the strategy, is that improving quarter-by-quarter or given that it's still an issue in Q2?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Yes, still had an issue in Q2, but it didn't have the same impact as it did in Q4, so it is improving.

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

Okay. And I guess, the magnitude of the investments that you're making, it's difficult for us to get a sense of how much of that is in the P&L. Is there any way we can triangulate that?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

I mean, we're not going to give that color. I think we're telling you that we are balancing all these many parts, that's what our job is to do. And I think we're doing that quite well, with process efficiencies, investments and delivering good profit growth here. So we're not going to provide the color on each piece.

Operator

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

Emily Foo - *BMO Capital Markets Equity Research - Senior Associate*

It's Emily Foo for Peter Sklar. So just changing the topic here. As your competitor rolls out their discount format in Western Canada, I was wondering if you felt any pressure in the markets where they've opened the stores? Or if it's too early to tell? And if you've taken any action on your front to defend your market share?



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Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Oh, so, absolutely, every time a competitor opens a new store, you're going to feel the impact of it. But we knew they were opening, we knew the timing of the opening. So we would have had a plan in place in each of the individual markets and we're quite pleased with our performance against the openings.

Emily Foo - BMO Capital Markets Equity Research - Senior Associate

Okay. And it's a few weeks into Q3 now. I know it's going to take time for the course correction, but have you seen any changes thus far for the balance that you've been doing between sales and margin?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Well, we've started before the beginning of Q3 and we have seen some traction in some of the areas we've invested in, but I'm not going to go any deeper than that.

Emily Foo - BMO Capital Markets Equity Research - Senior Associate

And on the loyalty program and the data that's -- the data insights that you are trying to use to drive profitable tonnage, can you give us some examples of recent initiatives that you've been able to capitalize on this?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Well, I think the examples would be some that I would have talked already where you basically look at a category and you calculate the optimal price from a margin perspective that still drives -- is still in the best interest of the customer, but still drives some additional margins. And those would be -- so I don't have category-specific examples that I would be going into detail. But it's along those lines. Just was going category by category looking at what you can do in each category, as I said, it results in a little bit less promotional intensity across the business. And that's where you would see it.

Operator

(Operator Instructions) Your next question comes from Keith Howlett from Desjardins Securities.

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

Yes, so just wanted to spend a bit of time on the headwinds that are hopefully diminishing. But on drug reform, you mentioned that the gross margin was down due to lower gross margin at Shoppers Drug Mart. Is your expectation that that headwind will disappear sort of in the second half? Or are you still facing some pressure there?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Yes, Keith, we expect to keep facing some pressure on health care reform, but I would say it's more at the normal level that we would be used to seeing. It's tough as that to say. And on the margin this quarter, it was a little bit of drug reform and it was a little bit of mix as well within the portfolio.



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

And then, on the labor situation, I was wondering whether you -- independent of legislative changes on minimum wage, whether you're having difficulty with shortage of labor in markets or, I guess, Quebec and some other market seems to be having some issue there. Whether that's causing pressure on your wage bill?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

That's an interesting question. We really haven't felt that. I feel like we have been able to get the labor that we need at the prices and at the wages that we have set. I would say the only place where we have felt it over the last couple of years would be in the transport area, in the trucking area where there has been quite a bit of pressure on labor there.

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

And then just on the general merchandise business, I think, I heard Darren say, it was 60 basis points headwind on same-store sales in the quarter. How do you view the trajectory of that business through the balance of the year in terms of as a headwind to overall performance?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Well, I think, by Q4, it will start lapping some of the declines, but the trajectory right now is still to have a -- as a headwind if you just think about where we are in the cycle. So I don't see that improving as we look at Q3 dramatically.

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

And then just one last question on personalization and promotions. How are consumers engaging with the Optimum Program? Are you seeing more people take advantage of the personalized offer? Or do you find it sort of plateaued or people get bored with the personalized offers? Or what's your experience with being able to tailor your promotions to each consumer?

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

Yes, so I would say that what we're seeing is an increase in the penetration. So we've had an increase in the members. So we're now over 18 million members and we have seen an increase in the penetration of sales through loyalty in all of our divisions, but I understand the point. We are looking at some new ways to maybe innovate in loyalty that will make it a little bit more exciting for the consumer as well that would be part of one of the investments we would be looking to make.

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 wondering if you could give us an update on the evolution of e-commerce in food certainly, but also in the beautyBOUTIQUE side?

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Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Yes. So, I mean, I highlighted the beautyBOUTIQUE as one of the ones that we were quite pleased with because we had started our evolution with just being on the prestige side, and now we offer the mass offering as well on beauty. So we've combined that and we have seen a significant increase of e-commerce sales. We have a goal, a strategy to go after a younger demographic. So definitely going after Millennials and Gen Zs, which did mean that we had to reach them a different -- in a different way. So we have been increasing certainly our social presence on online as well. So we're pretty pleased on the beauty side in our market share that we're seeing and the increasing sales we've seen. But still early days. We just launched that in the quarter. And then I would say on the food side, we haven't been actively increasing the number of outlets. So I think we're over 700 now and 2019 was about how do we actually improve the customer experience and we're pleased. We've seen very large growth. Obviously, it's starting from a smaller base but we've seen very large growth in absolute sales in terms of e-commerce in food and in comp sales. So those who do like the click-and-collect experience or the Instacart experience really like it and continue to come back for it. So we've seen an increase in comp sales there and we've seen new people trying it out too also like it as well, so higher penetration. So good performance in terms of sales on the food side. And then the other piece would be some of the new technology that we've got on the drug side as well, which we can easily and seamlessly go into an auto fill for some prescriptions right within the HealthWATCH pharmacy system that we've been rolling out. So we've got good progress in all elements of our e-commerce strategy.

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

That's really helpful. Just on -- more specifically on the food side, certainly, anecdotally, there does seem to be some unevenness at a store-by-store level in terms of customer experience. Is that something that you are monitoring because certainly you already have -- those are customers who have already tried it, would like to do it, but may be aren't having the greatest experience. So how do you get at that?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Yes, absolutely. So we would monitor all of our stores just like we would in every other metric that we have and we would always have some stores that perform better than other stores and that would be something that we would focus on. There's basically 2 metrics that we're focused on in for the click-and-collect business. The first is the number of substitutions a customer gets and second is the time to get to the car. And so both of those are key elements of having a great service and those would be the areas we're focusing on. And yes, we absolutely would love to have a consistent service across all of our stores.

Operator

Your next question comes from Keith Howlett from Desjardins Securities.

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

Yes. So just wanted to ask about advertising and marketing expenditures, which I guess are getting harder to measure on a comparable basis. But is there -- are you experiencing any decline in flyer costs or reduced flyers and shift to digital or is that sort of still some time away?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

I would say that we've been using social and online services more in order to -- and a little bit -- rely a little bit less on flyer and that is something that we think will evolve over time. So certainly trying to engage all of our store managers or franchise owners to be active in that part because we see that might be a good way to reach our customers as well. And so we've been measuring that. So the number of people who view it. So that's actually data that's pretty easy to see and we can see when we're successful with the campaign and when we're not. So that would be how we're measuring.

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Operator

We have no further questions. I turn the call back to over to the presenters.

Roy MacDonald - *Loblaw Companies Limited - VP of IR*

Well, thank you everybody for your time this morning. If you have any follow-up questions, I'm around all day and please mark your calendars for November 13 when we'll be back online to discuss our Q3 results. Thank you, operator. Have a great day.

Operator

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

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