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L.TO - Q2 2012 Loblaw Companies Ltd Earnings Conference Call

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Keith Howlett *Desjardins Securities - Analyst*

PRESENTATION

Operator

Good morning. My name is Michelle 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. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session.

(Operator Instructions). I would now like to turn the call over to Ms. Kim Lee, Vice President of Investor Relations. Please go ahead.

Kim Lee - *Loblaw Companies Ltd - VP of IR*

Thanks, Michelle. Good morning and welcome to the Loblaw Companies Limited second quarter 2012 conference call. This call is also being webcast simultaneously on our website at Loblaw.ca.

The joined here this morning with Galen G. Weston, Executive Chairman; Vicente Trius, President; and Sarah Davis, Chief Financial Officer. Before we begin today's call, I want to remind you that the discussion will include forward-looking statements such as the Company's beliefs and expectation regarding certain aspects of its financial performance in 2012 and future years. These statements are based on certain assumptions and reflect Management's current expectations, and they are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from current expectations.

These risks and uncertainties are discussed in the Company's materials filed with the Canadian securities regulators from time to time including the Company's Annual Report and second quarter 2012 report. Any forward-looking statement speaks only as of the date they are made. The Company disclaims any intention or obligation to update or revise any forward-looking statement whether as a result of new information, future events or otherwise, other than as required by law.

Certain non-GAAP financial measures may be discussed or referred to today. Please refer to our second-quarter report and other materials filed with the Canadian securities regulators from time to time for reconciliation of each of these measures to the most directly comparable GAAP financial measure. An archive of this conference call will be available on our website.

I will now turn the call over to Galen Weston.

Galen Weston - *Loblaw Companies Ltd - Executive Chairman*

Good morning. Thank you for joining us. In the second quarter we continued to execute our plan. We're beginning to gain traction on the top line, particularly in our core food and drug businesses as we continued our disciplined approach to improving our customer proposition.

We remain confident that our ongoing investments in infrastructure, including the completion of our IT implementation will, enable efficiencies and expense leverage to drive future earnings growth.

Our outlook for 2012 is unchanged. We continue to expect full-year net earnings to be down year-over-year. I will now turn the call over to Sarah to walk us through the results.

Sarah Davis - *Loblaw Companies Ltd - CFO*

Thank you, Galen, and good morning.

Let me start with the performance in our Retail segment. Retail sales increased by 1.1% to CAD7.2 billion in the second quarter of 2012. Same-store sales increased by 0.2%. Growth on the top line was driven by sales in our core food and drugstore businesses, partially offset by declines in general merchandise and gas bar sales. Apparel sales in the quarter were flat.

During the quarter, our average quarterly internal food price index experienced modest inflation, which was lower than that in Q2 of 2011 and lower than average [dpi] in the quarter of 2.5%. In the Retail segment, we reported gross profit of CAD1.6 billion, down [CAD15 million and 40 basis points] on rate year over year. This decrease was primarily driven by increased transportation costs and higher input costs that we did not fully pass on to consumers, which included CAD10 million of our previously announced CAD40 million investment in our customer proposition.

The drop in gross margin rate this quarter was also impacted by mix, as we saw a higher proportion of food sales which had lower margin.

For the Retail segment, operating income was CAD275 million, down CAD58 million or 17.4% year-over-year. This decrease is attributed to the CAD15 million decrease in gross margin, CAD5 million in net notable items, increases in labor and other operating costs and the impact of foreign exchange.

Notable items included CAD20 million in incremental costs related to the IT and supply chain projects, and a charge related to costs associated with the transition of certain Ontario labor agreements, a CAD10 million decrease in stock-based compensation expense and a nil charge compared to the CAD15 million charge recognized last year for certain commodity tax matters. The increase in labor costs included an estimated CAD5 million investment in our customer proposition related to improving service in our stores.

Together with our investment in gross profit, our incremental investment in the customer proposition in Q2 totaled approximately CAD15 million. Increases in other operating costs included higher marketing expenses mainly related to the transition of prescription files we purchased from Zellers, and occupancy and refurbishment costs related to new and renovated stores.

Now, turning to our Financial Services segment, revenue in the segment increased by 14.9% to CAD139 million compared to CAD121 million in Q2 of 2011. The increase was primarily driven by higher interchange fee and interest income from increased credit card transaction volumes and receivable balances. Higher PC Telecom revenues also contributed to our Financial Services revenue growth.

Operating income in the Financial Services segment was CAD15 million in the second quarter of 2012, up from CAD12 million in the same quarter last year. Increased revenue drove the improvement in operating income. On a consolidated basis, operating income was CAD290 million in the second quarter compared with CAD345 million in Q2 of 2011.

Operating margin was 3.9% compared with 4.7% in Q2 of last year. Interest expense was CAD77 million, down CAD1 million compared to Q2 of 2011.

Our effective tax rate for the quarter decreased to 25.4% from 26.2% to Q2 of 2011. The decrease was due to further reductions in the federal and Ontario statutory income tax rate and a decrease in income tax expense related to certain prior year income tax matters.

For the quarter, Loblaw realized basic net earnings per common share of CAD0.57 compared with CAD0.70 in the second quarter of 2011. Free cash flow was CAD437 million versus CAD407 million last year. The increase in free cash flow is due to the change in non-cash working capital, partially offset by the year-over-year decrease in EBITDA and an increase in fixed asset purchases.

During the second quarter, our capital expenditures totaled CAD233 million. We continue to estimate our 2012 capital expenditures to be approximately CAD1.1 billion.

For 2012 our outlook remains unchanged. We continue to forecast costs associated with the transition of certain Ontario labor agreements and -- to be in a range of CAD30 million to CAD40 million. Our estimate for incremental expense related to our investments in IT and supply chain projects continue to be about CAD70 million. In addition, we remain on plan to invest an incremental CAD40 million to strengthen our customer proposition related to value, assortment and experience in our store.

I would now like to turn it over to Vicente, who will provide some context for the quarter.

Vicente Trius - *Loblaw Companies Ltd - President*

Good morning everyone, and thank you for joining us. Let me start with a market overview.

In Q2 the market remained tough. While unemployment was stable with continued concern for the global economy, consumer confidence slipped during the quarter. With budget conscious customers our marketplace, while rational, is competitively intense and increasingly so, as new square footage from more players enters into the mix.

In addition, inflation slowed compared to an inflationary environment last year which put pressure on the top line. While I am not happy that earnings are down, we are on plan. We are staying on strategy, consistently executing. We made steady improvements in important metrics, especially in our core business, food and drug.

Sales on absolute income store basis increased. Traffic through our stores improved, measured by an increase in customer count, and reflects customer feedback results that continue to exceed our targets.

We drove improved trends in both tonnage and market share for Q2. While fresh led, our teams delivered improved performance across all food departments in both divisions, discount and conventional. We are moving in the right direction.

We are making headway in terms of strengthening our customer proposition. We are differentiating ourselves. In the eyes of the customer, it is about making sure that we offer our customers the right value, the right assortment and the best experience across all of our banners. It's about understanding our customers, emerging trends and consistently executing to offer discerning consumers what they are looking for.

We are going category by category. We're making sure that we have customized assortments, compelling displays and are delivering competitive value through our store network. This is a process, one that takes discipline and time.

To date, we have completed and implemented full category assortment reviews on a number of priority categories and are seeing positive results, not only in terms of sales but in mix, with improved margin performance and competitiveness in those categories.

Despite ongoing drug reform across the country and resulting deflation, our drugstore business delivered sales growth in the quarter. Script count was up 5.2%, driven by solid organic growth in our position of prescription files from Zellers.

As an update, our team has successfully transferred files from 106 locations. With retention rates ahead of our target, we are confident that this acquisition will serve to drive traffic and loyalty at our stores.

Earlier this morning we announced the promising partnership between JCPenney and the Joe Fresh brand, by which Joe fresh will be in almost 700 stores across the US by spring of next year.

Now, let me give you an update on our SAP implementation. During Q2 we made progress on converting costing, ordering and replenishment to SAP as we work towards go live on those variables in Q3 and in advance of our plan to transition our first store pilot to SAP by year-end. At store level we rolled out our SAP readiness program to more than 350 stores in preparation for our 2013 rollout.

We are confident that we are moving at the appropriate speed, have the right team and a plan that would get us to our 2014 finish line with little to no disruption to our customers. Looking ahead, we're focusing on steadily building our business. We have cycled over the challenging comparisons from the first half of last year and remain on plan for the second half.

With that, let's open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Iren Nattel, RBC.

Irene Nattel - *RBC Capital Markets - Analyst*

Could you please talk about where you are seeing the most competitive intensity in the store, in other words, which categories? And also which categories in which you have completed the review, what changes you have made and what kind of lift you've gotten there and whether that impact is driving your overall tonnage lift?

Vicente Trius - *Loblaw Companies Ltd - President*

Good morning. Due to competitive reasons, I'm not going to give you details behind the categories. Having said that, if we look at the last quarter there has been pressure in the market from a standpoint of inflation being less in last year than Q1.

We have seen this environment -- we have been proved our (inaudible) trends in inflation, or trends in tonnage, more so in our core which is food and drug, we are coming ahead of the 0.2% and our customer count is up. Now, we are very pleased with what we're doing on the categories. We are doing an in-depth assortment review that focuses on consumer trends of the customer and improves competitiveness of those categories.

We have rolled out more than five categories. We see solid traction on those categories, and this translates in improved sales. This translates in improved margins, better mix, so the customers are buying more of the breadth of our assortment whilst we are improving competitiveness.

We see this as an ongoing process. As you would know, we could have about 50 or 60 categories in our stores. So we see doing that in the process of two years to 2.5 years.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great and that is quite helpful, thank you. Wondering if also if you could talk out apparel, which was flat, which was kind of unusual because for the last couple of years your trends have been up. So could you talk a little bit about what happened there?

Vicente Trius - *Loblaw Companies Ltd - President*

Sure. If you look at it from a market perspective, actually, the whole apparel market was down during Q2. And within this environment we were flat on sales. We continue to leverage the strength of our brands; it is a competitive advantage in our stores and we will continue to do so.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great, thank you.

Operator

Michael Van Aelst, TD Securities.

Michael Van Aelst - *TD Securities - Analyst*

Just to follow up first on the tonnage comment. You said the tonnage was up, but you also said inflation was up and same-store sales were only up 0.2. I would assume you're saying food was up more than 0.2, but can you give us any indication of your increase in tonnage to support your indication that it was up?

Vicente Trius - *Loblaw Companies Ltd - President*

What I can tell you is that we think that is a scenario (technical difficulty) we see improved trends in tonnage and share, and we have seen better traction at the end of the quarter.

Michael Van Aelst - *TD Securities - Analyst*

When you say share, are you talking versus either traditional grocery stores or are you talking about versus all food retailers?

Vicente Trius - *Loblaw Companies Ltd - President*

We think the market which would include all food retailers.

Michael Van Aelst - *TD Securities - Analyst*

So I take it that means that total industry tonnage is relatively flat or down.

Vicente Trius - *Loblaw Companies Ltd - President*

I'm not going to comment on the total industry. What I can tell you is we see within this environment improved trends in our share in tonnage. That as far as I will go.

Michael Van Aelst - *TD Securities - Analyst*

Taking a look at your SG&A costs, if I back out the stock-based compensation and the IT, it looks like -- I think it was up around 4.5% or so and that followed about a 3% growth in Q1. I know you had some higher Zellers costs related to the Zellers marketing to retain the scripts. But does that explain the expanded pace? Or is there an underlying trend here where we're going to see higher inflation or higher SG&A costs in that magnitude for the rest of the year?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Okay, I will take that. It's Sarah. So basically the SG&A costs are up for a few reasons, so a couple of them that you mentioned -- the IT costs and the stock-based comp as well as the labor deal, which was CAD10 million higher than last year. We also had the investment in labor included in that.

Then the other component would be a negative impact on foreign exchange as well as the marketing costs related to Zellers. And the other piece, which isn't ongoing, which will be an ongoing piece is just the increase in our occupancy costs associated with some new stores that we opened as well as the renovations that we have been completing over the last few quarters. So, those would be the main pieces, the marketing being one-time but the others being ongoing.

Michael Van Aelst - *TD Securities - Analyst*

All right. And the Zellers marketing, is that pretty much done now? Or do you have to keep doing that for the first few quarters?

Sarah Davis - *Loblaw Companies Ltd - CFO*

It is done, essentially done.

Michael Van Aelst - *TD Securities - Analyst*

And finally on the tax rate, I think the last guidance you gave was 27%, but you are trending below that so far. Can you give us an update?

Sarah Davis - *Loblaw Companies Ltd - CFO*

I would still use 27%. It's a hard one to predict exactly. I know Q3 sometimes we do have some adjustments so I would use 27% for the year. It might come in slightly lower than that, though, given Q1 and Q2 are below that.

Michael Van Aelst - *TD Securities - Analyst*

Thank you.

Operator

Patricia Baker from Scotiabank.

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Patricia Baker - *Scotiabank - Analyst*

Thank you very much and good morning. First of all, and I just want to make a comment. Thanks for the heightened disclosure and additional information that was in the press release this quarter. I find that, and I'm sure everyone else does, pretty helpful.

And secondly, I want to talk a little bit about the customer proposition expenditure and that whole initiative. If we look at the spend in the second quarter of CAD15 million that would imply, on an ongoing basis, a run rate of let's say CAD60 million on an annual basis. But then if you look at the first half, you spent CAD25 million, implying a run rate of CAD50 million. But you are still sticking to the CAD40 million.

So, this implies that we're going to have a dial down in the second half. And I'm a little puzzled or concerned about dialing down either the pricing and/or the labor in the second half, and how that will permit you to maintain the positive trends that you indicate that you were getting in terms of tonnage. Is there any commentary you can give us on that?

Vicente Trius - *Loblaw Companies Ltd - President*

As we have clearly stated all along, we saw a first half a lot more challenging than the second half. I can tell you that we have been in line and pretty consistent in our gross margins over the last four quarters, and we feel very comfortable that this is the right level to continue focusing on our customer proposition, which is improved competitiveness and services across our banners through the second half of the year.

Patricia Baker - *Scotiabank - Analyst*

So, Vicente, does that mean -- you spent CAD10 million in margin this quarter, CAD5 million on labor. And presumably, you're trying to create a different customer perception and, as you say, proposition and what they feel they're getting in the store in terms of value and in terms of service. So would it be fair to say, though, that you will continue to invest that much in labor so that the customer experience doesn't change in the back half?

Vicente Trius - *Loblaw Companies Ltd - President*

We will continue to invest in labor from a standpoint we have invested in the fresh areas. We invested in the front end. And obviously we see a second half probably less challenging in the area of gross margins, and at the right level where we can continue to improve on the category by category competitiveness and rollout of assortments for our customers.

Patricia Baker - *Scotiabank - Analyst*

Okay, thank you.

Operator

Perry Caicco, CIBC World Markets.

Perry Caicco - *CIBC World Markets - Analyst*

Thanks. I just want to explore gross margins for a minute or two. You have been running a declining gross margin rate I guess for four consecutive quarters, and obviously part of this is simply rising costs that you are unable to pass through.

I'm just wondering what the outlook is for gross margins over the next couple of years. Are continual price investments and rising commodity costs going to keep pushing margins down? Or is there any window through mix management or better buying practices to mitigate the decline?

Vicente Trius - *Loblaw Companies Ltd - President*

I'm not going to give you guidance as we look at the future. What I can tell you is that I believe that the levels of gross margins [have created] over the last four quarters are at the right level. It allows us to focus on our customer, improve our competitiveness, improve our services in the store, so we feel comfortable at the level we are in. And I believe we are doing it at the right speed.

Perry Caicco - *CIBC World Markets - Analyst*

Right. The Quebec market looks like it's going to be getting a little more competitive with Wal-Mart and Target adding assets there over the next couple of years. How do you feel about your mix of conventional and discount stores in that market in your current competitive position? Do you feel that you are ready for the changes that are coming in that province?

Vicente Trius - *Loblaw Companies Ltd - President*

To be honest, I see the competitiveness across all provinces. It is nothing about Quebec (technical difficulty) through all the provinces. And we see our banners very well positioned whether it is legal, whether it's Loblaw or Maxi. And we are doing the same things in improving our competitiveness in servicing our stores as well, and we're getting traction. Our customers are telling us so.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. Just lastly, I just want to talk about market share. You've got obviously very modest same-store sales results and very limited square footage growth, so your market share is likely to remain under some pressure for quite some time. How important is market share to you? Are you at all concerned about continual share losses? Or do feel you can mitigate market share losses by performance in other areas?

Vicente Trius - *Loblaw Companies Ltd - President*

Well, I mean the market has been under pressure. We have increased square footage. We have declining inflation within this marketplace. Our trends in market share and our trends in tonnage are improving.

Most importantly, our core in food is doing better. And it is doing better than the 0.2 in food and drug. So we feel that we're getting traction.

Perry Caicco - *CIBC World Markets - Analyst*

Does that mean that you are gaining share or you are not losing share as fast as you were?

Vicente Trius - *Loblaw Companies Ltd - President*

I'm improving trends in share and tonnage, and we have seen better traction at the tail end of the quarter.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. That is fine, thanks.

Operator

Peter Sklar, BMO Capital Markets.

Peter Sklar - *BMO Capital Markets - Analyst*

Back on the Quebec grocery market, just as Wal-Mart continues to convert all of its discount stores to supercenters, can you talk a little bit about how both your Maxi stores and your conventional stores that are in close proximities to Wal-Mart supercenters, how they have performed throughout that process as the Wal-Mart supercenter has opened and as those stores have matured?

Vicente Trius - *Loblaw Companies Ltd - President*

Well, we're focusing more and more on the customer, and this takes a different dimension when you look at conventional and when you look at discount. So if you look at the conventional stores, it is more about differentiation and improved competitiveness. The differentiation comes through the assortment. It comes through the fresh experience. It comes through the service at the best price.

When you look at the discount opportunity in Quebec, we have a very strong brand with Maxi, very well positioned. And in discount with the lowest prices in the market, and I think we are positioned to compete with Wal-Mart.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. And how does it trend, though, as the supercenter opens? I assume they immediately take some share and then over time you get some of that back. Can you talk a little bit about how it unfolds for you?

Vicente Trius - *Loblaw Companies Ltd - President*

Sure. This is -- in the market in general when you have somebody that opens, you will have maybe some impacts in some stores. What I feel the most constant about is that with the right positioning and the right [stage of] performance. And even if you have maybe a little dip, you recover fast because you have the right customer proposition.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay. Sarah, just one question, I believe on Loblaw you have about CAD1.9 billion of cash. Can you talk about how much of that you need to run the business? Like what is core cash you need to run the business and what would you consider to be excess cash?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Well, right now we probably are sitting on a little more cash than we need to run the business. And so -- but we feel going through some of these times that we've gone through, whether it is the credit market or the SAP coming this year, we like having the cash for the time being. But really be the appropriate amount that we would like to have is -- we wouldn't want to be any less than CAD700 million of cash, would be where we like to be.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay, thank you. That is all I have.

Operator

Chris Li, Bank of America Merrill Lynch.

Chris Li - *BofA Merrill Lynch - Analyst*

Can you maybe talk a little bit about what were some of the positive drivers that helped offset some of the gross margin pressures you experienced during the quarter?

Vicente Trius - *Loblaw Companies Ltd - President*

I'm going to refer to one -- the category reviews. We think and I can tell you that we have seen good performance in ethnic, with growth, solid growth I would say. We have seen a good performance in health and wellness.

We had a 5.2% increase in script count. This is driven by our organic base as well as the transfer of the scripts from Zellers. We were able to transfer about 106 stores in record time and ahead of our target objectives (technical difficulty) from our (inaudible).

Other areas that we're getting some good traction, let me give you another example, would be on the fresh and what we're doing behind fresh. Fresh is about experience, which is the [theater], how you execute is about assortment. The assortment takes a different dimension because it's about the quality and the specs, and sometimes I talk as well about the taste. And this challenges you in a manner to look at your sourcing and your supply chain end to end.

So we've done very good improvements in many different categories. I'm going to give you an example that -- it's important. I pick always tomatoes because tomatoes are a very sensitive product. Shelf life tends to be a little bit shorter, so how you source it correctly from the right source, getting the right level of ripeness, and presenting it to the customer with a proper shelf life is critical. But you can get though you that a point of differentiation to the (inaudible) consumer that is substantial.

We have just really done that, and our improved not only assortment but the quality of tomatoes is very, very good. And we partner with different suppliers across the network and globally.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay, that is helpful. And I guess related to that, in light of the recent droughts and the impacts on food cost, what is your outlook on your input costs for the rest of the year? Are your suppliers starting to raise prices again?

Vicente Trius - *Loblaw Companies Ltd - President*

Not yet at this stage, although obviously -- I mean corn costs across many products, so we should expect to see maybe some added inflation.

Now, this can play in many different manners. For example, if you look at beef, it could create at times maybe overabundance in the beginning, and not necessarily a shortage. So it will play in different manners depending on the category.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. And just I guess for Sarah, you mentioned earlier that foreign exchange had a negative impact on your SG&A expense for this quarter. Can you give us more colors on that? I just wasn't sure exactly what items you were referring to.

Sarah Davis - *Loblaw Companies Ltd - CFO*

It would be any of our payables at the end of the quarter that are at -- we mark to basically the -- at the point time we would change to the latest exchange rate, so it would be based on the payables at that point. So it impacts both, the SG&A. The FX would impact SG&A and the cost of goods sold, so in gross profit as well. But we did see a bit of a negative impact in SG&A in this quarter.

Chris Li - *BofA Merrill Lynch - Analyst*

Thanks a lot.

Operator

David Hartley, Credit Suisse.

David Hartley - *BMO Capital Markets - Analyst*

Just wanted to ask a little bit more about your gross profit line, cost of goods sold. It seems that it is not really being negatively affected by promotional spending or investments in price, above and beyond what you have signaled out in terms of your customer proposition. Have I got that right?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Okay, I can take that. Yes, that sounds about right. The impact we talked about -- there is an increase in transportation costs, which is mostly fuel and then otherwise the investment there. But other than that, that would be -- it is not a huge amount of promotional activity in the quarter for us.

David Hartley - *BMO Capital Markets - Analyst*

Okay, so as we look forward into the second half of the year, I think you signaled that gross profit margins may come under a little less pressure. Is there something there that you could point to as a reason for that? Is it more investment in private label? Is it less transportation costs? Are you seeing just improvement from your initiatives in terms of getting a better mix? Could you talk a little bit about that?

Sarah Davis - *Loblaw Companies Ltd - CFO*

I think the main reason would be that Q3 and Q4 of last year, the rates were lower. So it is just an easier comparison on a year-over-year basis.

David Hartley - *BMO Capital Markets - Analyst*

Okay, great. And just finally with the SG&A, I mean there was a sizable component to the increase in SG&A related to -- I guess we'll call them one-time items or other items that you called out earlier in the year. The remainder seemed to be kind of more fleeting, or at least some of it is.

When you go forward in the next couple quarters and next year, how do you see SG&A growth taking shape, given that some of these investments you are making today may fall off and actually may turn perhaps negative for the SG&A line, which would be a positive? What would you say?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Well it's definitely for the IT and supply-chain costs, which have the biggest impact on us. We have talked a little bit about that. But this year we know that it will be CAD70 million of incremental next year. We have basically said the cash expense will reduce, but the total expense will stay essentially flat.

And it will be 2014 and then after the rollout where we will start to see the decrease in [billed] cost, reducing from 1.8% of revenue today down to 1.2% by 2016, as well as we will start to see some of the benefits. When we look at other expenses we always have pressure on labor because of the inflation -- position of the contracts that we have. So we always have to look for productivity to offset that.

Other costs we expect, we have seen some increase in our depreciation not related to IT and supply-chain, but related to the new stores as well. As you add new stores, which we did last year, that will increase, as well as some of the renovation costs result in higher depreciation. So that is there to stay.

And then as we -- so other than that, I think the costs are -- we are expecting to remain essentially flat. But we'll always be looking for opportunities to reduce our cost structure as we go through the year.

David Hartley - *BMO Capital Markets - Analyst*

If I could sneak one more in, just on the merchandise write-offs in the quarter, I noticed it was [CAD16 million] this year relative to [CAD20 million] a year ago quarter. How do you see that trending going forward? And does this signal anything at all outside of your seasonal items to some of the bleeding off in the merchandise assortment is coming to an end?

Sarah Davis - *Loblaw Companies Ltd - CFO*

I think we will always have a provision for our inventory in every quarter. It is lower this year. It's -- part of the reduction is related to just the lower inventory level that we had and better inventory management, definitely on the seasonal items that you mentioned.

David Hartley - *BMO Capital Markets - Analyst*

Okay, thank you very much.

Operator

Vishal Shreedhar, National Bank.

Vishal Shreedhar - *UBS - Analyst*

Thanks a lot. Just on your Joe Fresh initiative with JCPenney, can you help us understand what the capital cost for that is, any marketing spend, any distributions spend, and also what the profitability split will be?

Vicente Trius - *Loblaw Companies Ltd - President*

Yes, first let me expand a little bit on Joe Fresh. Let me start by saying that we believe on the addition from [Rod Johnson] on creating a specialty department store, and we feel very good that in this store-within-a-store concept the Joe Fresh apparel fits very, very well.

It is an opportunity to leverage our brand across almost 700 stores. This has added scale, has limited financial risk and it has no capital. It is a wholesale arrangement, but where we control the brand and is actually accretive from the start. So we see it as promising.

Vishal Shreedhar - *UBS - Analyst*

Okay, so it is accretive from the start. In terms of capital costs, [very likely] to wholesale arrangement?

Vicente Trius - *Loblaw Companies Ltd - President*

No cost of capital and very low incremental expense; you might need a few people to manage, but it is very, very simple.

Vishal Shreedhar - *UBS - Analyst*

Okay, great. And on inflation, where do you see that trending in the near term? Do you think we have troughed or is there more to go in terms of softening?

Vicente Trius - *Loblaw Companies Ltd - President*

Well, I see inflation to continue to come down at this stage. There is pressure. And it is to be seen what this corn impact will do in the short term, but the corn impact is maybe for two or three months at the very most. But I would see trends coming down.

Vishal Shreedhar - *UBS - Analyst*

Okay. So when you talked about the corn impact, the two to three months, do you say the two or three months' impact before would see it put upward pressure on inflation? Is that the way to think about it?

Vicente Trius - *Loblaw Companies Ltd - President*

Yes, a little bit, but it is to be seen.

Vishal Shreedhar - *UBS - Analyst*

Okay, and lastly on this SAP implementation, the final step when you start linking up to the stores, could you help us from your standpoint understand what could go wrong? And if something goes wrong, how should investors think about the impact to the P&L and the impact to the business, and what steps Loblaw has to mitigate the risks in front of it related to this SAP implementation at the store?

Vicente Trius - *Loblaw Companies Ltd - President*

Sure. First let me start by reminding everybody that this is two-year. We see the implementation of SAP by 2014. We're in the process of implementing costing and replenishment and ordering, and we're on target to roll out the first store by Q4.

We have the right teams, we have the proper planning and we don't see at this stage any major disruptions. Going forward is a plan that has some room as well to maneuver. So we control the speed that we can roll out the stores.

I'm going to leave it at that. We have room to maneuver. And if you control the speed, you can also control any potential impacts.

Sarah Davis - *Loblaw Companies Ltd - CFO*

If I could add a couple of things, we have converted every warehouse that we have to new systems as well as the whole transport system. We have converted a lot of other components like finance and all of that. We really haven't had any disruptions to the business, so we're very optimistic that we will be able to do it.

But given that it is bringing the stores and the DCs together, we'll be cautious as we go through. But to Vicente's point, we can always pull it down if it is not as going as well as we would have liked.

Vishal Shreedhar - *UBS - Analyst*

Okay. Is there any way for an investor to discount the potential impact? Let's say at the beginning, things don't go to plan. Is there any way for us to discount that to say this could be the impact? Is there 20 stores being converted at the first tranche or --?

Sarah Davis - *Loblaw Companies Ltd - CFO*

I think the biggest impact financially would be that it will [take cover], in which that case we would have to hold onto consultants and the integrators who are helping us with it. So it would just take the project a bit longer. But from a financial perspective, we would stop it if we started to see any impact to the stores.

Vishal Shreedhar - *UBS - Analyst*

And Vicente said you had room to maneuver within the plan. That is correct?

Vicente Trius - *Loblaw Companies Ltd - President*

That is what I said, yes.

Vishal Shreedhar - *UBS - Analyst*

Thank you.

Operator

Jim Durran, Barclays.

Jim Durran - *National Bank Financial - Analyst*

Just a couple of follow-up questions. First on the Joe Fresh, can you just give us an idea how you're feeling about the US test on your standalone stores?

Vicente Trius - *Loblaw Companies Ltd - President*

We feel positive about our startup in the US with our stores in Manhattan, and let's say we are right on target with our expectations.

Jim Durran - *National Bank Financial - Analyst*

And does the JCPenney transaction give you any sort of certainty, I guess, in terms of when you may add more stores?

Vicente Trius - *Loblaw Companies Ltd - President*

No, no. But within this agreement obviously we can open standalone stores. It would generate a focus a lot more on urban stores, and with JCPenney it will be basically our agreement and in (inaudible) stores. But we will be cautious as we move through this process.

Jim Durran - *National Bank Financial - Analyst*

And just to be clear on the JCPenney transaction, so are you expecting that to come sort of March, April, or May timeframe that you will have actually 600+ boutiques in place doing business?

Vicente Trius - *Loblaw Companies Ltd - President*

Yes, we are. We're in the process already of putting the orders in place. There is capacity in our suppliers to fulfill these orders and we see those stores rolling out by spring of 2013.

Jim Durran - *National Bank Financial - Analyst*

Okay. And just going to Maple Leaf Gardens when we have done tours of the stores and seen some product categories with a little bit of extra revenue lift to them, there was talk about trying to deploy some of those initiatives into some of your other stores. Can you give us a sense of where you are at on those initiatives?

Vicente Trius - *Loblaw Companies Ltd - President*

Yes, we're actually right in the midst of the process of rolling out many of those initiatives, mainly so across our conventional business, obviously. But if you go to the stores, let me give you examples.

Like if you go to the bakery, you will see cupcakes, which the whole cupcakes and pastries that you saw at MLG, you will see an improved assortment on Artesian breads. You will see improved assortment of ethnic vegetables, tropical fruits, Canadian corn-fed beef, and I could go on and on. So you are seeing improved cheese and deli, and we're very excited and the customers are loving it.

Jim Durran - *National Bank Financial - Analyst*

And then last question, just on the IT side for SAP. Can you give us ideas of this we look at 2013 as to when chunks of stores will start to be integrated into the SAP platform?

Sarah Davis - *Loblaw Companies Ltd - CFO*

So, basically, what our plan is to do one this year and see how everything works. So it is basically a test of all the systems, supply chain as well as fulfillment (inaudible) forecasting and replenishment system that we've got as well. And then we're going to hold off for a little while and then we will slowly rollout starting in Q1, but not ramping up really until Q2. So in Q2 we'll have a pretty good sense of how things are going.

Jim Durran - *National Bank Financial - Analyst*

And do you still feel you will be going through the tail end of the process in 2014?

Sarah Davis - *Loblaw Companies Ltd - CFO*

Yes.

Jim Durran - *National Bank Financial - Analyst*

Great, thank you.

Operator

Keith Howlett, Desjardins Securities.

Keith Howlett - *Desjardins Securities - Analyst*

Yes, I had question about your pharmacy business in Quebec. I was wondering if you could speak as to how many, roughly speaking, how many pharmacies you've got there and what your intention is more pharmacy in Quebec going forward.

Vicente Trius - *Loblaw Companies Ltd - President*

Well, our overall -- like I said, our overall health and wellness business is doing well. We are increasing by 5.2% in our scripts. This is driven by organic as well as the Zellers transfer and this is across all of our banners, and in Quebec we will have about 25 pharmacies.

Keith Howlett - *Desjardins Securities - Analyst*

And I know you have taken some out of Loblaw of the large Loblaw stores in Quebec, so you have less pharmacies in Loblaw. So just going forward, do you think you would like to increase the fleet of pharmacies in Quebec or pretty much stay the way you are?

Vicente Trius - *Loblaw Companies Ltd - President*

We are fine the way we are, although we see the health and wellness area as an area we want to leverage going forward.

Keith Howlett - *Desjardins Securities - Analyst*

Just on No Frills, I was wondering if you could speak to No Frills outside Ontario, Western Canada and the Maritimes and how it is faring what your thoughts are, and whether there might be increased store count there?

Vicente Trius - *Loblaw Companies Ltd - President*

We are very pleased with our performance of No Frills outside of Ontario. If you look at the Atlantic or you look at the West, it's in a format that has success. And we will be looking at continuing to expand our footprint across Canada.

Keith Howlett - *Desjardins Securities - Analyst*

I was wondering on the general merchandise assortments in the large-format stores in Canada, how far -- excluding the Joe Fresh part of it how far along you are in transitioning the assortment. And I noticed some changes recently relating to the electronics area in some stores; just maybe how the overall program is going, and then specifically, what your thinking is on the sort of electronics part of the store.

Keith Howlett - *Desjardins Securities - Analyst*

Yes, we have converted this far about 28 stores on the right-hand side. We are seeing good improvements in the areas of home. Electronics obviously is a resetting and we're downsizing it, and we believe that's the right thing to do, downsizing electronics. In exchange we're building and our kids' world and we're building in the whole area of drug and beauty.

Keith Howlett - *Desjardins Securities - Analyst*

And then just on the arrangement with JCPenney, is there a term to the agreement?

Vicente Trius - *Loblaw Companies Ltd - President*

We will not disclose the terms. We will not disclose the terms of the agreement. It's a good agreement; good agreement, good partnership.

Keith Howlett - *Desjardins Securities - Analyst*

So, when I said term, I meant like is it five years or two years or 10 years?

Vicente Trius - *Loblaw Companies Ltd - President*

Got it, it is a four-year.

Keith Howlett - *Desjardins Securities - Analyst*

And when you say you can keep control over the brand does that mean the way it is presented or the fixturing or the --?

Vicente Trius - *Loblaw Companies Ltd - President*

Yes. Anything around the brand -- the way it is presented, the fixturings, and the value obviously and the (inaudible)

Keith Howlett - *Desjardins Securities - Analyst*

And would your arrangement be similar, just in general terms, as it relates to markdowns and shared promotion to Ralph Lauren JCPenney? Is it sort of a standard agreement or is it somewhat different?

Vicente Trius - *Loblaw Companies Ltd - President*

I will not give you the sort of details behind the agreement, but it is an agreement where we control the brand and it is a wholesale agreement where we supply the product to them.

Keith Howlett - *Desjardins Securities - Analyst*

Great, thanks very much.

Operator

Irene Nattel, RBC Capital Markets.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks, just a couple of follow-ups if I may. I think, Vicente, what Keith was really trying to get at is, do all of us shareholders need to worry about waking up one day and seeing a write-down on the Loblaw P&L for some inventory -- the Joe inventory at JCPenney.

Sarah Davis - *Loblaw Companies Ltd - CFO*

I'll take that. So, no, the shareholders don't need to worry about waking up and hearing about that.

Irene Nattel - *RBC Capital Markets - Analyst*

Thank you. Then just coming back to the whole category refresh thing, one of the trends we have been seeing within the market place certainly accelerating over the last six to 12 months is the proportion of transactions done on promotion.

Vicente, or whoever wants to answer, within the categories where you have done the refresh, have you seen consumers responding to the point where you are seeing less of that phenomenon in those categories? Or it doesn't really make much of a difference, and as a proportion of total transactions, regardless of category, promotions are still increasing? Or promote sales transactions on promotion.

Vicente Trius - *Loblaw Companies Ltd - President*

So, if you look at the market there is increased penetration of promotions in the market. We are focusing on balancing a lot better towards consistent shelf pricing. As you look at those categories, we go across the whole breadth of the assortment. We think it's competitiveness and we see a better performance in sales, which means you are mixing better across all of the press, and promotional activity goes down.

Irene Nattel - *RBC Capital Markets - Analyst*

And are you seeing -- what you just described, that phenomenon, are you seeing a higher success rate, if you will, in the category that you have reset?

Vicente Trius - *Loblaw Companies Ltd - President*

Yes, absolutely.

Irene Nattel - *RBC Capital Markets - Analyst*

Okay, excellent. Thank you.

Operator

I have no further questions at this time. I turn the call back over to Ms. Lee for closing remarks.

Kim Lee - *Loblaw Companies Ltd - VP of IR*

Thank you for joining us. I will look forward to talking to you on our next quarter. Have a great day.

Operator

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