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L.TO - Q3 2015 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 3Q15 adjusted net earnings available to common shareholders of CAD408m and adjusted basic net earnings per common share = CAD0.99.

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Vishal Shreedhar *National Bank Financial - Analyst*

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PRESENTATION

Operator

Good morning. My name is Angel and I will be your conference operator today. As a reminder, today's conference is being recorded. At this time I would like to welcome everyone to the Loblaw Companies Limited third-quarter 2015 conference call.

(Operator Instructions)

I'll now turn the call over to Sophia Bisoukis. You may begin your conference. Thank you.

Sophia Bisoukis - *Loblaw Companies Limited - IR*

Thank you and good morning.

Welcome to the Loblaw Companies Limited third-quarter 2015 results conference call. I am joined by Galen Weston, President and Executive Chairman, and Richard Dufresne, Chief Financial Officer.

Before we begin today's call, I want to remind you that the discussion will include forward-looking statements such as the Company's beliefs and expectations regarding certain aspects of the operating and financial performance in 2015 and future years. These statements are based on certain assumptions and reflect Management's expectations and they are subject to a number of risks and uncertainties that could cause the actual results or events to differ materially from our expectations.

These risks and uncertainties are discussed in the Company's materials filed with the Canadian regulators from time to time. Any forward-looking statements speak only as of the date they are made. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than what is required by law.

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

I will now turn the call over to Richard.

Richard Dufresne - *Loblaw Companies Limited - CFO*

Thank you, Sophia, and good morning, everyone.

We continue to deliver against our financial plan in the third quarter and are pleased with our progress. We delivered positive same-store sales and stable gross margins. Synergies continued to contribute meaningfully to our earnings. In the quarter, we grew adjusted basic earnings per share 10% compared to last year.

During the third quarter we met our deleveraging target. Adjusted net debt decreased by CAD527 million in Q3, resulting in the cumulative debt reduction of approximately CAD1.9 billion since the closing of the acquisition. Now that this target has been met, we will begin using our excess free cash flow to repurchase shares. Share repurchases will begin in the fourth quarter using our normal course issuer bid.

Turning to our retail results, total food retail same-store sales grew by 3.1% in the quarter, excluding gas and tobacco. Both our market and discount divisions contributed positively to this solid performance. Our internal food inflation was higher than the CPI rate of 3.8%. Inflation continues to be fueled by produce, meat, and grocery.

Same-store sales growth in drug retail remains strong at 4.9%. Front store same-store sales grew by 6.2% compared to 1.6% a year ago. Strong performance in all categories supported this result and food was a key driver. Pharmacy same-store sales grew 3.5%, driven by strong prescription count growth. Strong prescription count growth was partially offset by deflation in the average script value due to the continued impacts of drug reform and generic penetration. Prescription count increased by 4.4% on a same-store basis.

With positive same-store sales growth in both food and drug retail, total revenue in our retail segment was CAD13.7 billion, up 2.5% year over year. As reported, total retail adjusted gross margin was 26%, flat compared to the third quarter of 2014. This includes the impact of the previously announced changes to our franchise fee arrangements, which reduced both food retail sales and gross profit by approximately CAD43 million with the offsetting decrease in SG&A.

Excluding the impact of the changes to the franchise fee arrangements, adjusted retail gross margin was up 30 basis points. Food retail adjusted gross margin, when you exclude the positive impact of franchise consolidation, was up compared to the third quarter of 2014. The drug retail adjusted gross profit margin was lower than the third quarter of 2014, due to pressures from healthcare reform, partially offset by higher gross margin in front of store.

Turning now to expenses, excluding the impact of the changes of the franchise fee arrangement, total retail SG&A increased by 30 basis points to 19.1%. SG&A was negatively affected by the impacts of foreign exchange related to our US dollar payables and labor settlement costs associated with our new labor agreements signed last summer. Also, as we consolidate new franchises, SG&A dollars and rate will increase, but will be offset by higher gross profit. Servicing efficiencies continues to be a priority in our financial plan. Realized efficiencies positively impacted SG&A this quarter; however, they were offset by these other negative factors.

I'm pleased to report that we delivered CAD76 million in net synergies during the third quarter, compared to CAD44 million in the third quarter of 2014. Since the close of the acquisition of Shopper's Drug Mart, the Company has realized CAD222 million in annualized synergies, net of related costs. With our focus turning to GNFR initiatives and the increase in costs to achieve these efficiencies, the incremental impact of efficiencies will be lower in the fourth quarter. We continue to expect to achieve realized net synergies of CAD300 million in the third year following the close of the acquisition.

Our adjusted net interest expense declined by CAD17 million to CAD152 million in the quarter, reflecting a declining level of indebtedness. We expect interest expense for the fourth quarter to be around CAD133 million. Adjusted net earnings available to common shareholders was CAD408 million and adjusted basic net earnings per common share increased by 10% compared to the third quarter of 2014 to CAD0.99 a share.

We also continue to make progress on our previously announced restructuring plan related to the closure of 52 underperforming retail stores. These closures will reduce annual sales by about CAD300 million and result in a positive impact to EBIT of approximately CAD35 million. The restructuring and other related costs associated with the plan are now expected to total approximately CAD140 million, and CAD131 million has been booked so far in 2015.

In the fourth quarter we expect to incur a non-recurring charge of approximately CAD60 million in SG&A, associated with labor buy-down commitments within our existing labor contracts. Over the past five years, the Company has been transitioning stores to our more cost effective and efficient operating terms under our collective agreement. This will result in lower future SG&A expenses of approximately CAD10 million in 2016. The Company is committed to complete these labor buy-downs in Q4 of 2015.

Before I turn the call over to Galen, I would like to add further color to our fourth quarter. In Q4, we expect increased headwinds associated with healthcare reform, incremental investments in key projects and the cycling of last year's strong synergy performance. We remain confident in our strategy, business performance and financial plan going forward.

Thank you. I will now turn the call over to Galen.

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Thanks, Richard, and good morning, everyone.

Loblaw continued to execute against its financial plan during the third quarter. We maintained a stable trading platform, synergies were in line with expectations, and we continued to make progress on efficiencies, and as Richard indicated, we've now reached the deleveraging target that we established following the acquisition of Shopper's Drug Mart. Our business remains focused on a strategic framework that has supported our progress over the past year, providing the best in food experience, best in health and beauty, operational excellence, and growth. In doing so, we continued to deliver on our purpose to help Canadians live life well.

In the quarter, same-store sales in our food retail business, as Richard said, were up 3.1%, traffic was flat, and we saw tonnage growth in line with the market. Our market division continues its successful rollout of our enhanced fresh food and service programs and the discount division benefited from continued strong momentum in its superstore banner. At Shopper's Drug Mart, front store same-store sales growth were up 6.2%, lead by food and beauty.

Pharmacy same-store sales of 3.5% benefited from strong growth in prescription count, partially offset by continued deflation. It's important to note that regulatory changes in Ontario and Quebec began to negatively impact our drug retail margins in the third quarter and we expect fourth-quarter results to reflect a full quarter of these changes.

We continue to gain momentum in our eCommerce platforms. Our Joe Fresh.ca site remains our fastest growing distribution channel for apparel. Click and Collect, an online service that lets customers shop for groceries anywhere, any time and pick them up at their convenience, has proven to be very popular. Our pilot has now expanded beyond the Toronto area and by year end it will be available in 40 stores. And our Shopper's Drug Mart beautyboutique.ca website now makes our prestige beauty offer available to Canadians anywhere they live. Insuring customers have broad access to our key product offerings online remains a key investment priority for the Company.

I must take a moment to say a few words about our new President's Choice World Elite MasterCard. From my perspective, this is the most exciting financial product we've ever introduced, a premium card where you earn 3% on groceries, 3% at Shopper's Drug Mart, CAD0.03 a liter on gas at all Esso stations across the country, 3% on travel through the President's Choice travel service, and 1% on everything else. But here is the really incredible thing about this premium card; you get all that and you pay no fee.

Our outlook for the fourth quarter remains challenging due to the accelerated impact of healthcare reform, as mentioned earlier. However, looking ahead, we'll continue to deliver against our plan and build our portfolio of strong, complimentary but independent businesses and create long-term value. As part of that journey, having achieved our debt reduction target ahead of schedule, we are now well positioned to pursue a more active capital return strategy for shareholders.

Thank you. I'll now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We'll take our first question of Peter Sklar of BMO Capital Markets.

Peter Sklar - *BMO Capital Markets - Analyst*

Thanks, good morning. In the outlook section of your write up, you talked about incremental investment projects having a negative impact. Galen, you mentioned that in your commentary. That's new language in the outlook section, so I'm just wondering what these projects are. Is this Click and Collect in your food pilot in the Shoppers stores or are these new programs?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Good morning, Peter. It's Richard. Yes, Click and Collect is one and so that's what we mean. But let me tell you the story for what we want to say in our outlook, okay? Clearly the key driving factor for Q4 is going to be incremental healthcare reform.

Actually, when you look at our Shoppers performance in Q3, and when we look at the Shoppers performance, we exclude synergies, okay? So it's a performance excluding synergies. The Shoppers performance in Q3 year over year is actually down, largely driven by healthcare reform. In Q4, the impact of the healthcare reform will be even more significant, so that is the key driving factor of our outlook for Q4.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay, and just switching topics, I'm just wondering if you could talk about the inflation outlook for your grocery business. As you get into 2016, you'll be lapping the significant depreciation of the Canadian dollar as well as the increase in protein prices, so I'm just wondering how you see inflation playing out in terms of proteins, fresh and center-of-store grocery.

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Two things have been happening, I think as you know, in 2015. We continue to have strong inflation in fresh, although it has been moderating over the course of the year. It's really the second year of strong fresh food inflation.

And then we've also started to see, as you point out, because of the US dollar, an increase in inflation in the grocery side of the store. It is reasonable to assume that in 2016, we're going to start to see an increasing contraction in that inflation benefit that's been affecting the industry.

Having said that, it's really, really hard to predict inflation, so we try and be conservative in our own planning. You'll probably want to be conservative in your own modeling, but we didn't expect quite the level of inflation that we have right now to sustain all the way through the year, so it's hard to say for sure what's going to happen in 2016.

Peter Sklar - *BMO Capital Markets - Analyst*

Okay, thank you.

Operator

Our next question will come from the line of Irene Nattel of RBC.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks and good morning, everyone. I was wondering if we could just talk a little bit about the pace of efficiency gains at Loblaw's on the food side. Would you categorize them in line with plan, a little behind plan? Because it seems we saw deceleration from Q2 to Q3.

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes. I'll start and then I'll pass it over to Richard. We feel good about the absolute performance of our efficiency project. We are delivering the numbers. Where we feel less good, and this has been the case in previous quarters as well, is seeing those numbers flow through into the actual SG&A leverage of the business. In Q3 there is an underlying improvement in SG&A that we're reasonably satisfied with, although we wish it would be a bit better, but there's quite a lot of noise in the numbers that are obscuring what's really going on.

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes, and Irene, the FX and the labor settlement cost, those were significant dollar amounts, so they over shadow that benefit on efficiency, so that's how we look at it. But we remain committed on extracting more and more efficiencies and our plan contemplates more of them going forward.

Irene Nattel - *RBC Capital Markets - Analyst*

Okay, that's very helpful. Just looking at coming back to the whole Shoppers question. Presumably, the headwind of healthcare reform that's going to hit Q4 will carry over into 2016, correct?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes, so let me just expand on that one. Essentially, the two factors affecting us really is the Quebec portion, which kicked in, in September but it was retroactive to April, so there was some dollars in Q3 that were booked in Q3 but effectively related to past periods, so that affected Q3. The Ontario one is just kicking in as Q4 gets going, so in Q4 we'll have full Quebec and full Ontario hitting us. That's why the dollar impact will be more significant in Q4 than it was in Q3. To answer your question fully, yes, the impact of that will continue in 2016 and that will leave part of our budget as we had some in our budget in 2015.

Irene Nattel - *RBC Capital Markets - Analyst*

Understood. And then just again looking at Shoppers in terms of the investments that you're making in the current year, which are further moderating the results, where are you with those investments? Do we get it pretty much behind us in 2015? How should we be thinking about the cadence as we move through Q4 and into next year?

Richard Dufresne - *Loblaw Companies Limited - CFO*

The two buckets of investments that we talked at the beginning of the year had to do with the (inaudible) Center. That's done, so the center is up and running and people are there so that's done.

The other one was associated with training with Delta. Delta has been deferred a bit so some of those funds were spent in 2015 but there will be some spill over in 2016.

Irene Nattel - *RBC Capital Markets - Analyst*

Okay, that's very helpful. Just one final question, if I may. In terms of your same-store sales at Loblaw's relative to the inflation rate, there was a gap of, let's call it, somewhere in excess of 70 basis points. I'm wondering if you could provide a little bit of color there?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes. I think the headline on this is that we're comfortable with our sales performance. We look very closely at market share. We look very closely at tonnage. We look very closely at traffic and all of those metrics have us performing inside that stable trading range, against which we measure our internal performance. So that's good.

I think the tricky part, and we've talked about this in a number of different quarters, is that we don't think that what we call the street maps, subtracting same-store sales growth from CPI, is a really effective way to determine the underlying performance or tonnage of the business. That -- one of the principal reasons for that is mix distortions that happen as people trade into either higher sizes on items or higher-price goods and we're seeing a pretty meaningful shift going on right now in some of those areas.

The long and the short of it is we feel pretty good about our sales performance. Could it be better? Yes, I think it can always be better. We have great performance in some markets, which we feel really good about, and others where it's a little bit softer.

What I feel most positive about is the business's ability to react when we start to drift outside of that comfort zone and we saw some of that in Q3 and we also saw the business react to come back into the zone. The long and short of it is, we feel fine.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you very much.

Operator

Your next question will come from the line of Perry Caicco of CIBC World Markets.

Perry Caicco - *CIBC World Markets - Analyst*

Yes, thanks. When we look at the sales performance in the quarter, both adjusted for inflation and not adjusted for inflation, what are the key mix shifts that are influencing those numbers?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes. Fresh obviously is a shift. We're investing significantly in things like HMR. We see dramatically higher growth in our health food departments, our natural value departments, and these are all basically the same item, trading at a higher price point, so it's not price-based inflation but it's actually mix shift based inflation.

Perry Caicco - *CIBC World Markets - Analyst*

Okay. Are you experiencing any changes in your Alberta business and do you think there will be any impact in Q4?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

We are seeing indications of an increasingly deteriorating economic environment. We see that specifically in the oil towns, where you've had shutting down of big projects and increased layoffs.

We also see some indications now of things beginning to turn through our financial services products. Nothing dramatic at this point, but it's starting to turn.

I think I mentioned last time that the good news of this for our business is that the vast majority of our sales is in an opening price point retail format, the leading format in that market and so we actually think that it may benefit us. Certainly performance in that province today is very good.

Perry Caicco - *CIBC World Markets - Analyst*

As we -- just turning to the SG&A side of the business, the incremental investments you're making on key projects, including eCommerce, I wonder if you could frame for us kind of the size of the investments and what your expected rate of return is on those types of investments?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, so I'll start. We're not going to give you the details on the size of the investment. Suffice to say, our objective is to make those investments and to deliver SG&A leverage that shows up in our P&L. I think the way to think about it is that the size of the efficiencies may not entirely fall to the bottom line because of these incremental investments.

One of the reasons that we're talking about it in Q3 is because after having run a successful pilot with Click and Collect, we are now starting to move into that next stage and to ramp up the program. It doesn't cost an enormous amount of capital to run Click and Collect, but as you build volume up to scale, you are actually taking on an expense cost, a P&L cost, that is fundamentally negative. And when we look at the return model, suffice to say we think that it is a cost of doing business in food retail today, but we also have a line of sight to what we think is a satisfactory return and a reasonable profitability.

Perry Caicco - *CIBC World Markets - Analyst*

Okay, thank you.

Operator

Your next question will come from the line of Michael Van Aelst of TD Securities.

Michael Van Aelst - *TD Securities - Analyst*

Thank you. Most of the questions have been touched on, but just some follow-ups on them. First of all, on the last one, on the Click and Collect, if some of your competitors were to get into home delivery in a bigger way, is that something you would follow or would you stick with Click and Collect and just keep pushing the laurels of that?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Well, I think it would be imprudent of me to say never to any options out there that -- in this world of eCommerce, but at this point, our conviction around Click and Collect is growing. The customer response and the nature of the way that consumers are looking for convenience in most of Canada suggests that this is a superior customer service proposition than home delivery. But there would be others with a different view and they can make their investment choices as they see fit.

Michael Van Aelst - *TD Securities - Analyst*

All right. On the return of capital to shareholders, is it simply about returning the free cash flow received -- generated going forward, or is there any thought of being able to increase debt again, even though you've just lowered it below your target?

Richard Dufresne - *Loblaw Companies Limited - CFO*

There's no plan to increase debt, clearly. Free cash flow, obviously, it's after our CapEx. So when I refer to excess free cash flow, I mean free cash flow minus dividends. Free cash flow minus dividends were used to paying down debt for the last little while and now free cash flow minus dividend will go to dividend increase and share buybacks.

Michael Van Aelst - *TD Securities - Analyst*

Okay, thank you. That's what I thought. On the loyalty programs, have you guys gone through the -- finished the process of considering how you may integrate those programs? Is there anything you can update us on there?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes. I'd say we have finished the process of determining what the path forward is, but we are not disclosing it at this point, Michael.

Michael Van Aelst - *TD Securities - Analyst*

Okay, thank you.

Operator

Your next question will come from the line of Chris Li of Bank of America.

Chris Li - *BofA Merrill Lynch - Analyst*

Hi, good morning. First I just have a follow-up question to the healthcare reform headwinds once again. Just want to be clear. The incremental headwinds you expect, are you referencing primarily to the dispensing fee reduction in Quebec as well as some of the fee reduction in Ontario?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes. Plus we had some stuff that was budgeted, so that is also there but yes, principally those are the two most important factors.

Chris Li - *BofA Merrill Lynch - Analyst*

With the removal of the professional allowance rate for generic gross in Quebec, would it be a positive or negative for shoppers?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, I think it's -- I was just looking at Richard. I think that it's a neutral, is the way to think about it. It sort of moves over time, but net-net it's a neutral, not something to be overly concerned about.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay, that's great. My other question is, I understand the Company has recently changed some of the pricing practices with the suppliers. I wonder to the extent you can, can you go through what were some of the major changes and what's being done to minimize the potential impact on the Company's margins?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, so this is part of a process that we have undertaken really since we acquired Shoppers Drug Mart, which is to simplify the ways that we do business across the board.

We want to reduce volatility, we want to improve visibility, we want to reduce the amount of complexity that we engage in when we're negotiating with vendors, both on annual contract and then on short-term sort of promotional support. This is really just a communication to the vendors that we are continuing on that path, that it is part of a more collaborative business building approach with them and I think they understand the approach.

I think they feel supportive of the approach and it's going to be hard work to get through some of this stuff, as you change the nature of contracts, the type of conversation that you have with the vendor community. But at this point, we don't see any -- in fact, we see upside just from a process efficiency point of view and we don't see any risk to margin as a result of this at all.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay, thank you very much.

Operator

Your next question will come from the line of Jim Durran of Barclays.

Jim Durran - *Barclays Capital - Analyst*

Just wanted to circle back on a few things. First of all, the Quebec rebate situation. Certainly the Quebec government has positioned rebates from generic manufactures as an opportunity for pharmacists to offset the negative impact of the changes they are making on dispensing fee revenue. Are you saying that you don't expect that even if the rebate ceilings were moved that it will have any positive effect on the hit that you're going to be taking from drug reform in Quebec?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, that's essentially what we're saying. Remember that the structure of the market in Quebec is different to what it is here in Ontario. Those pharmacists are entirely independent and benefits that accrue to them don't necessarily accrue to their wholesale sort of partner, which is essentially what we are. That's the way to think about it.

Jim Durran - *Barclays Capital - Analyst*

And on your Sanis business, is there any opportunity to renegotiate your cost agreements with your suppliers to reflect the change in the marketplace?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Well, so as far as our cost negotiations are concerned, as part of our synergy initiative when we brought Shoppers and Loblaw together, we have been very pleased with the results that work across the board. It includes the drug business.

Is there opportunity to move further as a result of the regulatory changes? I wouldn't say a whole lot, but we are very focused on mitigating the impact of incremental drug reform and when Richard mentioned that we budget visible drug reform, and then we go about looking for ways to offset it, that's what we do. That's our job and we've been reasonably effective at doing that.

It's the un-budgeted drug reform that comes unexpectedly in addition to what we are expecting that is harder for us to address in the moment that it lands and that is a meaningful part of what's happening in Q4.

Jim Durran - *Barclays Capital - Analyst*

Thanks for that. That is exactly where I was going to trend to, is that now that you do know directionally what the Ontario and Quebec changes are going to be, do you see an opportunity in 2016 to offset as we move into the year?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, we do. I mean, the way -- again, I think the way to think about these external impacts, the regulatory impact, the strategic investment impact, is that we want to be able to cover those and still deliver the right kind of performance. I think what we're flagging here is that there is a meaningful impact in Q4 as far as the direction of the results and it's a governor on our ability to drive earnings growth in subsequent years. It doesn't stop us from doing it but it governs the quantum that we're able to put forward.

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes, we have time now to plan it so that when we hit 2016 we can put in place plans to mitigate it and that's what we are working towards right now.

Jim Durran - *Barclays Capital - Analyst*

Got it. Okay, thank you.

Operator

Our next question will come from the line of Vishal Shreedhar of National Bank.

Vishal Shreedhar - *National Bank Financial - Analyst*

Hi, thanks for taking my questions. Just on the EBITDA results that you posted consolidated, the synergy numbers were stronger than expected but the EBITDA growth in dollars didn't fully reflect the synergy. I know you highlighted some puts and takes there. But I was just hoping I could get a little bit more of a discrete bridge on what the help was.

Obviously, we know the synergies, we know th sales growth, the Shoppers comp was really strong in the front store, but what were the offsetting factors? I would have thought the EBITDA growth would have been a bit stronger given your sales growth.

Richard Dufresne - *Loblaw Companies Limited - CFO*

Think of this. Obviously, FX and labor settlement costs like our one-time event that affected EBITDA. But let's go back to what I said earlier regarding Shoppers' performance. I'm assuming that most of you were probably assuming that Shoppers earnings would be positive year over year in Q3.

We told you that it was negative so just think about the strength between a negative number and a positive number. Add that to our EBITDA and we probably get in the zone of where the street was.

Vishal Shreedhar - *National Bank Financial - Analyst*

What was the FX and labor impact?

Richard Dufresne - *Loblaw Companies Limited - CFO*

We didn't say the number, but combined it was in double digits in terms of millions of dollars.

Vishal Shreedhar - *National Bank Financial - Analyst*

Is this FX and labor impact, is it going to be recurring for a couple quarters?

Richard Dufresne - *Loblaw Companies Limited - CFO*

No, labor won't because it was a one-time cost associated with the new labor agreement in the Loblaw stores that we signed this summer. FX, it's essentially revaluation of payables, which is a picture you take of your payables at the end of the quarter compared to last year and then you book the difference in your income statement. So if the Canadian dollar continues to deteriorate, you could see more of that but you won't see labor settlement costs going forward.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay, understood. With respect to 2016, there's a lot of moving parts and a lot of initiatives that Loblaw has been working on for several years that seem to be culminating in 2016 and it looks like many are favorable. I know it's early, but I was hoping you could give us broad brush strokes of what, in your view, is going to define 2016? You've already talked about capital return, which is nice, but are there any major other items we should be looking toward?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Well, to me 2016 is going to be more of the same. We will continue to push forward both of our retail businesses. Synergies continue to be a key contributor to our earnings, albeit at a lesser rate than what we've experienced in the first two years. And as you've said yourself, return of capital will be a new thing that you'll hear about us in 2016.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay. The efficiencies that you capture from SAP and just the headcount potential there, is that going to be offset by investment or should we think of that as additive?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, so I think you've got it right. As we move from this implementation of SAP, we're not going to announce that we've completed it right now, because we can't officially say that, but we're very, very close to completing all of the stores. We really are moving into that optimization stage. What is optimization? It means running the business more effectively on the new system and it means realizing the benefits.

I think you can take some comfort from the fact that benefits are now being budgeted into the divisional P&Ls in the food business and we expect that to be one of the meaningful drivers of growth in the business.

I go back to the principal point. Our objective is to grow the business from an earnings perspective and absolute terms, but we do have some of these investments that are going to moderate the extent to which we can drive that number forward. We'll talk more about 2016 in the Q4.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay, and just lastly I just want to make sure I understood this. With respect to Shoppers, understand Q4 is going to get hit with drug reform and that wasn't planned at the beginning of the year, but with respect to [26], Shoppers EBIT growth pre synergy, the point you're trying to communicate is that there are initiatives underway to offset drug reform in the Shoppers business. Is that a fair characterization?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes.

Vishal Shreedhar - *National Bank Financial - Analyst*

Okay, thanks. Appreciate it.

Operator

Your next question will come from the line of Keith Howlett of Desjardins Securities.

Keith Howlett - *Desjardins Securities - Analyst*

Yes, I was wondering if you determined your broad capital plan for 2016?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Good morning, Keith. Yes, we did. Like as was mentioned earlier in the year, for 2015, our retail CapEx is expected to be around CAD1.2 billion and for 2016, our retail CapEx should be about CAD1 billion, so that's the number.

Keith Howlett - *Desjardins Securities - Analyst*

And then in terms of the dividend policy, as you've been integrating Shoppers there have been a number of dividend increases. Will the Board choose one specific quarter going forward to make dividend adjustment decisions?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Yes, Keith. Actually, we plan to make these announcements when we have our AGM, essentially. Our dividend policy, as we've discussed, is that we plan to increase our dividend every year and our target is to get to a pay-out ratio of around 25% over the next few years.

Keith Howlett - *Desjardins Securities - Analyst*

I just wanted to ask about the drug reform. Is the retroactive element of the Quebec change fully absorbed in Q3 or does some of it get absorbed in Q4?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Its been fully absorbed in Q3.

Keith Howlett - *Desjardins Securities - Analyst*

And then just in terms of the Ontario drug reform, I know they said they wanted -- I think they wanted to save CAD200 million, but I wasn't sure, have they announced -- which specific measures affect your business?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Like I said, it's the ones that kicked in early October, so essentially all of it.

Keith Howlett - *Desjardins Securities - Analyst*

So you experienced none of it or very little of it, I guess?

Richard Dufresne - *Loblaw Companies Limited - CFO*

In Q3, yes. Exactly. Because our quarter finished on October 10 so we have 10 days of Ontario drug reform in Q3 and the balance is going to be all in Q4.

Keith Howlett - *Desjardins Securities - Analyst*

And then just finally on Alberta and western Canada. There have been a little -- there have been some signs that Loblaw wants to introduce conventional stores in western Canada, in British Columbia with the City Market and I understand perhaps in Calgary in the first part of 2016 and there have been a few Your Independent Grocers. I'm wondering on a big picture point of view, what the strategy of Loblaw is on the conventional business in western Canada?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

We're a multi-format retail business. We believe that we can compete more effectively in markets when we're able to deploy multiple formats and you saw us bring no frills to western Canada over the last six or seven years. Now you're beginning to see us bring the market division, the full service supermarket concept and you're seeing it come through exactly as you described. In some cases, it's our franchise model, which is YIG; in other cases, it's the Loblaw business in corporate stores although lead by the inspire concept.

So yes, we're going to do that. We're continuing to do it. What I would just remind you is that not -- only a small portion of that business is coming from net new real estate. The largest portion of both the no-frills entry into the market and the Your Independent Grocer entry into the market is the conversion of a banner that we've had there for many years called Extra Foods, which we're actually phasing out and replacing with two concepts that are more current to our strategy going forward. In both cases, we are really encouraged by the results in no frills and in YIG.

Keith Howlett - *Desjardins Securities - Analyst*

Thank you.

Operator

Your next question will come from the line of David Hartley of Credit Suisse.

David Hartley - *Credit Suisse - Analyst*

Yes, thanks. Just a little clarity around the SAP deployment. Exactly where are you in terms of the store conversions, et cetera?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, so we will be, for all intents and purposes, finished by the end of the year. I think the date, don't quote me on this, I think it's November 27 or something. We were hoping we might be able to declare it done as a part of this call, but we're not quite able to do that. We've been converting the stores, I think as we was mentioned to you, at the rate of 30 a week and it's going very well.

David Hartley - *Credit Suisse - Analyst*

Okay, great. Thanks. You talked about some of the challenges here -- well, not challenges but some of the investments in costs related to the investments. When do you see those investments cost tailing off and you start actually seeing more benefit from other initiatives such as the synergies and other initiatives around efficiencies start to show up meaningfully?

Is that midway through 2016 as you lap a full year of it? Could you give us some color on the cadence of how you see things starting to hit the bottom line a bit more?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

I think our objective is to deliver benefits in every quarter. I think Q4 is an example of certain circumstances we believe in part outside of our control plus some incremental noise that is creating fog on that front.

Don't be unduly put off by our conversations about the investments. I go back to the same principal point. We will see bottom-line increases in earnings with that incremental investment. That is our plan.

I'm just flagging with everybody that those investments, strategic investments and drug reform, they are meaningful impacts and so they will just moderate the extent to which we can deliver growth. That's the way to think about it.

David Hartley - *Credit Suisse - Analyst*

That's fair. Just last question, I think you called out margin initiatives at Shoppers during the quarter, but we saw really strong growth on the front store. Could you give us an idea of what those margin investments are and is that a function of mix with more food or are there other initiatives there that -- and maybe you can speak to what comprised that growth on the front store?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, so the exclusive negative impact on margin in the Shoppers business is drug reform.

David Hartley - *Credit Suisse - Analyst*

Right.

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

What's driving the growth, really two -- it's sort of across the board, to be fair, in our front-of-store business at Shoppers but the two stand outs are food and beauty. Beauty, I think, is benefiting from the close of Target and also we think we run a very good proposition around beauty in Shoppers Drug Mart.

Food is a function of converting the assortment as part of the bringing together of the knowledge around food between Shoppers and Loblaw and the overwhelming factor is the addition of our corporate label programs, No Name and President's Choice, to the full line up in those stores in the dry grocery department. This is not being driven at this point by our fresh pilot. It's being driven by the core assortments in those convenience aisles in the stores.

We made the conversions at the beginning of the year, but it has taken us through to the third quarter to get the product in stock, to be able to understand the volume that the customer is interested in, in these stores -- or in these products, and so it's now running the way we expected it to run and it's delivering very, very strong results.

David Hartley - *Credit Suisse - Analyst*

And just as a final follow-up on that, when do you think you've optimized those conversions? Perhaps you have now. When have you optimized it in terms of the offering in each and every store from that perspective, fresh aside?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

Yes, so I'd say we're pretty much there now. You're never done. You're always evolving, tweaking, trying to improve but the substantial body of the work is complete across the country and the results are indicating that, that work's been good.

David Hartley - *Credit Suisse - Analyst*

Great, thank you.

Operator

We now have a follow-up question from Chris Li of Bank of America.

Chris Li - *BofA Merrill Lynch - Analyst*

Oh, thank you. Just a point of clarification. In the press release, it says that drug pharmacy gross margin was negatively impacted by health care reforms and the increase in usage of generic molecules. I get the part about healthcare reforms, but it's the second part about the increase in the usage of generic molecules. Does that mean the average profitability of generic molecules is less than branded, so that's why it's also having a negative impact on margins?

Richard Dufresne - *Loblaw Companies Limited - CFO*

The generic -- I don't know the word, more use of generic essentially affect both revenue and margins, so that's the impact.

Chris Li - *BofA Merrill Lynch - Analyst*

So you mean on the revenue is also being deflationary?

Richard Dufresne - *Loblaw Companies Limited - CFO*

Exactly, because penetration of generics is going up.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay. My follow-up is just on Wal-Mart. As you know, they are trialing with 7/11 in a few locations in the GTA for stock pick up. I was wondering, longer term how does the Shoppers network fit in with the overall Click and Collect strategy over the longer term?

Galen Weston - *Loblaw Companies Limited - Executive Chairman & President*

We're starting with pick ups from our existing full service supermarkets, but I think it's fair to say those points of convenience at Shoppers Drug Mart network represent a meaningful opportunity for us if it works.

Chris Li - *BofA Merrill Lynch - Analyst*

Okay, thank you.

Operator

We have no further questions at this time. I would now like to hand the call back over to Sophia Bisoukis for closing remarks.

Sophia Bisoukis - *Loblaw Companies Limited - IR*

Great, thank you, and thanks to everyone for joining us today. If you have any further questions, you can contact our Investor Relations team. Have a good day.

Operator

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