

Empire Company Limited

Empire Third Quarter 2023 Conference Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Empire Third Quarter 2023 Conference Call. At this time, all lines are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. If at any time during the conference you require immediate assistance, please press *, 0 for the Operator. This call is being recorded on Thursday, March 16, 2023. I would now like to turn the conference over to Katie Brine, VP of Investor Relations. Please go ahead.

Katie Brine

Thank you, Joanna. Good afternoon, and thank you, all for joining us for our third quarter conference call.

Today, we will provide summary comments on our results and then open the call for questions. This call is being recorded, and the audio recording will be available on the Company's website at empireco.ca. There is a short summary document outlining the points of our quarter available on our website.

Joining me on the call this afternoon are: Michael Medline, President and Chief Executive Officer; Matt Reindel, Chief Financial Officer; Pierre St-Laurent, Chief Operating Officer; and Doug Nathanson, Chief Development Officer and General Counsel.

Today's discussion will include forward-looking statements. We caution that such statements are based on Management's assumptions and beliefs and are subject to uncertainties and other factors that could cause actual results to differ materially. I refer you to our news release and MD&A for more information on these assumptions and factors.

I will now turn the call over to Michael Medline.

Michael Medline

Thanks, Katie. Good afternoon, everyone. I'm going to start by acknowledging that this was not a straightforward quarter due to both the high inflationary pressures we continue to face, as well as our efforts to recover and move on from the cybersecurity event in November, which had significant impacts across our business this quarter, as expected.

As high inflation persists, we are seeing how strong we've become as we are still putting up solid numbers and sustaining the fundamentals of our business effectively, but we are looking forward to high inflation abating. Inflation is bad for Canadians and for Empire Company. When it abates, we will see positive momentum and be well positioned to deliver stronger performance. Empire Company is best positioned to prosper in the non-high inflationary environment.

Today, I'm going to focus on three topics; key market trends on our Q3 results, a brief update on our cybersecurity event, and an update on some of our Horizon initiatives, specifically Voilà and Scene+.

As I've said over and over for a long time, the continued high level of inflation is challenging for Canadians and for our business. This quarter, we saw food inflation remain stubbornly high, and we saw customers continue to adapt their shopping behaviours due to this inflationary environment, with many people shopping multiple stores, trading down on products, buying more on promotion, and filling smaller baskets.

Our team remains highly focused on providing value to customers during this time. Over the next few weeks and months, we will continue to accelerate on this front with the planning of several additional initiatives to emphasize and expand our value proposition to our customers.

We received hundreds of new supplier cost increase requests this quarter at a comparable size and volume as we experienced in the fall of 2022. We expect inflation to remain high for a few months.

We don't have a crystal ball, however, as we look forward, we believe that supplier partner requests for cost increases have peaked, and we will also soon be cycling high inflation numbers from last year. We are hopeful that food inflation will soon peak, then abate, then end, which will be very good news.

Our Own Brands portfolio continues to provide significant value to customers and grew faster than the market for both the quarter and the fiscal year. We are focused on leveraging our Own Brands portfolio across all of our banners to provide value to customers. This month, we began the rollout of 230 non-food Own Brands products at Longo's stores.

Our discount business showed excellent performance again this quarter with double-digit same-store sales growth and outpaced share growth versus peers. Last month, we achieved our Project Horizon goal to open 31 new FreshCo stores by the end of Fiscal '23. As of today, we have a total of 44 FreshCo stores operating in Western Canada.

We are very pleased with the momentum and growth trajectory of this banner. Taking FreshCo to Western Canada was a key decision we made in 2017 to turn around what was then a struggling region for us. I'm sure glad we made that call. We also continue to see benefits from implementing our Scene+ loyalty program at FreshCo, which exceeded all of our targets in Q3.

Overall, our sales this quarter increased by 1.5 percent with same-store sales of 0.1 percent. In addition to the impacts of high inflation, our results were affected by lapping strong sales due to Omicron last year, as well as the impacts of the cybersecurity event across our business.

Our gross margin, excluding fuel, was essentially flat with last year, but our margin was also adversely impacted by the cybersecurity event. We're very pleased with how we continue to improve the fundamentals of this business. This is a result of continuing to effectively execute our strategy with additional benefits from Horizon initiatives.

We delivered an adjusted EPS of \$0.64 this quarter. Management estimates that there is an additional impact of at least \$0.06 related to the cybersecurity event, which caused a temporary decline in sales and short-term disruptions to operational effectiveness. Consistent with regulatory guidance, we cannot include the sales in our adjustments, and Matt will share some more details on this shortly.

Moving to an update on the cybersecurity event, I will start by saying that these cyber attacks are a nasty piece of business. I wouldn't wish them on my worst enemy. Throughout this event, our priority was to do the right thing for our customers, our employees and our business. However, this event had several one-time impacts on our Q3 performance and results. I am pleased to say that we're over it now and have fully returned to business as usual in Q4.

Now for an update on our Horizon initiatives starting with Voilà. Our comps declined 14.7 percent year-over-year, but this is not a particularly meaningful metric this quarter, as Voilà experienced significant growth last year as a result of the Omicron outbreak, particularly in Central Canada.

If you look at Voilà's performance against Q2, which we believe is a more accurate measure this quarter, we continue to see strong sales momentum growing by 9.4 percent over the second quarter. Both CFCs had positive double-digit growth and Voilà continued to outperform against the market.

Looking ahead to Q4, we anticipate the Omicron impacts from last year to be much less significant and expect to see a return to positive year-over-year same-store sales.

Today, we are also pleased to announce that we will integrate Grocery Gateway into Voilà starting in July. We said from the start that at the appropriate time, we could drive efficiencies by integrating Grocery Gateway into Voilà. In addition to these efficiencies, Grocery Gateway and Voilà customers will both benefit by gaining access to each other's assortment. Both businesses are now at the right place to begin this integration.

Similar to the IGA.net transition, Grocery Gateway to customers will transition to Voilà over a six-week period, offering Longo's as a significant shop-in-shop on the Voilà platform. We also remain on track for CFC3 to open in Calgary in the first quarter of fiscal '24 and are excited to be bringing our world-class e-commerce grocery business to the Alberta market to serve our customers.

On to Scene+. We continue to be very pleased with the evolution of our new Scene+ loyalty program. This quarter, we exceeded our targets on several key metrics, including new member sign-ups, active members, and overall program awareness. Next week, we will be launching Scene+ in Quebec and in our Thrifty Foods banner in British Columbia, which is the fourth and final regional launch. We have been working closely with our Quebec franchisees and Thrifty store managers to prepare, leveraging the learnings from our past rollouts.

Now, before I hand it over to Matt, I want to have a shoutout, a congratulations to Mark Holly, our former SVP Real Estate on his new position as Crombie REIT's new President and CEO. While it's always difficult to see such a strong leader leave our fold, we could not be happier that he will be leading a company with such strong ties and strategic importance to our business.

With that, over to Matt.

Matt Reindel

Thank you, Michael. Good afternoon, everyone. I'll provide some additional colour on our results, an update on Horizon, and then we'll move on to your questions.

Let me spend some time to break down our results, as the impact of the cybersecurity events, combined with what we can and cannot include in our adjusted EPS metrics, plus what we have in our results last year, makes our quarterly results harder to follow than normal.

Our reported earnings per share were \$0.49. When you compare that to the \$0.77 we delivered last year, there are three reconciling items that need to be considered. Firstly, for the cybersecurity event, there is a significant timing difference in Q3 between the direct costs we have incurred and the minimal amount of insurance recoveries that we have received. The negative impact of these direct costs net of insurance recoveries was \$0.15 and is reflected in our adjusted EPS metric of \$0.64.

Secondly, consistent with regulatory guidance, we cannot include in our adjusted EPS metric, the impact from the temporary decline in sales and the impact of temporary disruptions to operational effectiveness, such as the loss of planning, promotion, and fresh item management tools. We estimate that the negative impact from this was at least \$0.06.

Thirdly, our prior year earnings per share included \$0.14 of unusually high income from investments and other operations, including large lease termination income and property gains from Crombie. When you do the math from these three reconciling items, you can see why we are pleased with our Q3 performance even in the face of this harsh inflationary environment.

Now let me provide some additional colour on the impact of the cybersecurity event.

In Q2, we estimated that the total impact on fiscal '23 net earnings would be \$25 million dollars. This was our gross cost less anticipated insurance recoveries. We also mentioned that there may be some timing differences between when we can recognize the costs and when we can recognize the insurance recoveries.

Since Q2, we have a more complete understanding of the impact of the cyber event and the process to make insurance plans. Our estimate for Q2 was close, but we've increased the amount by \$7 million to reflect some additional direct costs and a little more shrink than we had initially estimated. We now expect that the total impact on net earnings will be approximately \$32 million, which will be reflected across both fiscal '23 and fiscal '24.

The vast majority of the cost will be incurred in fiscal '23, but we now believe that our insurance claims make it longer to process, and these recoveries will occur in both fiscal '23 and fiscal '24. It's important to repeat that we only had minimal insurance recoveries in Q3.

To provide our stakeholders with more meaningful and comparable financial reporting, we've decided to provide adjusted financial reports and metrics, which remove most of the noise from the one-time impacts of the cybersecurity event. I say most, because as I mentioned earlier, these metrics do not adjust for the estimated impact of the temporary decline in sales and the temporary disruption to operational effectiveness. We will continue to update you on the financial impacts of the cybersecurity event in future quarters.

Now, let me move on to our results.

From a sales growth perspective, it was a challenging quarter. While the cyber event had a temporary negative impact on our same-store sales, our sales growth was also impacted by the stubbornly high level of inflation and the associated change in consumer purchasing behaviour towards value and discount. Plus, the fact that we were lapping elevated Omicron sales last year.

Having said that, now five weeks into Q4, we are seeing sales momentum pick back up and expect stronger sales growth in our last quarter of fiscal '23. It's important to note that we are not changing our strategy during this period of inflation. Our business fundamentals are strong, and we will be well positioned to deliver stronger results when inflation starts to abate.

Moving on to gross margin. Our margin, excluding fuel, is flat to last year, but as Michael mentioned, our margin rate was negatively impacted by the cybersecurity event mainly due to elevated shrink in our fresh departments. Our underlying margin rate continues to benefit from Project Horizon initiatives and the solid execution of our strategy.

Shifting gears to SG&A. Our SG&A in Q3 was \$80 million dollars and 75 basis points higher than last year. As I explained last quarter, the vast majority of the increase in SG&A is related to planned investments in current Project Horizon initiatives and future key initiatives. While these initiatives require upfront SG&A investments, we've proven that these types of investments provide great returns to our shareholders. However, bear in mind, in Q3, a large part of the increase in dollars was nonrecurring, and due to the cybersecurity events, including direct costs, such as professional services for IT and legal.

Our balance sheet remains strong. Our funded debt to Adjusted EBITDA ratio remains at 3.1x, which is in line with Q2. This provides ample liquidity for our capital allocation strategy. We have invested \$554 million in capital so far in fiscal '23. This quarter, we renovated 12 stores, opened our 46th Farm Boy and opened our 43rd FreshCo store in the West. Subsequent to the quarter, we opened our 47th Farm Boy, and with today's announcement, we have now confirmed 50 Farm Boy locations in Ontario.

With regard to our share buybacks, as of this week, we have repurchased approximately 7.4 million shares in Fiscal '23 for a total consideration of \$276 million. We remain on pace to reach our target of buying back \$350 million in shares in our Fiscal '23.

Finally, I wanted to give you an update on Horizon. We remain on track to achieve Horizon's target of delivering a \$500 million increase in annualized EBITDA by the end of fiscal '23. When we first announced Horizon, this translated to a 15 percent earnings per share CAGR and 100 basis points increase of EBITDA margin.

Based on our latest forecast, we are now projecting that this will translate into a 13 percent EPS CAGR and a 50-basis point increase in margin. The difference is largely due to COVID and the cybersecurity event, which slightly delayed some of our key initiatives, including Scene+, personalization, and space productivity. Also, our depreciation expense is higher than we initially modeled as we were able to more quickly execute some of our more capital-intensive projects over the period. Finally, the cost of fuel is higher than we had initially modeled.

All this being said, despite having to navigate through a pandemic, high inflation, and a cybersecurity event, we are thrilled that we are on track to achieve the initial Horizon objective of \$500 million of annualized EBITDA by the end of Fiscal '23.

I'm going to wrap up. It's great to see the business operating as usual again after the cybersecurity event and also to see that we have regained sales momentum in the early weeks of Q4.

With that, Katie, I'll hand the call back to you for questions.

Katie Brine

Thank you, Matt. Joanna, you may open the line for questions at this time.

Q & A

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. If you would like to ask a question, please press *, followed by the number 1 on your telephone keypad. If your question has been answered and you would like to withdraw from the queue, please press *, followed by the number 2.

First question comes from Mark Petrie at CIBC. Please go ahead.

Mark Petrie — Analyst, CIBC

Yes. Good afternoon. Thanks for the comments about the sales momentum into Q4. I also wanted to ask about gross margin trajectory. Specifically, you have been putting up some pretty healthy gross margin expansion over the last number of quarters, I think, driven in large part by higher private label penetration as well as merchandising efforts and promo effectiveness. Just curious what the trajectory of that is in Q4 so far? How you're thinking about the runway of those efforts paying off.

Matt Reindel

Yes. Thanks, Mark. Good question. Yes, we are particularly proud of our track record consistently quarter-over-quarter of being able to improve our gross margins, and that continued in Q3. I know it was masked by the cybersecurity event, which basically ended up with us having a flat margin. But if you exclude the event, we did grow our margin. As we go into Q4, we expect that trend to continue.

The impact on gross margin that happened during the event is behind us. Our planning and promotional tools are back up and running and firing on all cylinders. We expect that we will continue to increase our margin. Again, just to reiterate, our growth in margin is based on our Horizon initiatives and not because of inflation.

Mark Petrie

Yes. Understood. Okay. I also wanted to ask about the impact of combining the Grocery Gateway infrastructure into Voilà. Can you give us a sense of what costs that will add to the existing Voilà infrastructure? When will the Grocery Gateway warehouse actually close?

Matt Reindel

Yes. Okay. On the cost side, basically, what will happen is starting in July when that consumer transition happens, and Grocery Gateway customers will start ordering through Voilà. The biggest change in cost is some of the drivers and some of the logistics people will move from Grocery Gateway into Voilà, because that additional volume requires that additional variable labour piece.

Where we benefit is from the synergy on the fixed cost side. We will have all of the Longo's assortment into the Voilà hive and will benefit from the highly efficient operation of that function and then, of course, benefit from the white-glove service. We benefit from the efficiencies through the back office. There will be some variable pieces of labour that move over to Voilà. I think that's it.

Then your second question was about the existing warehouse. We're looking at the existing Grocery Gateway warehouse. What they also have in that facility is their commissary. That commissary will continue to operate as a key part of the assortment at Grocery Gateway. The commissary will continue to operate. Those products will be sent over to the Voilà building so that we continue to operate and give those commissary products. Over time, we will look at the rest of that facility, but it's part of our commissary strategy moving forward.

Mark Petrie

Okay, thanks. One more, if I could. On the topic of cybersecurity, obviously, there's only so much you can do to reasonably protect yourself. What do you do differently after this incident? What are the cost implications for the business, if any?

Michael Medline

Yes. Hi, it's Michael. Hi Mark. How are you? I hope we're not pulling you off March break or something today. For obvious reasons, I'm not going to give you details of what we do on cybersecurity at our Company. I think everybody out there is at risk and is strengthening everything they're doing. We did have a robust cybersecurity system in place that obviously was breached on November 4 and the days prior.

We have made significant changes to all elements of our cybersecurity. We will bring forward, from plans that we had over the next few years, we'll spend a little bit more which will really improve our cybersecurity in the short and medium term. It's really just accelerating our plan, but I don't think it will have any sort of material difference in terms of our CAPEX going forward.

Mark Petrie

Okay. Appreciate all the comments guys. All the best.

Michael Medline

Thank you.

Operator

Thank you. Next question comes from Kenric Tyghe at ATB Capital Markets. Please go ahead.

Kenric Tyghe — Analyst, ATB Capital Markets

Good afternoon. Michael, I appreciate the colour, the commentary with respect to the improved momentum in this quarter. I wonder if you could help us better understand, perhaps, even sort of month-by-month through the last quarter, the extent of the change in consumer behaviour, I mean we've all been expecting a trade down, but this was definitely a sharper trade down and a more pronounced impact on your results than a lot of us might have expected. Can you just speak to what changed, where, and why in the quarter and quite how severely it changed through the course of the quarter? Was this progressive with each passing month and credit card bills coming in from Christmas? Or was this just that you saw it sort of step off as we headed into the quarter and it just never came back?

Michael Medline

I'd say that there are so many factors coming to bear that it's hard to isolate on one thing. It's hard to believe, but Omicron was pretty wicked last year in P9. That has an effect as well as the cybersecurity as well. I would say that starting in about P7 when we really saw—inflation has been bad for a long time, but there were some real sticker shock with some of the grocery pricing starting in P7. We saw an impact, but that's not really what threw us off the momentum we had. It was more of the cybersecurity and the Omicron.

I'm very transparent with you. Our business does better, not surprisingly, it turns out, in times of much lower inflation. We share with all Canadians, first of all, that we want inflation to come down, but our business will do much better as the inflation abates later this spring and into the summer.

I'd say that also, there's timing in seasons too, is that January is normally, as you point out, a lower sales month for grocery as people are coming off the Christmas season, and especially in times of inflation for a full-service grocer.

All these things came into play, and as you remember, we had a quarter before this, we were running at 3.1 comp overall. We ran a 0.1 here. It's early in this quarter, only five weeks in, but we're seeing more normality with what we're facing. We'll do better than anyone would have expected given the circumstances, but we need inflation to cool down.

Kenric Tyghe

Thank you, Michael. One more for me, a follow-up on the e-commerce—the Grocery Gateway integration to Voilà. How much of this was always part of the plan versus perhaps in response to market dynamics? Just wanted to better understand the timing on that shift, given where we are in terms of the market and the state of the consumer?

Michael Medline

Yes, it's Michael again. Thanks for the question. It had nothing to do with the market dynamics. When we made the partnership, we weren't sure what the timing would be, but we always knew that with Voilà's incredible infrastructure that at the right time, if Longo's wanted it, then we would then partner and bring these two great e-commerce solutions together to serve the customer.

The reason I say it didn't have anything to do with the market is you don't suddenly make these decisions and be able to plan them out and get the assortment ready and make all the IT changes in a few months. This is being worked on for—I don't know how many months, a long time. It wasn't the current market economics that had us do it. Same time, I'm darn glad that we're doing it now given the current market economics.

Kenric Tyghe

Thanks, Michael. I'll get back in queue.

Michael Medline

Thank you.

Operator

Thank you. Next question comes from George Doumet of Scotiabank. Please go ahead.

George Doumet — Analyst, Scotiabank

Yes, good afternoon. Michael, last quarter you give us some qualitative information on the conventional stores, and you mentioned transactions and same-store sales. Can you perhaps give us a little bit of colour there? On to Matt's point about kind of the five weeks into Q4, the pickup in comps. Is that just kind of noise around, I guess, anniversary-ing Omicron? Or is there maybe anything else in that pickup?

Michael Medline

I'm going to toss it over to Pierre to begin because I think he'll have the best answer for you, actually.

Pierre St-Laurent

Okay. Into the quarter, as we said, the cyber event had an impact on our same-store sales across the board for all banners, including discount and full-service. January, it was mostly impacted by Omicron, elevated sales last year. Right now, we're back, like Matt said, on the same trend or even better than we were before the cyber event.

Right now, the thing we're seeing is our transaction count remains extremely healthy in our full-service banners. People are not leaving our banners. They are trading down. They're shopping more stores. Where they're trading more down is mostly in fresh, and we are highly developed in fresh.

It's just a matter of time that a customer will increase their basket size, when they will have less pressure on their budget, but we feel very confident that customers will continue to come into our stores. As I said, transaction count in full-service banner is very healthy. And when we measure our performance versus peers, I mean, discount to discount, full-service to full-service, we're extremely pleased with the performance on both sides.

George Doumet

Okay. Thanks a lot. Maybe just looking at a couple of weeks of the quarter. Should we expect any direct or indirect kind of impact from the cyber-attack in these early weeks? Anything you could help us with in terms of understanding the impact there?

Matt Reindel

Yes. Just to clarify, in terms of are we expecting any more impact from the cyber-attack, no it's behind us. The impact on financials, though, yes. We will continue to incur some direct costs in Q4, nowhere near to the extent that we had in Q3, just a small amount. We may get insurance recoveries in Q4 or we may get them in Q1 of next year. There's a little bit of a moving picture, but I think the key message is that the vast majority of the costs are behind us.

George Doumet

Okay. One last one, if I may, on this 13 percent EPS CAGR for Horizon. I guess looking above and beyond this year, and the next couple of years, do you have enough initiatives and momentum to sustain that level of growth?

Matt Reindel

The simple answer is we have a new three-year strategic plan. I think as we said before, we're not talking to the market externally about it, but we have one internally. Again, the rationale for that is that for the past six years, we've been executing a turnaround. Now that turnaround is complete. Now we are competing effectively.

We have that plan internally. It has a series of key initiatives put against it. We're excited to bring those to the market and bring those to fruition. Yes, whilst we're not giving a number yet, we're very excited about the progression of the business over the next three years.

George Doumet

Great. Thanks for the answers.

Operator

Thank you. Next question comes from Irene Nattel at RBC Capital Markets. Please go ahead.

Irene Nattel — Analyst, RBC

Thanks, and good afternoon, everyone. Just following up on the discussion around trading down. Pierre said that seeing trading down in fresh. Are you seeing trading down to lower-priced options and into frozen? Or are you seeing trading down as in volume going down and going into discount banners?

Pierre St-Laurent

There're many types of trading down that we are seeing. National brands to private label, which is obvious, more and more. Because we're growing faster than the market,, we're a bit more impacted.. Trading down, is not good for same-store sales. It's good for customers and it's good for us but we are doing extremely well in Own Brands right now, and that's one of the trade downs.

Yes, we can also see that a move from fresh to frozen fruit or fresh to canned meat are some of the types of trading down. Obviously, people are looking for deals and pressure on promotion is there. There are various trading down behaviours we're seeing in the market. Every single customer has choices to make, and it's a personal choice, but we have all those options available for our customers. We're trying to show that value to customers every day.

We have many initiatives, I think Michael said in his opening remarks, that the team is focusing right now. And a couple of months since we recovered from the cyber event, the team is building those initiatives to demonstrate the value we have in our stores for customers. We're seeing, as I said, very positive trends right now with those initiatives.

Irene Nattel

That's very helpful. Thank you. When we think about your private label penetration, how would you describe it relative to pre-pandemic/the renewed emphasis on private label? You also mentioned — I forget the exact number of new private label product introductions. Can you give us an idea of what sort of categories you're targeting?

Pierre St-Laurent

As I said, I think a year ago, in Horizon, we had an initiative to rebuild every single category in Own Brands. We have four different ways of rebuilding, which are now complete. Most of it is on shelf right now, which is good, but we're not totally finished because we have to put the new products we developed in the last wave, onto our shelves. Most of it is on the shelf now, and we rebuilt every single category.

In some cases, we have more assortments. In some other cases, we have less assortments. We revisit their formulas, we revisit the packaging. You can see more and more value-sized products in our assortment. I cannot speak specifically on every single category, you can spend a full day to speak about it, but it's across the board. It's in every single category, mostly in grocery for sure, because it's where the value is. But, we also have those Own Brands product also in fresh, frozen, dairy, and every single category.

Irene Nattel

That's great. Thank you. Final question, please. Just thinking about the evolution of the FreshCo presence in Western Canada. Can you talk about the evolution of the different store cohorts as you've gone through the different waves? How they're maturing, whether there's sort of been any changes that you've made and how you would describe the existing network in terms of how long it's taking to get to maturity?

Michael Medline

Hi, it's Michael. I'd say that when you open a new store with a new brand in a new market, people don't just suddenly pop out of their old store and come to your store, no matter what you do and how good it is. I think what we see is that the first year is good. After that, it just accelerates. That's in every market we saw. We went to BC, if you remember first. The first year was good and we said it was good. Then it really kind of rocketed after that as customers saw our offer —one of the reasons we went to Western Canada, was because there was a hole in the market for discounts like that in that kind of box. As soon as they started trialing it and they could get multicultural items they didn't have before, they gravitated toward us, and then we started seeing that explode.

We went to each market in a different order, in different cities and different order, and they all followed that pattern. It gives us a really great—and very consistent among the stores. It gives us great confidence when we open up stores. Pierre, do you have anything you want to add?

Pierre St-Laurent

No. We have great franchisees also that are really close to their community, and we are seeing adjustments in their assortment to be relevant for their community. We're really pleased with their engagement to make sure that we have the right assortment for their needs. Just be pleased with that.

Michael Medline

Katie is showing me a note here, Irene, that I forgot to mention, that there's minimal cannibalization. If you remember way back when we announced this in—I think it was late 2017, whenever it was, we got a lot of questions from shareholders and analysts about what it will do to cannibalizing.

We have gone through an unbelievable amount of work to say this is the right market to convert a Safeway to a FreshCo. We've experienced less cannibalization than we had thought we would at the beginning, and it's incredibly minimal. It was additive and there wasn't a lot of taking away sales from existing stores.

Irene Nattel

That's great. Thank you.

Michael Medline

Thanks.

Operator

Thank you. Next question comes from Chris Li at Desjardins. Please go ahead.

Chris Li — Analyst, Desjardins

Hi, good afternoon, everyone. Just following on something you said earlier. You mentioned transaction trends remain healthy and that customers are not leaving the stores but just trading down on certain categories. Just wondering, is that what gives you the confidence that as inflation normalizes, customers will shift back? Even as inflation normalizes, it's still going to be quite a bit higher than what it was a year ago. I'm just trying to understand how easy it would be for you to win them back once inflation normalizes.

Michael Medline

The answer is yes. That is a great indicator of our confidence and a bunch of other things, too, that we look at, including customer studies, and brand studies, and we have a lot of data that we take a look at. There's always, I can't say 100 percent of everything acts the same way, but it's pretty obvious to us as the prices go down that we benefit disproportionately, just like we were impacted disproportionately when prices went up. There's a good study by the RBC economist this week that people only have this much money to spend.

A lot of customers, they're not shopping around even more, some of them are, they just have only so much money they can spend. When they can spend it on more goods or they have more—or other input costs like high inflation rates or high petroleum rates or costs, people only have so much money, and that makes some difference as well.

I can tell you that every single day, we watch to see what's going on in terms of cost increases and price increases and inflation. We're very pleased to say that we're seeing really hopeful signs. Like I said, I'd like to see a higher Canadian dollar. That will even help us more on the fresh side. But especially on the grocery side, we're going to be seeing inflation come down in our estimation.

Chris Li

Okay. That's helpful, Michael. Maybe just related to that, obviously, there was a big gap in same-store sales between yourself and your peers and for good reasons, as you mentioned earlier. As inflation kind of takes shape the way that you envision in the back half of the year, as things start to normalize, is there a reason to believe that your same-store sales growth should not be similar to your peers?

Michael Medline

Well, it's always hard to say how fast and how slow things happen, but there's no reason to believe it shouldn't be higher at some point, too. We're a way better company than we were. We were doing great before the pandemic and inflation, and we're better today. As things stabilize, we'll give them a good run for the money.

Chris Li

Okay. Great. In terms of Grocery Gateway. I'm just wondering if you can share with us the size of the business. Is it comparable to Voilà? What I'm trying to understand is if the volumes are significant enough to really move the needle on getting Voilà to EBITDA breakeven quicker?

Matt Reindel

Will it help accelerate our path to getting CFC1 to breakeven quicker? Yes, absolutely. We've said all along that's the key driver of getting to profitability is sales volume. If you visit the CFC just so you get the feeling just how efficient a building like that is. It is all top line sales driven. Yes, it will help us get to breakeven profitability quicker.

We've not disclosed what the amount of the sales is currently for Grocery Gateway, but it's smaller than Voilà let's put it that way. It's still a significant chunk of business. So we're very, very happy to be combining those two businesses. It will help our CFC for sure.

Michael Medline

Yes. I mean, Gateway has been around 20, 25 years, whatever it's been. It has a good book of business, but Voilà rocked it by quite some time ago —and that doesn't mean Grocery Gateway is not good, but Voilà is bigger. I think that as Anthony Longo and his team got to know Voilà and how we do business and the leadership of Sarah Joyce, he felt more and more comfortable entrusting their business and customers to Voilà, and that their customers are going to get even better treatment.

Chris Li

Okay. Thank you, and all the best.

Michael Medline

Thank you, so much.

Operator

Thank you. Next question comes from Vishal Shreedhar at National Bank. Please go ahead.

Vishal Shreedhar — Analyst, National Bank

Hi. Thanks for taking my questions. I'm interested in knowing a little bit more about how you see the next years unfolding with respect to items directly in your control. As you look at your plans and initiatives in the years ahead, maybe you can give us a sense of what the big drivers of growth will be over the next several years? Is it promo effectiveness? How much legs does that have? Space effectiveness or new store growth or Voilà levers? How should we think about it?

Michael Medline

Yes, there's so many. Let me give you a few. I think Scene+, which is just in its infancy and it's just about to go into Quebec, which is one of our strongest, if not our strongest market, is going to have a huge impact over the next few years. Not only because the customers really like it, but because of what we can do from a personalization and data standpoint.

Space productivity initiative, which we don't talk a lot about is, to me, one of our most exciting things, and as some people like me used to call it, category reset part two, but I'm not allowed to call it that, I've got to call it Space Pro.

You're going to see Voilà continue to take off. We are cognizant that we have to be as efficient as we can be, and we'll continue to—as we spoke last quarter, that we take our efficiency and our costs very, very seriously, and we'll see more on that. What else you want to add, Matt?

Matt Reindel

I'll just add the work that we've been doing on our stores, does not end at the end of Horizon. We've had fantastic returns from that renovation and new store program over Horizon, and that will continue. That's a renovation program that will continue into '24 to '26 and we'll continue to add stores.

Michael Medline

Pierre doesn't let us talk much about the sales driving initiatives as well, I'll stay quieter on that. Obviously, as we become a more mature company and we're past the turnaround phase, we have a lot of initiatives to be able to drive sales coming up and real estate is just one part of it.

Vishal Shreedhar

Okay. Thank you for that colour. Management said on the call that FreshCo was gaining shares versus peers, if I heard that correctly. Just given the backdrop and the uncertainty, wondering if there's any plans to further expand that banner or your content with the size of the business currently? Meaningfully expand it?

Michael Medline

No, we're content with the plans we have so far in place. When we look at the markets, we look at where full service does well. We even have to make choices now on which banners we put into different markets because we have our choice, not just discount but between the full-service.

We saw an opportunity in Western Canada to really grab some market share and improve our business. By the way, turnaround a struggling region, which we've done. I think we're happy. We'll continue to look as we always do now, where we can put FreshCos up in Ontario and Western Canada where they make sense. That's our current plans are what we've already told you.

Vishal Shreedhar

Thank you.

Michael Medline

Thank you.

Operator

Thank you. Next question comes from Michael Van Aelst from TD Securities. Please go ahead.

Michael Van Aelst — Analyst, TD Securities

Hi, thank you. Just a follow-up on that question. I take it from your response, there's still no consideration of a discount banner in Quebec or Eastern Canada, or Atlantic Canada, sorry?

Michael Medline

I don't usually comment on future things, but I'm going to, in this case, just be clear that no, not at this point. We're happy. I mean —obviously, we look at everything, right? And then we look at the markets, we look at the opportunities, we look at what our competitors are doing, we look at what our opportunities are. In terms of the real estate plan that we've shared with you, we're content with it.

Michael Van Aelst

Okay. I just want to clarify on the shrink commentary you gave. At one time you talked about shrink being included in that \$32 million number that you're breaking out for cybersecurity amendments. If I understood you correctly, you talked about shrink as well being one of the reasons why adjusted gross margin was flat, excluding fuel. Is it adjusted for or not, the shrink?

Matt Reindel

Yes. The shrink is adjusted. That's included in the adjusted EPS. What you'll see in the financial disclosure, we don't show an adjusted gross margin number. We just have a gross margin as is. That's the reason that we called that out, is that gross margin is flat, but we know that there was an impact from the shrink.

Michael Van Aelst

Okay, that's helpful. Thank you. When you look at the volumes of your business, I know you talked about —customers aren't leaving the stores, but the tonnage I would have to think is down considering where the sales are and where inflation is. I'm wondering what you're doing to protect differently, near term at least, to protect margins and volume—and I guess, as volume efficiencies diminish?

Pierre St-Laurent

Considering the very high level of inflation, considering a lot of behaviours from customers to trade down in different ways, like I described earlier, right now with the high level of inflation, the overall market tonnage is down according to metrics we're having from third parties. The overall market tonnage is down. The math between same-store sales and inflation is no more relevant in a high inflation period like we have right now. We're not in a normal business right now and there's so many trade-downs that we cannot do that math like we did in the past years.

Michael Van Aelst

Yes, I understand that. I'm assuming you can see the tonnage in your business. Am I wrong to assume that your actual unit counts are down or your tonnage count? Have you estimated it then?

Pierre St-Laurent

Absolutely. Basket size is lower and we have higher inflation. There are less items in the basket, but we have more transactions to mitigate some of those losses.

Michael Van Aelst

Okay. Is there anything else you're doing from a cost standpoint to try and protect margins in the interim until you see volumes pick up again?

Pierre St-Laurent

We're doing well in margin because most of it—not most of it, all of it is Horizon initiatives. We will continue to benefit from it. We have our tools that it's well embedded in the day-to-day work in our merchandising group. The prom optimization is doing well. This space productivity will generate some benefit as well. Scene+ with more personalization, that will help to be more relevant in our promotion with customers. We have many initiatives to continue to protect margin and to deliver sales. We feel very confident that we have all the tools in hand to navigate through this high inflation period right now.

Michael Van Aelst

All right. Thank you, and good luck.

Matt Reindel

Thanks, Mike.

Operator

Thank you. The last question comes from Peter Sklar at BMO Capital Markets. Please go ahead.

Peter Sklar — Analyst, BMO Capital Markets

Matt, I just want to make sure I understand this \$0.15 adjustment. That is the direct costs of the cyber event that accounting rules allow you to pull out less the insurance recoveries you received during the period. Is that correct?

Matt Reindel

That's correct. To give you a little bit more background. Those direct costs comprise two main elements. One is the shrink that we incurred in the business and the other is all of the direct costs associated with actually managing through the cyber event such as hardware and software restoration costs, professional fees, legal fees, etc. Those total costs are basically in those two buckets. And yes that's what's in the adjusted EPS.

Peter Sklar

Okay. There's no accrual for anticipated insurance recoveries?

Matt Reindel

No, the insurance recoveries can only be booked when you have the virtually certain threshold for accounting. They will only get booked when we reach that point with you the insurer.

Peter Sklar

Okay. When we see Q4, is the way it's going to play out, there'll be like these costs, these direct costs will be less, and net of them, there'll be some insurance recovery. There will be an adjustment in Q4, but it's likely to be a smaller number. Is that sort of how it's going to play out?

Matt Reindel

Could be. There's a possibility that when we get the insurance recovery, we'll actually have a negative adjustment. We'll have a very small amount of cost, but we'll have the insurance recovery. So, yes.

Peter Sklar

Okay. Got it.

Michael Medline

I think it's good, Matt, right? To be clearer for those on the phone. Okay.

Peter Sklar

Yes. No, I understand. I just wanted to ask you one thing on—like you've given us an update on Project Horizon, the \$500 million of EBITDA. I don't see EBITDA growing by \$500 million. Can you kind of reconcile where is the \$500 million going? Is some of it invested back in the business and some of it are the items you talked about like COVID costs and cyber events? Just explain where is the \$500 million?

Matt Reindel

Yes. First of all, as we said, the Horizon objective is \$500 million in annualized EBITDA growth over that period. As we've defined in the MD&A, that excludes any of the impact associated with the cyber event. You've got to back all of those out from the difference in the annualized impact of EBITDA and actually what we generate actually in our P&L by the end of Fiscal '23. It is a little bit lower than what we had initially modeled. There's a couple of reasons for that.

First, is there's some timing issues. The cyber event and to a certain extent, COVID delayed some of our key initiatives. We thought there would be more of that EBITDA reflected in our actual Fiscal '23 results as opposed to an annualization impact. There's also the depreciation is a little bit higher than what we had modeled and fuel costs are a little bit higher than what we have modeled. The biggest impact is the annualization impact versus what you will see in the Fiscal '23 P&L.

Peter Sklar

Okay, got it. That's it. Thank you.

Michael Medline

Thanks for the great questions, everyone.

Operator

Thank you. I will now turn the call back over to Katie Brine for closing comments.

Katie Brine

Great. Thank you, Joanna. We appreciate your continued interest in Empire. If there are any unanswered questions, please contact me by phone or e-mail.

We look forward to having you join us for our fourth quarter Fiscal 2023 conference call on June 22. Talk soon.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating, and we ask that you please disconnect your lines.