Message from Operating Management

Food Retailing

Strategic Focus

At Sobeys, our strategy is to differentiate ourselves from the competition by sustaining our focus on food while meeting the changing needs and expectations of our customers – region by region, community by community, one store at a time. We are determined to “out-food”, “out-fresh”, “out-service” and “out-market” those who choose to compete with us for a greater share of Canadian consumers’ food requirements.

Our strategy remains unchanged, but our customer relationships continue to strengthen as a result of the significant investments we have made in our food-focused customer offerings. Over the past three years we have strategically invested $1.6 billion in new, expanded and upgraded stores and infrastructure, as well as the “back shop” systems and processes that support our retail focus. At the same time, we have made substantial product and service improvements and additions in every region of the country, including the successful introduction of our repositioned private brand, Compliments.

Progress in fiscal 2006

We made solid progress in fiscal 2006, improving the quality, variety and merchandising intensity of our products and promotions – with numerous local, regional and national initiatives and innovations. Highlights include:

• SMART Retailing – our store based operational excellence and productivity program which was implemented in 675 stores by the end of fiscal 2006. As well, we developed and began implementation of the newest element of SMART Retailing – Peer-to-Peer, which allows for best practice comparison between groups of similar stores;

• We advanced our Urban Fresh Fill-In format with smaller, right-sized Sobeys and Sobeys express stores in the high growth Toronto market;

• We successfully completed the national roll-out of our Compliments private label brand with the introduction of more than 3,000 products within the three-tiered brand portfolio. As well, we developed and introduced the new Compliments Organics and the Compliments Balance-Équilibre lines;

• We acquired Rachelle-Béry, a small, specialty chain in Quebec focused on organic/natural supplements and health and wellness products, as part of our ongoing commitment to build capability to meet the changing needs of our customers; and

• We added hundreds of fresh and ready-to-serve products in our deli, produce, seafood and meat departments—including store specific, local market favourites.
In fiscal 2006, our efforts resulted in solid improvements to both our top and bottom line, during a period of continued – and significant – investment in the expansion and upgrade of our store assets, optimization of our business processes, improvement in our price competitive position coast-to-coast, enhancement of our product offerings and development of our people. In aggregate, these initiatives attracted more customers to shop in our stores more often, driving higher sales per square foot from increased traffic and higher average customer transaction size. Our eight consecutive quarters of industry leading same store sales growth combined with the continued expansion and rejuvenation of our store network resulted in market share gains in each of our four operating regions.

While we are pleased with the progress made in a challenging year – progress along a continuum – we know there is much yet to accomplish.

We have been investing in a very targeted manner – and the numbers show that where we have focused first, our results are stronger. Stores we have touched are delivering higher sales per square foot, SMART Retailing has led to reduced product waste and a lower cost base, and service and promotional initiatives have led to larger basket sizes.

As we move forward, we do so with the confidence that we are focused on initiatives that will continue to drive our success. In the year ahead, we will continue to:

1. Maintain our unwavering commitment to focus on food: to “out-food”, “out-fresh”, “out-service” and “out-market” those that choose to compete with us for a greater share of Canadian consumers’ food requirements;

2. Improve our cost base and productivity; and

3. Invest in and develop our people, as we continue to nurture a service and performance culture.

Our strategies are working because of the dedication and commitment of employees and franchise affiliates across the company.

We have the financial resources necessary to sustain our focused investments – investments that are clearly delivering results, with much more in store.
Real Estate

Strategic Focus

Prior to the creation of Crombie REIT in March, 2006, the foundation of the strategic focus of our real estate operations was the ownership and management of a major commercial property portfolio, located primarily in Atlantic Canada. Within that focus, we had been pursuing a diversification strategy, targeting geographic expansion in Ontario, often in conjunction with Sobeys. With the launch of Crombie REIT, Empire retained a significant interest in the portfolio, but now as equity investors with a 48.3% ownership interest rather than as operators. Crombie REIT – with broader access to capital markets – is now better able to pursue expansion opportunities in its target markets in Ontario and Western Canada, and as investors, we will benefit from its growth and progress, just as we have from our stake in residential development through our investment in Genstar.

Our remaining wholly-owned real estate operations are now focused on commercial development through Sobey Leased Properties and wholly-owned ECL Properties, a property development company which also holds the real estate assets we have retained within Empire. Our experienced real estate team is responsible for managing both Sobey Leased Properties and ECL Properties. Our strategic focus moving forward is to position ECL Properties as the developer of choice for our key clients, notably Crombie REIT.

Progress in fiscal 2006

It was a successful and eventful year for both our commercial real estate and residential operations. In fiscal 2006, Genstar once again surpassed our expectations with strong growth in both residential lot sales and earnings. Genstar contributed $32.9 million to Empire’s earnings in fiscal 2006 as compared to a $21.3 million contribution last fiscal year, a 54% increase. Continued strength in residential markets in both Calgary and Edmonton were the primary drivers of our growth in fiscal 2006 and we are pleased to see that activity remains robust. Genstar’s U.S. residential activity was strong, generating a $6.9 million equity earnings contribution compared to a $2.2 million contribution last year. Our commercial property portfolio, through ECL Properties and Sobey Leased Properties, generated earnings of $26.7 million in fiscal 2006 as compared to $24.4 million a year earlier, a 9.4% growth rate.
Employees of all our operations performed exceptionally well, not only on a day-to-day basis but also dealing with the major changes that were involved with the launch of Crombie REIT in the final quarter of fiscal 2006.

While successfully managing the launch of Crombie REIT, our team also proceeded with several important development projects during the year. These included:

- the major redevelopment of Avalon Mall, NFLD where Sears replaced Walmart, and Winners replaced Sobeys as anchor tenants;
- the “demalling” of Fredericton Mall, NB which is being redesigned as a power centre;
- commencing the redevelopment of County Fair in Summerside, PEI, with a newly built Sobeys, a new medical centre, and additional ancillary retail premises;
- Phase II of Greenfield Park site in Montreal; and
- the completion of Martello Towers, a 108 unit condo development in Halifax, part of the Park Lane complex.

Going forward, we are positioning ECL Properties as a product development pipeline for Crombie REIT, which has the first right to buy our development projects. Our major goal for fiscal 2007 is to develop and expand our property pipeline – this is consistent with expanding value for shareholders of Empire. Our development expertise, combined with the growth and expansion goals and strategies of Crombie REIT, provides us with significant opportunities. As well, we have the benefit of strong relationships and market knowledge, which each company can effectively leverage. Going forward, where we see important development opportunities we will continue to expand within the Atlantic region, while also looking to expand in Quebec and Ontario and to establish a presence in Western Canada.
Theatres

Strategic Focus

Through our history, Empire Theatres has pursued a strategy of controlled expansion, growing steadily into our position as the second largest theatre chain in Canada, by focusing on being the premier entertainment venue in the markets we serve. With the acquisition of 28 theatres with 206 screens across Canada last year, we doubled in size overnight, and became a coast-to-coast national player. The acquisition provides Empire Theatres with the opportunity to achieve economies of scale, improve purchasing power and represents a new platform for growth coast-to-coast. Despite the doubling of our screen count, our basic mission and approach that has served us well remains unchanged: we are committed to providing a terrific out-of-home cinema experience for our customers.

Progress in fiscal 2006

The movie-theatre industry is very dependent on quality movies to ensure growth in the box office. Fiscal 2006 was a relatively poor year for blockbusters, in fact, the box office in North America declined by 6%. Empire Theatres revenue, on a same-theatre basis, performed slightly better than the industry over this time period.

Clearly, the major event of fiscal 2006 was our acquisition of a significant portfolio of former Cineplex/Famous Players theatres, which meant overnight expansion across the country, with over 100 screens in Western Canada and close to 100 in Ontario – added to our existing base in Atlantic Canada. Following the acquisition, our major priority has been to integrate the new theatres – by developing a new operating structure and implementing common systems. By year-end, we had a new point of sale system in place – and we are moving forward with the next phase – building the brand nationally by bringing the newly acquired theatres up to the Empire standard.

This process has engaged the staff of both our existing theatres and our newly acquired theatres; all employees have been managing the change and are excited about ensuring that our customers continue to enjoy the optimum theatre experience. We remain committed to offering modern, clean theatres and excellent customer service.

Moving into fiscal 2007, we expect a better year at the box office, with some promising new blockbuster movies being released. With our greatly expanded theatre network, we are well positioned to take advantage of this industry improvement, and to accelerate our operating performance as we complete the integration of the acquisition and the refurbishment and rebranding of the acquired screens. Our controlled expansion continues in our national marketplace. We have announced two major new state-of-the-art theatre complexes at Dartmouth Crossing in Dartmouth, Nova Scotia, and in Bolton, Ontario.
Investments

Strategic Focus

A successful investment strategy has been key to expanding value at Empire – delivering strong returns for shareholders while also providing the financial flexibility to support the expansion of our core businesses.

Our strategy is based on a long-term perspective with a focus on proven management and traditional fundamental analysis, and our preference is for high quality businesses that we feel are priced below their intrinsic value. With a highly disciplined stock-picking approach, we limit our portfolio to a relatively small number of high-quality, liquid investments – the portfolio has averaged only 12 stocks over the last five years. Most of our portfolio investments are leaders in their respective sectors and are well positioned for long-term growth. Our Investment Committee meets regularly to review the performance of existing investments and to debate the relative merits of prospective investments. This approach has resulted in superior performance, consistently outpacing passive index-based investments and money-market returns.

Progress in fiscal 2006

In fiscal 2006, dividend income amounted to $8.3 million, realized investment capital gains amounted to $37.2 million and the unrealized capital gain position on portfolio investments grew by $74.7 million. Total portfolio investment market value, which excludes investments in Crombie REIT and Genstar, climbed by 30.6%, from $465 million at the start of the fiscal year to $607.3 million at fiscal year-end – largely as a result of share price appreciation from our investment in Wajax Income Fund and financial services stocks.

Empire’s 2006 investment performance builds on an impressive history of value expansion. Total investment return for the twelve months ended March 31, 2006 equaled 25.8% (2005 – 26.9%) compared to 28.4% for the S&P/TSX Composite Index (2005 – 13.9%) and 7.8% for the S&P 500 Index in Canadian dollars (2005 – negative 1.5%). Over the past four years, for the period ending March 31, 2006, the investment portfolio has generated an annual compound rate of return of 17.6%, compared to 13.5% for the S&P/TSX Composite Index and -3.0% for the S&P 500 Index in Canadian dollars over the same time period.

We remain committed to maintaining a high quality, liquid investment portfolio, to provide the added financial flexibility to support and expand value in our core operating businesses. During fiscal 2006, we allocated $40 million in investment capital to assist in the funding of the acquisition of 28 movie-theatres by Empire Theatres and a further $50 million in investment capital to purchase 1.3 million additional common shares of Sobeys – increasing Empire’s ownership interest from 68.4% to 70.3%.