FINAL TRANSCRIPT

Empire Company Ltd.

Second Quarter Results Conference Call

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PRESENTATION

Operator

Good afternoon, everyone. My name is Sarah (phon), and I'll be your conference Operator today. At this time, I'd like to welcome you all to the Empire Company Limited Second Quarter Results Conference Call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. If you would like to ask a question during this time, simply press *, then the number 1 on your telephone keypad. If you would like to withdraw your question, please press the # key. Thank you.

I'd now like to turn the call over to our host, Mr. Paul Beesley, Executive Vice President and Chief Financial Officer. Sir, you may begin your conference.

Paul Beesley — Executive Vice President and Chief Financial Officer, Empire Company Ltd.

Thank you very much, Sarah, and good afternoon, and welcome to Empire Company Limited's second quarter fiscal 2014 conference call. Thanks for joining us today.

Our comments will focus primarily on the financial results for the second quarter ended November 2, 2013. We will then be open to your questions.

This call is being recorded in live audio on our website at www.empireco.ca.

Joining me on the call this afternoon are Marc Poulin, President and Chief Executive Officer; François Vimard, Executive Vice President, Sobeys; Paul Jewer, Chief Financial Officer, Sobeys; and Stuart Mahoney, Vice President Treasury and Investor Relations.

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

This morning we released Empire's financial results for the second quarter ended November 2, 2013. During the quarter, we successfully completed the Empire Theatres asset sale transactions, generating proceeds on disposal of $247 million and a net gain of $105 million.

Accordingly, in our quarterly reporting, Empire Theatres has been classified as a discontinued operation, which requires segregation of its financial results. As a result, our remarks on the consolidated results of the Company reflect the performance of continuing operations.

I'll now provide a review of the financial results for Empire consolidated, and also of investments in other operations. Marc will then discuss Sobeys.

Empire reported consolidated sales in the second quarter of $4.43 billion, a $79.7 million or 1.8 percent increase over last year. Consolidated adjusted net earnings from continuing operations, net of non-controlling interest, in the second quarter were $78.1 million or $1.15 per diluted share compared to $82.7 million or $1.21 per diluted share in the second quarter last year.

Items which are considered not indicative of underlying business operating performance which impacted after-tax net earnings during the quarter consisted of transaction and finance costs of $17.9 million associated with the Canada Safeway acquisition; organizational realignment and restructuring costs of $5.1 million; dilution gains of $3.1 million; and gain on the disposal of assets of $2.3 million.

The Company's financial position and liquidity remain healthy, with cash and cash equivalents of $792.5 million at the end of the quarter versus $389.9 million a year earlier. At the end of Q2, the Company also had funds held in escrow of approximately $2.8 billion, which were subsequently used post quarter-end on November 4th in connection with the funding and closing of the Canada Safeway acquisition.

Empire's investments in other operations recorded adjusted operating income contribution to Empire of $10.9 million in the second quarter versus $10.7 million in the same period last year. Crombie REIT contributed equity earnings of $5.4 million during the second quarter compared to $4.2 million last year, with cash distributions received in Crombie REIT in the quarter of $8.8 million versus $8.2 million last year.

At the end of the second quarter, the fair value of our 42.1 percent ownership interest in Crombie was $527 million on a carrying value of $195 million. For detailed information on Crombie REIT's performance, please see their latest quarterly release dated November 8th.

On the residential property side, Genstar contributed equity earnings to Empire of $8 million in the second quarter compared to $4.6 million last year.

I'm now pleased to turn the call over to Marc.

Marc Poulin — President and Chief Executive Officer, Sobeys, Empire Company Ltd.

Thank you, Paul, and good afternoon, everyone. The market environment in the second quarter remained very competitive, as we expected.

Although the current competitive market dynamic did impact our overall gross margin, the impact on our adjusted earnings was largely offset as a result of operating cost control. I'll now provide some financial highlights.

During the second quarter, Sobeys' sales increased 86.4 million or 2 percent to $4.4 billion. We delivered same-store sales growth of 0.2 percent. Gross margin percentage declined 51 basis points from the second quarter last year. However, this was largely offset as a result of lower selling and administrative expense to sell, which declined 50 basis points from Q2 last year. As a result, the effect of the highly promotional environment on our adjusted net earnings was largely mitigated.

Excluding transaction costs related to the Canada Safeway acquisition of $16.8 million in the second quarter, and again on disposal of assets, Sobeys' second quarter adjusted EBITDA was $203.9 million compared to $201.8 million last year.

During the quarter, we continued to take advantage of opportunities to grow the business. Our investment in property, equipment, and investment property purchases totalled 110 million. We opened, acquired, or relocated 15 stores versus 12 last year.

Net retail store square footage increased by 99,000 square feet in the quarter, with total square footage of 29.8 million square feet at the end of the quarter, a 2.4 increase from the second quarter last year.

We were pleased as we exited the quarter to have successfully closed the acquisition of Canada Safeway. As we have said before, this acquisition represents a highly strategic opportunity for Sobeys to leverage its existing asset base and effectively create a new platform for growth.

The required resources and plans are in place and we have begun the integration. I'm pleased to report that employee morale is high, that the team is excited, and we will obviously report on our progress as we move along. For now, we reaffirm that we are comfortable with the $200 million annual run rate cost synergy to be realized over the next three years.

Notwithstanding the significant focus we've put on the effective integration of Canada Safeway, we are also advancing our business and improving our overall customer value proposition though our Better Food for All movement. As you know, our food-focused, fresh-driven offering has a natural appeal for Canada's increasingly health conscious consumers, and we are committed to making it more compelling every day. Our research suggests a sizable consumer segment that say they would like to eat better than they currently do, and we intend to provide Canadians with what they are looking for.

During the quarter, more and more customers have seen the positive changes that we have made to our food offerings, changes that encourage Canadians to eat better, feel better, and do better. They have also seen the support we provide in our stores, as well as through our flyer, in our online presence, and through our digital tools, all of which empowers, enables, and motivates Canadians to eat better every day.

You probably noticed in the quarter the media and in-store presence of Sobeys' spokesperson Jamie Oliver. We have been pleased with the positive feedback received to date from our Better Food for All campaign, and we are firmly committed at Sobeys to show Canadians that better food tastes great, is easily available, convenient to prepare, and leads to a healthier life.

At the same time, we will continue to enhance our overall customer value proposition and store experience. On October 25th, we opened a new store concept Sobeys store in Sage Creek, Winnipeg, and on November 28th we opened our first Sobeys extra store in Burlington, Ontario, both of which deliver on Sobeys Better Food for All mission.

At 58,000 square feet, the Burlington store offers the customer extra departments, products, experts, services, and savings. The consumer is offered a wide variety of fresh and great-tasting products, healthy and wholesome choices, sustainable options, and time-saving ideas.

For example, the Sobeys Kitchen features pizza made fresh daily in a stone oven, signature sandwiches freshly grilled and served hot, the Carvery that offers items such as a sterling silver hot roast beef dinners, soup, chili and chowder, a coffee and smoothie bar, a sushi bar, and a noodle bar.

And our save better pricing provide extra savings to customers. Sobeys helps make the better food basket affordable by offering over 3,000 low price features, providing bonus Club Sobeys points on over 1,000 products, and offering more than 4,000 private label products.

We're pleased to report that the reaction has been so far very positive. We are seeing more and more customers discovering shopping and saving on better food at Sobeys, and we continue to roll out our new concept Sobeys stores. This week, we open in St. Catharines, and tomorrow we will open a store in Evanston, Calgary, Alberta.

In closing, we know that any period of heightened promotional activity will generate quarter-to-quarter volatility. This is simply the ebb and flow of the business. We have experienced it many times before.

We are a long-term player, and over time we are confident that we will continue to profitably grow the business. Our long-term growth prospects remain firmly intact.

The Canada Safeway acquisition, together with ongoing improvements to our store environment, our offering, and our focus on executing our sales and productivity initiatives positions us well for sustainable and profitable growth. We will continue to work hard to bring Better Food for All to more and more Canadians.

We are now happy to respond to your questions.

Paul Beesley

So, Sarah, we'll take questions from analysts now. Thank you.

Q&A

Operator

At this time, I would like to remind everyone in order to ask a question, please press *, then the number 1 on your telephone keypad.

Your first question comes from Perry Caicco of CIBC. Your line is now open.

Perry Caicco — CIBC World Markets

Thanks. Good afternoon. Marc, I was just wondering if you could just dive a little bit into the same-store sales number. Where exactly was internal inflation? Was traffic up or down? And was basket up or down?

Marc Poulin

Well, same-store sales were not driven by inflation, as inflation was negligible again this quarter. Traffic and baskets were pretty much on the trend we've been experiencing since the beginning of the year.

Perry Caicco

And how was the same-store sales trend exiting the quarter?

Marc Poulin

The market remains extremely volatile and competitive. It's very difficult to—the problem is that, honestly, it fluctuates from week to week; I wouldn't use a random walk analogy, but pretty much some weeks are very good, some weeks are very disappointing, and there's no—it does show that basically it's a promotionally driven market, and some weeks you win, some weeks you lose, and overall there's no consistent trend at this stage.

Perry Caicco

If you were to give us a bit of an outlook for Q3, would it be a continual investment in margins to try to hold sales together?

Marc Poulin

As you know, we're not in the position to give forward-looking statements.

Perry Caicco

All right. Just switching gears over to Safeway. You've owned Safeway for a month now; how are the sales trending there?

Marc Poulin

Well, again, this is a Q3 result and we are not in a position to talk about future results. We had zero days of sales in this quarter from the Safeway acquisition.

That being said, with Safeway we're very pleased about the current integration efforts that have started with the acquisition, the people there; very, very enthused group of new employees coming through the acquisition; very excited about how the integration process is going so far.

Perry Caicco

And have you made any organizational decisions concerning Western Canada and Safeway?

Marc Poulin

Not at all. We're in the—at this stage we're more in a phase where we are enjoying the liberty that we have to talk without any restraints, and trying to learn as much as we can from their market understanding and their practices, and sharing on ours because as we said all along through this merger, we're trying to get the best of both worlds. And that can only occur if there is sharing of information between the two groups, and for the first few weeks of this acquisition that's going to be very much the focus. That, and obviously structuring all the work related to the system switchover that needs to occur as part of this acquisition.

So those two elements have really been the key focus of our management team and Safeway's management team so far on top of just communication of what is Sobeys, what's our mission, what's our sense of purpose, and that has been extremely well received.

Perry Caicco

And my last question is just on cost, Marc. You say costs are down from last year. What were the biggest components of the savings? Head office, logistics, or store labour?

Marc Poulin

Well, there are also some specific factors that kind of offset one another. There have been some stores that have been reversed from impairment because they are picking up in volume. And on the other hand, we've had also significant additional expenses associated with the launch of our new Better Food for All positioning, and the marketing expenditures associated with this campaign on top of it.

So there are numerous factors that played in and out. Obviously we worked very hard at sweating the assets. We worked—we knew that we wanted to make a major investment in the quarter, in communications with our customers, and therefore we planned accordingly. And so a lot of—nothing—as usual, we continuously strive to go at costs, and it's never one big initiative that delivers on the cost side. It's tons of little initiatives that do so, but we were quite pleased with how overall it turned out in this quarter.

Perry Caicco

Okay. Thank you.

Operator

Your next question comes from Peter Sklar of BMO Capital Markets. Your line is now open.

Peter Sklar — BMO Capital Markets

Marc, back on the cost side. If you look at your SG&A margin, like if you go back to the first quarter, it was about flat year-over-year, and this quarter that you just reported this morning you were down 40, 50 basis points. So I'm just wondering what was the change? Was there any major cost programs that were implemented during the quarter? Are you leveraging off of higher revenue base, say, as you ramp up the target business? Or just exactly what is—can you give us a flavour on what's going on there?

Marc Poulin

Well, I wish we were leveraging on a much higher revenue base than what the market allowed us to take from that perspective. I think it’s overall, everybody is aware that in a very difficult environment like the one we're currently experiencing costs are a key factor that will enable us to remain competitive. And there's been a significant effort being put on communicating those facts to the whole organization.

And as I said earlier, it's not one big project, but it's a series of little moves that allow us to be in a cost position that we've been able to demonstrate. So it's kind of—it's a battle that they're on, I would argue on a daily basis, and we clearly are working on that front, but it's not one big thing that I can say, well, that's the cause of it.

Peter Sklar

Okay. And the last topic I wanted to address, just on Canada Safeway. So Safeway Inc. has been reporting Canada's Safeway's earnings for the last two quarters. They've been reporting declining sales and earnings for Canada Safeway. Now I know there's a lot of noise surrounding that with foreign exchange, drug reform, and corporate charges. I'm just wondering if you could help us understand what is really happening with the core earnings or the underlying results in the grocery business, and what's your sense of how they have performed over the last couple of quarters in terms of same-store sales and gross margin?

Paul Jewer — Chief Financial Officer, Sobeys, Empire Company Ltd.

Yeah. I think, Peter, we'll obviously give some more perspective on Safeway when we release our third quarter results when we actually have some Safeway results reflected in our number. I think you've identified a number of the things appropriately that have impacted Safeway's results when they were part of the US business the last couple of quarters.

Peter Sklar

Okay. That's all I have. Thank you.

Operator

Your next question comes from Michael Van Aelst of TD Securities. Your line is now open.

Michael Van Aelst — TD Securities

Yeah. You've covered a lot of it, but I just wanted to finish off on that SG&A line. And it seems you've said it was a series of little moves that helped you get the drop in SG&A year over year, rather than a timing shift I'd assume. So can we assume that you can keep SG&A flat to down for the next few quarters as you cycle through some of these moves?

Marc Poulin

We're working very hard on the SG&A line on a daily basis. Obviously it's a battle in this context when there's relatively low growth in the marketplace to be able to work on the concept (phon) at the same time, but everybody in the Company is fully conscious of the importance of the SG&A line in these days.

Michael Van Aelst

Okay. And the $5.1 million in organizational and realignment costs, can you explain a little bit what was behind that?

Marc Poulin

So as you know, the Empire Company is strategically refocused over the last few years, but now with the acquisition of Canada Safeway complete (phon) it's a consequence (phon) of our strategy to be a food-focused company with investment in food and related real estate. And, therefore, the holding company structure that we've had in the past doesn't apply in the same fashion, will not apply in the same fashion in the future, and we are starting to work to simplify our internal administration given those new strategic orientation.

Michael Van Aelst

To what degree can you cut costs as a result of removing this holdco structure?

Marc Poulin

Well, we're not in the position at this stage to release any information on that nature. There's still work to be done. Just let's put it that way: this is the beginning of a process that will see hopefully completion in Q3.

Michael Van Aelst

So will we see more costs in Q3? Or is it all in Q2?

Marc Poulin

Obviously Q3 we'll see costs also associated with the integration of Canada Safeway. And I think you've got to take this overall—as part of an overall commitment to deliver on the synergies we've identified through the acquisition. So it's not—there's no stone that will not be uncovered in the search for synergies. And obviously as we are in a position to deliver those synergies, very often they do come with initial costs and, therefore, I think you can fully anticipate that in Q3 and even in Q4 and Q1 next year you will see a series of costs, one-time costs associated with the restructuring of the business in order to deliver those synergies that will bring the Company to a much better place in the long term.

Michael Van Aelst

Thank you.

Operator

Your next question comes from Jim Durran of Barclays. Your line is now open.

Jim Durran — Barclays

Good afternoon. Just starting on the reorg costs, the 6.8 million. Is that largely going to be a one-year payback on that time frame?

Marc Poulin

I think we will be in a position to define this at a later—as I said, this is initial and it's not fully—it's not a full—it's not the whole initiatives that are (unintelligible). As a whole, our intent is actually to bring us to the $200 million worth of synergies.

Jim Durran

Yeah. On the synergy side, it'd just be helpful if you could tell us how far along you were able to get, given the constraints on going after your analysis on procurement savings before the actual completion of the acquisition was done?

Marc Poulin

We could do very little because obviously this is probably the area where the Competition Bureau was, and rightly so, most wanted to be very careful about those because—and, therefore, we could start planning or thinking on it conceptually on how we will go and reach those synergies. But could not do actual cost comparisons until we actually formally acquired the assets.

Jim Durran

And, Marc, are you going to set up like a separate team to go after this? Or are you just going to have the two groups working together?

Marc Poulin

Well, we do have teams working together on this. So it's kind of—your question is kind of a mix of the two. So we do have resources that are dedicated to the integration and we do have resources that we'll share.

Our approach on the integration, and that's been the one all along, it is both teams working together and it's the Safeway people, for example, in systems that will implement within their own work the systems that come along with the Sobeys' suite of systems that we have. So it is very much working together.

And again, if I take systems, from the Sobeys' perspective we're going to proceed the way we've always proceed in converting the various regions with that we had from their legacy systems to SAP, which are not only the people inside the business doing the conversion because they will be the ones using the tools afterward being the priority. But the people, these people are supported by a team of people that are coming from all aspects of the business from all parts of the country so that this transition goes as smoothly as it's been going for the last few conversions we've done.

Jim Durran

Yeah. On the new DC in Quebec, are we at a point now where it's starting to contribute positively to reduction in SG&A? Or is there still a way to go yet?

Marc Poulin

So the DC in Quebec is now up and running full speed ahead. Obviously we still believe that there other opportunities for further enhancement because that's the nature of the beast, and that's the culture of the Company where we continually strive for small improvements that help the operation. But we're not in the implementation stage anymore. We are in continuous improvement phase now.

Jim Durran

Okay. And then last question; when you announced the Safeway Canada acquisition you identified potential EBITDA dollars that might go away through divestiture. Is there any update there on how much EBITDA might get divested now?

Paul Jewer

All we'd say at this point is that we're quite well along in the process, and in the third quarter we expect we'll have a further update in terms of where we are with the divestitures. There's no material change from anything that we've identified in terms of our expectations that we identified in our prospectus when we filed it earlier in the summer.

Jim Durran

Great. Thanks, Paul.

Operator

Your next questions comes from David Hartley of Credit Suisse. Your line is now open.

David Hartley — Credit Suisse

Thanks, and good afternoon. I just want to ask you a bit about the real estate that you have on hand or acquired at the Sobeys' Empire level. Have you given more thought to planned vending into Crombie REIT? Or sale into Crombie REIT in the near term?

Marc Poulin

So if I get your question is do we plan to sell more assets to Crombie REIT in the near future?

David Hartley

Correct.

Marc Poulin

We are not in a position to answer this question at this stage. Obviously, yes we do have other assets in the—that we have acquired that haven't been disposed of to Crombie, but as you know, some of those assets from a real estate point of view will also have to be divested as part of the requirements of the Competition Bureau. So that is currently our first priority.

Paul Jewer

But we obviously have an ongoing pipeline of development projects that we work on that as we develop them we look at opportunities to flip them to Crombie REIT. That was the case in the past, and that will continue to be the case going forward.

David Hartley

Okay. And have the assets been identified that have to be divested at this point?

Paul Jewer

Yes. Yeah. The 23 stores that were required to be divested were part of the Competition Bureau order, so yeah, those have been identified.

David Hartley

Right, I thought so. Okay. And just in the quarter, have you seen any changes in terms of from your distribution business that have significantly impacted on the SG&A? I know there's no one big thing, but was that a significant enough contribution, whether it be the Quebec DC or even just fuel costs?

Marc Poulin

Fuel—on the fuel costs we'll have to get back to you...

Paul Jewer

Nothing significant…

Marc Poulin

(unintelligible).

Paul Jewer

Yeah. Nothing significant on the DC side. I think, as Marc said earlier, obviously we'll continue to enjoy the benefits associated with the Quebec DC becoming more fully operational as opposed to just in the process of being implemented. And distribution infrastructure has been one way that we've generated savings over the last number of years, and we'll continue to focus on doing that. But no big one thing that we'd point to.

David Hartley

Okay. And I think in the past you've kind of given the cadence of savings that you—or the synergies and how they should flow over the next couple of years. How should they flow over the next 12 months?

Marc Poulin

Well, the current priority is clearly on systems implementation and on generating the low-hanging fruit on the synergy side. There will be a slow but—we haven't been able, and I don't think we're in a position to be able to break it on a quarter-by-quarter basis what we are. We remain totally confident to achieve $100 million run rate at end of year one.

David Hartley

Okay. Thank you very much.

Operator

Again, if you would like to ask a question, please press *, then 1 on your telephone keypad.

Your next question comes from Vishal Shreedhar of National Bank. Your line is now open.

Vishal Shreedhar — National Bank

Thanks a lot. Just on the pricing side, curious how it's manifesting? Is it predominantly promo pricing or shelf pricing? Is it in one region versus the other? One banner type versus the other? Any colour would be appreciated.

Marc Poulin

Well, obviously we never give colour from a region-by-region basis on anything, as you know. As far as promo versus shelf pricing, the pressure is being felt on multiple fronts, including staples, which tends to be—actually on staples it's both shelf pricing and promotional pricing.

But overall I would say it is and it remains a promotional pricing story to a large degree where everybody is trying to win every week playing the game very hard on promotional spending, and, therefore, creating lots of variability on volume and on the business that is typical of these kinds of environments.

We are also making efforts that are re-juggling our merchandising program because these, to be honest, these promotional pricing spurs are not very healthy either for—from an overall margin management perspective and, therefore, we need to readjust our pricing strategy, and we've done so in Q2 versus Q1. As you know, we had some issues with that. We feel we're in a better position, but the market remains incredibly promotional in Q2, and makes it a challenge every week to get the mix right.

Vishal Shreedhar

In terms of the increasing demand for promo from consumers, is that due to a widening gap between promo prices and shelf pricing? If that's the case, can you comment on how comfortable you feel with your shelf pricing currently?

Marc Poulin

I think—I'm not sure it's coming from consumer. Obviously it starts from the food offered in the promotionals, and while consumers are intelligent enough to take advantage of all the promotions we're throwing their way, so that's where it starts, let's be honest.

That being said, we're in an environment that's incredibly promotional. It will yield imbalances between regular shelf price and promotional pricing, which have significant impact on margin. So there's clearly an emphasis on our part to look at how we can balance the overall offer to the consumer to generate great value to consumer and at the same time generate proper level of excitement from a promotional perspective.

More importantly than that is also the fact that at the end of the day you've got to have a compelling offer to present to the consumer, and we've made—we've introduced a significant number of new programs this quarter designed at generating excitement with the consumer. So it cannot be, in our belief, excitement cannot only come from promotional activities on a weekly basis.

It actually needs to come from an exciting store, and I think our Burlington store, for example, this year based in the Toronto region or Evanston in Calgary starting tomorrow, are very good examples of our commitment to bring even more excitement in our merchandising to customers not only in those concept stores, but across the network as we roll those programs across the network.

And we've rolled a number of them in this quarter, and we've obviously invested a significant effort in training, in margins to support those new initiatives, and this is our commitment to long-term growth. It is not our intention, given the—to stop on those initiatives that are required to generate a healthy business in the future.

Vishal Shreedhar

And last question. In terms of capital returned to shareholders, how should we think about that? Is the priority predominantly first to de-lever? Or could there be dividend growth in the near term? How should we think about it?

Paul Jewer

Well, obviously there's a priority for us to de-lever, but as we said in the summer when we went through the process of issuing the equity and the debt, we consistently in our history have found ways to also provide for an increasing dividend. It's always based on a guideline that we set for ourselves based on trailing revenue.

Vishal Shreedhar

Thank you.

Operator

You have a follow-up question queued up from Michael Van Aelst of TD Securities. Your line is now open.

Michael Van Aelst

Thanks. As you put together your 12-month budget or outlook, I guess do you anticipate promo activity easing as the square footage starts to slow in the second half of next year? Or do you expect that just to continue at the same pace?

Marc Poulin

Honestly, we still believe that the markets will remain very difficult for the time being. Obviously it's not an easy feat to predict, nor is inflation, by the way, which we have clearly not with the inflation we've been experiencing so far this year in line with what we have in our initial budget.

So these are very difficult things to predict. I think on that front the teams are expected to realize fully the environment in which we currently live and to plan accordingly. And, therefore, it's our commitment to deliver better value to customers that at the end of the day will allow us to improve on our performance.

Paul Beesley

Sarah, are there any more questions?

Operator

There are no further questions queued up at this time. I turn the call back to the presenters.

Paul Beesley

Thank you very much. Ladies and gentlemen, we greatly appreciate your continued interest in Empire, and look forward to having you join us for our Q3 fiscal 2014 conference call scheduled for March 13th. Good-bye.

Operator

And this concludes today's conference call. You may now disconnect.

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