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PRESENTATION

Operator

Good morning. My name is Connor (phon), and I'll be your conference Operator today. At this time, I would like to welcome everyone to the Empire Company Limited First Quarter Results 2016 Conference Call. All lines have been placed on mute to prevent any background noise.

After the speakers' remarks, there'll 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'd like to withdraw your question, press the # key. Thank you.

Ken Chernin, Director of Investor Relations, you may begin your conference.

Ken Chernin — Director, Investor Relations, Empire Company Limited

Thank you very much, Connor. Hello, and thank you for joining us.

Our comments today will focus primarily on the financial results of the first quarter of fiscal 2016 ended August 1, 2015. Following our comments, we will then be open to your questions.

The 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, Chief Financial and Administrative Officer; and Clinton Keay, Executive Vice President, Finance.

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 and factors.

I will now turn the call over to François, who will provide a review of Empire's financial results, Marc will then discuss Sobeys.

François Vimard — Chief Financial and Administrative Officer, Empire Company Limited

Thank you, Ken, and thanks to everyone for joining us today.

Empire's consolidated sales in the first quarter were $6.25 billion, an increase of $26.5 million, or 0.4 percent. The increase in sales was primarily the result of food inflation experienced during the quarter.

This was partially offset by the store closure associated with the network rationalization last year, the decline in oil price impacting fuel revenue, and store divestiture in the same period last year.

Sobeys' same-store sales growth for the quarter was 0.5 percent. Excluding the negative impact of oil price on fuel sales, same-store sales would have been—what have increased by 1.2 percent.

Sobeys' gross profit for the quarter was $1.52 billion, a decrease of $29.9 million, or 1.9 percent compared to the same period last year. First quarter gross margin decreased 50 basis points to 24.3 percent compared to 24.8 percent for the first quarter last year.

The reduction in gross margin during the quarter relative to the same period last year was clearly the result of the significant amount of change introduced in our Safeway business as we focused on the integration.

Before implementing the changes, we identified the various risks associated with the integration. However, we underestimated the impact and the time required for the organization to adapt to those changes, which had a clear negative impact on our first quarter results.

Partially offsetting these factors were synergies realized during the quarter relative to the Canada Safeway acquisition.

Consolidated EBITDA in the first quarter was $314.1 million compared to $342.5 million in the first quarter last year, a decrease of $28.4 million, or 8.3 percent. EBITDA margin decreased to 5.03 percent from 5.50 percent last year, a decrease of 47 basis points. The decrease in EBITDA was primarily the result of a $29.9 million decrease in full retail in gross profit, as well as severance costs of $6.4 million associated with the previously announced organizational realignment and distribution centre restructuring costs for $4.7 million.

These factors were partially offset by the realization of $51 million in synergies related to the integration of Canada Safeway and lower selling and administrative expenses relative to the same period last year.

After adjusting for items which are considered not indicative of the underlying business operating performance, consolidated adjusted EBITDA for the quarter was $325.2 million, a decrease of $17.3 million, or 5 percent over the first quarter last year. Adjusted EBITDA margin in the first quarter was 5.20 percent, down 30 basis points from 5.50 percent in the same period last year.

Finance costs net of finance income in the first quarter were $32.9 million, down $10.7 million, or 24.5 percent compared to the same period last year. The lower finance costs are the result of lower interest expense resulting from the repayment of debt with proceeds from the sales of noncore assets and free cash flow generation.

The Company's effective income tax rate for the first quarter was 26.8 percent compared to 25.3 percent in the same period last year. The increase in the effective tax rate was primarily attributed to partial non-taxable proceeds on disposition of certain stores in the same period last year.

In the first quarter, Empire recorded adjusted net earnings net of noncontrolling interest of $121.7 million, or $1.32 per diluted share compared to $129.1 million, or $1.40 per diluted share in the same period last year, a decrease of $7.4 million, or 5.7 percent relative to the same period last year.

With respect to our overall consolidated financial condition, at the end of the first quarter Empire's consolidated ratio of funded debt to total capital was 27.2 percent compared with 35.4 percent last year.

Cash and cash equivalents at the end of the first quarter equalled 384 million. Free cash flow for the first quarter was $216 million versus 391.3 million in the same period last year. The decrease in free cash flow was attributed to a decline in cash flow from operating activity, coupled with a reduction in proceeds from the divestiture of noncore assets and higher cap expense.

As of today, we have repaid over $1.6 billion in funded debt since the acquisition of Canada Safeway, and subsequent to the end of the quarter, Standard & Poor's rating service revised its outlook on Sobeys from BBB negative with a negative outlook to a BBB negative with a stable outlook.

Investment in other operations reported operating income of $10.9 million in the first quarter versus $13.2 million in the same period last year, a decrease of $2.3 million.

Equity accounted earnings from Genstar were 4.9 million in the first quarter, a decrease of $3.1 million compared to $8 million recorded in the same period last year. The decrease relative to last year was primarily due to fewer lot sales.

Equity accounted earning from the Company's investment in Crombie REIT were 7.4 million, an increase of $0.1 million over the same period last year. We refer you to Crombie Q2 news release on August 5th for details on its most recent quarterly results.

At the end of the first quarter, the fair value of our 41.5 percent equity accounted ownership interest in Crombie was $687.8 million on a carrying value of $362.1 million.

I will now turn the call over to Marc Poulin.

Marc Poulin — President and Chief Executive Officer, Empire Company Limited

Thank you, François, and good day, everyone. During the first quarter, Sobeys' same-stores sales increased 0.5 percent, and excluding fuel sales, same-store sales increased 1.2 percent.

Our internal food inflation for the quarter was calculated at 2.4 percent.

Sobeys' first quarter EBITDA decreased by $26.3 million, or 8 percent compared to the same period last year to $303.1 million. As François discussed earlier, the decrease in EBITDA was primarily the result of gross profit being $29.9 million, or 1.9 percent lower relative to the same period last year. This was largely the result of the significant amount of change that was introduced in our Safeway business as we focused on the integration.

We have identified the core issues at the root of our challenges in the first quarter, and we have allocated the necessary resources to ensure that we bring our performance back in line with our expectations in the coming quarters.

In what remains a very competitive retail food environment, the rest of our business performed to our expectations, driven by the ongoing rollout of our Better Food For All strategy, which continues to resonate well with our customers.

Also impacting Sobeys' EBITDA for the quarter was an aggregate $11.1 million of onetime cost arising from the ongoing organizational realignment and distribution centre restructuring. Partially offsetting those factors was the realization of $51.0 million in synergies from the Canada Safeway acquisition during the quarter.

After adjusting for items which are considered not indicative of underlying business operating performance, Sobeys' adjusted EBITDA for the first quarter was $314.2 million, a decrease of $15.2 million, or 4.6 percent from the $329.4 million in the same period last year.

Adjusted EBITDA margin for the first quarter was 5.03 percent compared to 5.29 percent in the same period last year, a decrease of 27 basis points.

Overall, we remain confident in our ability to deliver $200 million in annual run rate synergies at the end of year three, but we cannot underestimate the time and effort that will be required to deliver on those opportunities now enabled by common systems. We continue to identify incremental opportunities for improvement, and we remain committed to reducing costs wherever possible across the organization.

I will now provide some highlights on recent initiatives. As previously announced, we acquired Co-op Atlantic's food and fuel business. We are now supplying food and gas to a vast majority of the member-owned Co-op locations, and we have long-term supply agreements and franchise agreements with them.

We acquired the former Target distribution centre in Rocky View, Alberta. We are currently retrofitting the facility to be our third fully automated distribution centre. When the conversion is completed in 2017, it will have the capacity to efficiently distribute dry grocery to all stores in Alberta, Saskatchewan, and part of Manitoba.

During the quarter, we continued the rollout of our new concept stores across the country, including our 11 stores in Ontario in the community of Fonthill, as well as our first new concept store in Atlantic Canada in Paradise, Newfoundland.

We also opened a Sobeys Urban Fresh in downtown Ottawa, which is the first Urban Fresh store outside of Toronto in this province.

Subsequent to the end of the first quarter, we opened our first South Asian grocery store called Chalo FreshCo in Brampton, Ontario. The South Asian market is one of Canada's fastest growing and largest multicultural population, and this 50,000 square foot store provides customers with a one-stop shop for all their South Asian grocery needs, as well as a range of popular North American brands at low discount prices.

With the consolidation of the Sobeys and Safeway private label portfolios completed, we are working on the next phase, which will include common use of private label fresh brand, messaging, and product. This includes the harmonization of assortment, as well as focusing on aligning in down costing.

Let me close by acknowledging that although we experienced a challenging first quarter, we are aggressively tackling the root cause of those challenges. We are working quickly and allocating the necessary resources to ensure we bring our performance back in line with our expectations. And we remain both confident and excited about the direction and progress we are making to strengthen our business and deliver long-term value to our shareholders.

We are now happy to respond to your questions.

Q&A

Operator

At this time, I would like to remind everyone in order to ask a question, press *, then the number 1 on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from the line of Perry Caicco with CIBC World Markets. Your line is open.

Perry Caicco — CIBC World Markets

Thank you. So maybe we should just get right into the core issues that occurred at Safeway. So how exactly did the IT integration effort, for example, affect gross margins? Let's start there.

Marc Poulin

Okay. So clearly the impact on the Safeway issue is not technical in nature in the sense that the system does work as intended, but it's more how we are using the tools and the—to manage the business. And the main impact on gross margins is shrink-related associated with our ability to forecast currently the way it should be done and, therefore, how it impacts our fresh operation.

There's also, to be honest, an impact also on how people are managing the promotional program if they're not used to the tool as well, which ended up in markdown estimates not being aligned with expectations.

Perry Caicco

So is this being addressed with a training effort? Or is there any sort of reorganization involved?

Marc Poulin

It's going to be addressed with training. That being said, we are also in the process of putting the two things together and realigning the organization with people of the Edmonton office and people in the Safeway office being meshed together into one unit that will be positioned in Calgary.

So that is going on at the same time as we need to integrate the two teams into one.

Perry Caicco

And how long do you think it will take to stabilize the situation?

Marc Poulin

It's a few quarters for sure as we need to go through this integration at the same time and get the—as you said, training is an important part of it; that training doesn't occur overnight. So we're talking a few quarters to get things back under control.

Perry Caicco

And my last question. Does this delay your efforts to align the programs between the two chains?

Marc Poulin

Not significantly, although clearly there are—there's a slight delay associated with that, but not significant. From our perspective, getting a—the Sobeys team is obviously more knowledgeable about the system than the Safeway people are. So it is important in our mind that we get to that transfer of expertise that will be associated with putting the two teams together into the business as well. So that's going to help.

So we're clearly focusing on building a great team for our western business.

Perry Caicco

Actually I'm sorry, I said that was the last question. But what's the state of your central purchasing at this point?

Marc Poulin

Stable. There's no...

Perry Caicco

So this doesn't impact or hasn't been impacted by your efforts in centralized purchasing?

Marc Poulin

No, but I'm...

François Vimard

No, not at all.

Perry Caicco

Okay. Okay. That's good for me. Thank you.

Operator

Your next question comes from the line of Patricia Baker with Scotiabank. Your line is open.

Patricia Baker — Scotiabank

Thank you very much. I want to stick with the same topic and get a little bit more information here. So this was a pretty big hiccup, I guess, in the Canada Safeway operations. And at what point did the fact that you'd really underestimated the ability of the organization to deal with this change, at what point in the quarter did that come to light?

François Vimard

I would say clearly we were seeing that the margin wasn't where we thought it would be already starting at the beginning of Q1. But you go deeper to understand the root cause, somewhat because of the knowledge of the people on site in terms of using the new tools, the fact that we're changing the team in place, to really get to the real root cause it took a bit more time that we would have expected...

Patricia Baker

Mm-hmm.

François Vimard

So really it was more by the end of the quarter that really we had identified the root cause and starting to put the team together to be back on track.

Patricia Baker

And just going back, is the shrink and the demand forecasting, that's the big thing that hit the quarter or hit the Safeway business?

François Vimard

Yeah. There's many elements, but like Marc said, when you change the process on the produce side at the same time you're changing the tools, so clearly there's impact in terms of forecasting demand and I think additional shrink. But also there's impact that affects the pricing. And the promotional activity, that has impact on margin too.

Patricia Baker

Okay. And just this may seem a bit simplistic, but you indicated that looking for transfers of expertise and that sort of the legacy Sobeys people already know how to use these systems, et cetera, et cetera. So did it—as you were putting these systems in place you didn't go back and think about the training that those people had to have before they were able to optimize these tools? Or is it something completely different?

Marc Poulin

No. Clearly there was a lot of training—

Patricia Baker

Mm-hmm.

Marc Poulin

—that occurred before. But obviously practice and being live is—it doesn't necessarily reflect in the business on the day-to-day. And then there's—it is a lot of change in the way people operate, and when things don't necessarily happen the way they want sometimes they have a tendency to revert back to old practices, but that doesn't work when you don't have the same tools.

So it's clearly change management associated with integration that caused people to need to change and grasp new processes. And it's a lot of work and it's a lot of demand on people, and honestly we probably moved a little bit faster than we thought because the technical phase of the integration went well.

So it was probably a misread on our part that we were more stable than we actually were.

Patricia Baker

Yeah…

François Vimard

Patricia, that's a key point. I think that has to be clear for everyone. The fact that clearly we implemented technical aspects by the end of Q4, what we saw was that everything was okay, but at the same time, as you know, we have announced at the end of Q4 a change in terms of structure, impact on—

Patricia Baker

Mm-hmm.

François Vimard

That was a lot of pressure we were putting on people on both sides—I'm talking about the Sobeys and Safeway team back out west—and that amount of change, like we said, had a larger impact than we thought it would be. And we maybe as a management team made a mistake of going too fast on that.

And I think now at least it's clear to identify what the challenge is and we're going to work on it.

Patricia Baker

Would you say now at this point, François, that the people understand better what they have to do? Because essentially what you were trying to do is put in place kind of a behavioural change program, so do they now have a better understanding of what it is they have to do?

François Vimard

Yeah. There's a lot of people involved in the process.

Patricia Baker

Yeah.

François Vimard

And like if there's a change management. And we're changing the team at the same time, so we're integrating the two teams together. So if it was only one change on board it will be easier, and that's what like Marc said. It's going to take a few quarters to get over it because we have two changes going at the same time, which is the team—

Patricia Baker

Mm-hmm.

François Vimard

—and the management. And that's why before stabilizing, in my experience, it will take a bit more time.

Patricia Baker

Okay. And just let's see if you could provide us with a little bit more colour on another statement that is in the press release and was made on the call, and that is that the rest of the business performed to your expectations in the still-competitive environment. Can you provide us with a little bit more colour or whatever to give us some confidence on that the trends are positive in the Sobeys' legacy business?

Marc Poulin

Yeah. The Sobeys' legacy business performed to expectations overall. I mean there's puts and takes, as you can imagine in a business of that size. But we—and I would say Q4 trends and Q1 trends are not dissimilar on that business. So it's not that it's—that business, while performing to expectations, we're working hard at it.

It's not—this business is never an easy business. You have to be competitive and earn your dollars every day of the week, but it's performing on the same trend that you saw in the last three quarters.

Patricia Baker

So I'll paraphrase that for you. So the momentum on that side of the business that was evident in Q4 and Q3 was maintained through Q2?

Marc Poulin

Q1?

Patricia Baker

Q1. I'm sorry, Q1, yes. Sorry, my mistake.

Marc Poulin

I should remind you that I'm not allowed to make any prospective...

Patricia Baker

Yeah. It's no longer prospective. Q1.

Marc Poulin

Yeah. Q1 is fine. Q2 I won't comment.

Patricia Baker

Okay. Thanks. Bye

Operator

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

Peter Sklar — BMO Capital Markets

Thanks. I take it from your comments that sales at Safeway would have been weaker than you had anticipated. So can you explain how the issues regarding integration would have impacted the top line revenues? I assume you're going to talk about that you weren't able to execute on your pricing and promotional programs, but can you just talk a little bit how the integration affected the top line sales?

Marc Poulin

Well, actually—so there were clearly things that we knew that would have an impact in Q1 and actually had put promotional plans to try to compensate for it, which these promotional plans didn't pan out the way we were—because of—we were expecting part of it because of our inability to work properly with the system.

But for example, private label, we've completed the full integration of our private label to Compliments in the store, so you don't see Safeway products in Safeway stores any more, or in our warehouse. But as we do this integration now we're living—we had to slow down on private label promotions because—so that we could smooth out the inflow of Compliments products and outflow of Safeway products across the network.

But on top of it, now we're living through the natural phase of customers having to adapt to the Compliments brand, which is not unexpected and not unusual. We lived that when we did the Thrifty transition, and it's a normal phase of this transition. So that's an example that did impact our sales.

Another example of what impacted our sales is our produce business. In the Safeway world they used to be provided a procurement service that came from the US in terms of how they procured produce. Now we procure produce on our own as the transitional service agreement with Safeway has been terminated.

Obviously, even though people have to train and shadowing the business for numerous months before they actually go live, those buyers they're procuring live for the first time and they are—there's a learning curve associated with that, which is not un-normal. But as we ramp up our ability to procure appropriately there's some mistakes being made, and that could impact the execution at store level, which obviously then impacts sales. So there are things associated with that.

The reality of this business is that if you make a mistake anywhere else—anywhere in the total supply chain it will have an impact on customers and somewhat of an impact on sales. So we're living a little bit of that in the Safeway business right now.

Peter Sklar

Okay. And on another issue, you talked about—you highlighted in your write-up that there was a loss of wholesale customers. Can you talk a little bit about that and identify what that relates to? Is that related to the integration? Or is that in the Sobeys organization?

Marc Poulin

No. We knew that we would lose—there would be a loss of wholesale business. One example of it, I think, is Target. I think a lot has been written about it how they were wholesale customers of ours. They're unfortunately not anymore, so that's one example of loss of wholesale business.

So we knew as we planned this year that there would be a loss of wholesale business associated with some customers who chose not to or couldn't be in business anymore.

Peter Sklar

Right. And just a last question I have is just I'm a little confused on the synergies. I believe you said in the MD&A that you experienced 51 million of synergies in the quarter. Could you just explain exactly what you mean by that? And how do we relate that to the 200 million of annual synergies that you expect when everything's said and done?

François Vimard

Yeah. And that's the same message we gave in the MD&A over the past few quarters. So if you look last year, in Q1 we had still 28.2 million of synergy. That's what's realized during the quarter. That 51 million is the synergy realized during the quarter, Q1 fiscal '16.

So as you can see, the momentum it seems that if you add up four quarters like that we should be at least at the level of 200 million. We are working on and we have a way, obviously. We've taken more in the outlook (phon) for 2017. So that's the way you should read it, but clearly the big element right now we're working on clearly is the business in Safeway.

Peter Sklar

Right. But just so I make sure I understand, François. So if I take the 51 million and annualize it, you're there at the 200...

François Vimard

Yeah. Yeah. Yeah. Exactly. That's the way you look at it, Peter, but as we've said, there's more activity that we have announced in June that should realize additional synergies starting in '17. So there's always a bit of seasonality with procurement, so some quarters are a bit higher than others, so there's a bit of that.

So multiply by 4 is not exactly the way you should do it, but it gives you a sense of what it should be.

Peter Sklar

Okay. Thank you.

Operator

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

Michael Van Aelst — TD Securities

Yeah. Thank you. A couple of things to follow up on; first of all, can you quantify how much of the about 60 basis point contraction in gross margin was related to the integration as opposed to market factors?

François Vimard

The only element we can say is mainly that if we had performed as we were supposed to at the Safeway we should have generated a margin that would have been at least or not higher than last year.

Michael Van Aelst

Okay. And then secondly, it seems like you're feeling the effects of the Western Canada economic slowdown more than some of the others out there. Do these challenges in Western Canada make you think harder about expanding the FreshCo banner outside of Ontario sooner rather than later?

Marc Poulin

I think there's two questions in your question. So I'll go to the first one, the impact of Western Canada. Obviously our mix of business is different than some of our competitors. Some have no presence in Western Canada. We obviously have a good, fair presence in Western Canada, and it is true that the economy in Western Canada is not what it used to be.

Specifically, there's about 15 stores, plus or minus a few, that we could relate with significant impact that are, especially known northern stores (phon). These stores, the impact is really, really measurable. The rest of the business is maybe not as buoyant as it used to be overall for the market, but it's more difficult to measure.

And given our self-inflicted wounds, if I can use that expression, difficult for us to tell you whether it's just the overall market, or it's just the fact that we're not performing to expectation for our customers and that—so I'll refrain from making comments on the business overall, apart from those stores that we clearly know is the result of lower economic activities in those markets.

As far as FreshCo is concerned, we're still working on the same platform that—we did mention the last time around that we're closing in on the second year of our program to optimize the operation. Things are going according to plan. We're very pleased with the FreshCo results and the way the performance, operational performance, of the business has been improving, but we're just not ready yet to make a decision about what's the next phase for that business.

And the team still has a few more milestones in our mindset to deliver to us, and we'd like them to focus on those.

Michael Van Aelst

All right. And just finally. Since you acquired Safeway, to what degree have you had to adjust pricing in Western Canada to maybe make it more competitive?

Marc Poulin

Regular prices haven't been adjusted. We kept the business pretty much as is, as we were—it would have been difficult for us to do it, given the systems. And obviously promotional strategies have fluctuated according to the marketplace.

I guess the most significant change in the customer proposition has been the introduction of Air Miles in the Sobeys business. That's been more what's happened for our customers. But from a pricing and promotional point of view it's been more business as usual with a few experiments here and there, but nothing—we basically always said that we want to make the transition to the new system and the new processes first and foremost before we actually look at the way we're going to market in the western region.

Michael Van Aelst

All right. Thank you.

Operator

Your next question comes from David Hartley with Credit Suisse. Your line is open.

David Hartley — Credit Suisse

Hi. Thanks. And, Marc or François, I'm just wondering if you can maybe give us a sense of how you're seeing this remedying happening over the coming quarters? Are we going to see gross margins improve as SG&A increases on a relative basis and come kind of hopefully to a close within the next couple quarters? Or how do think it'll show up on your financials?

Marc Poulin

Well, two impacts, but the key for us is gross margin because most of the impacts we are seeing right now in our difficulties in integration are gross margin related, so clearly we're working diligently to show progress on that front. There is going to be SG&A positive impact eventually also because some of the system-related issues are also related to labour at store levels and the management.

And further down the line you will see overall head office expenses actually reduce as we integrate the two teams and move toward one unified team. That obviously will enable head office SG&A reductions to occur towards the end of this fiscal.

So the plan in itself is pretty much the same plan we had, but execution of the plan will improve, which will yield the readjustment of the numbers as I've just described.

David Hartley

Okay. And so when I think about the $200 million in synergies, I mean how much of what you've just listed is included in that number? Because it seems like, well, as you said, we're at 50 million—yeah, not quite the way to look at it—times by 4, but it seems that there's some incremental there that maybe is not counted for. Is this some of the opportunity you talked about in June?

Marc Poulin

Well, there's some activities that are not accounted for in this 200 million. The most obvious one, if I refer to my script, is the fact that we're building a fully automated warehouse in the north of Calgary. Obviously you don't see any of that in the 50 million because it's not operational, but it will be, and that will obviously as you've seen in our experience going to be beneficial to the cost structure of the business.

Some SG&A; the marketing programs currently are, and the way we go to market we haven't touched, so obviously that will have eventually an impact on our cost structure. And we still have we're running two businesses pretty much right now, although they're getting more and more integrated as time goes on, but it's not fully integrated like it will eventually be.

But some of the synergies we're already benefitting from. Our private label program is fully integrated, so the cost advantages associated with that are starting to show up in the numbers. Yes. Clearly we feel good about the combined business from a cost perspective.

David Hartley

Okay. So as you kind of backfill these—so get the gains from some of the synergy initiatives that you're working on and you backfill and cure your problems, is there any reason to believe that there will be some kind of—how shall I call it—structural cost increase in the business that will safeguard against some of the issues you're having today? I understand that there's a lot of training here involved to cure this issue and once you train people it takes care of itself, I suppose. But is there any other cost that would stick around over time to ensure this doesn't happen again?

François Vimard

We don't think so. I think, David, the point is that like we said—and we announced this in June—like you said, it's integrate the team. The transition will be longer than we thought it would be, so getting those savings may take a bit more time, but at the end there won't be any additional structural costs. We don't foresee any of it.

David Hartley

Okay. Great. Thank you very much.

François Vimard

Okay.

Operator

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

Jim Durran — Barclays Capital

Just wanted to continue on on the SG&A focus for a second, so SG&A in the quarter was down year over year. Am I wrong, though, in assuming that some additional dollars have to be invested that you may not have been planning, and so that down in Q2, Q3 may not be the direction of SG&A?

François Vimard

Yeah. In Q2 also we have some capital gains, the SG&A, yeah, one in Q1, so that affects Q1 SG&A. But if you exclude that, SG&A was still a bit down.

And on a temporary basis maybe in Q2, but again we don't give any forecast, we won't see the same reduction we're supposed to see because it's going to take more time to get where we want it to be.

So it's more a delay than additional costs, I would say.

Jim Durran

Yeah. And...

Marc Poulin

And as much as we've focused on the Safeway business, we're quite pleased with the way our SG&A cost structure overall in the business is going. So it's—

François Vimard

For the rest of the business.

Marc Poulin

For the rest of the business. So we're not overly worried on the SG&A line at this stage.

Jim Durran

Okay. And I may have misheard, but your measured food inflation, was it 2.4 or 3.4?

François Vimard

Two.

Marc Poulin

Two.

Jim Durran

Two. So that’s materially lower than we’ve seen from some of your competitors. Can you explain to us why that might be so?

Marc Poulin

Well, I think timing is probably the biggest factor. We’re leaping the cost increases of last year...

Jim Durran

Yeah.

Marc Poulin

And while meat is still significantly higher than it was last year, the inflation we’re seeing in meat is lower that what we saw in Q1 of last year. Produce, still the impact of Canadian dollar, but we suffered some of that in Q4 of two years ago, and that’s when it actually started. So this is getting less of an impact.

And on top of it, this quarter is May, June, July, basically, so we’re more in the local growing season, so there’s a little bit less of an impact of currency on our produce business, so the inflation produced is lower. And so we haven’t seen yet much inflation inside our stores, at least not in this quarter.

And so I think it's just the fact that we're leaping and I think it's mainly—I would suspect it's mainly timing related.

Jim Durran

Okay. No, that's helpful. Better Food For All, how many stores now are sort of affected by that program either fulsomely or partly? And what are your plans over the next year or two in terms of number of stores that you would hope to touch?

Marc Poulin

Okay. So for the second part of the question, a little bit early to tell. We haven't discussed our capital plan with our Board and got approval for it, so I'm not going to speculate on the reaction of the Board on that.

In terms of how many stores, all the stores are impacted indirectly—well, directly and indirectly. They don't necessarily have to be renovated to see the impact of the strategy in our merchandising, the way we go to market, and the programs being offered and the products being offered to customers.

Obviously in the renovated stores all of those showcases a lot better because the store was designed with that in mind. So in that regard we see better results around the various programs in the stores that have been renovated, and we're pleased with what we're seeing.

Jim Durran

Okay. Last question, just on the acquisition facility; is it totally paid off now? It was like 200 million as of the end of Q4. I couldn't find any disclosure on it for this quarter.

François Vimard

No, it is totally paid off.

Jim Durran

Great. Thank you.

Operator

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

Vishal Shreedhar — National Bank

Hi. Thanks for taking my questions. François, I think you indicated earlier in the call that the total business performance would have been in line—margins would have been in line to flattish versus last year if Safeway had performed in line with your expectation. Just quickly, is that food retailing EBITDA margin that you're referring to?

François Vimard

I'm talking about gross margin and EBITDA margin.

Vishal Shreedhar

Okay. And—

Marc Poulin

Just, Vishal, we said flat or above, not negative.

Vishal Shreedhar

Oh got it. Got it. Okay. So I guess my next question...

Marc Poulin

We don't want to tell you things that we never divulged, so we just say it's within that and negative.

Vishal Shreedhar

Okay. Understood. So I guess my next question isn't as relevant, but I was just wondering if the core Sobeys business would have been deteriorating on margin. Like is there price investment going on there? I know you indicated that's in line with expectation, but I'm just trying to gauge what that means.

Marc Poulin

Yeah. The core Sobeys business would have been flat to positive.

Vishal Shreedhar

Got it. And the sales trends would have been obviously positive as well, probably better than Safeway. Is that a fair way to think about it?

Marc Poulin

Yes.

Vishal Shreedhar

Okay. With respect to management's indication that these business issues that you highlighted and you chatted about in the quarter they'll be remedied by the end of 2016, fiscal 2016. How comfortable are you with that statement? Are you seeing signs of improvement already?

Marc Poulin

We are clearly thinking that we can resolve this in the next few quarters, and we're working diligently to that extent.

Vishal Shreedhar

Okay. And I know you've implemented SAP in other stores. Is it just the fact that there's so many things going on that's different in this time? Is it the time line? Or I'm just trying to gauge if there's something that could go awry versus your plan and maybe extend that time line from beyond 2016?

Marc Poulin

Well, we did—and it's not unusual that we have blips in the business after implementation of SAP. Obviously the Safeway business is a big business, so when we had glitches in Thriftys we didn't bring it to you guys because after implementation it's normal. It's not that there's not a little—but the size of Safeway is obviously relevant.

And yes, there's a lot more change in the business right now than you would find in a normal implementation. I'll just go back to produce. In Safeway we're not only implementing a new system, but we're also implementing a new buying process because we didn't used to procure produce, so we're living through that.

So I think this is a little bit more complex than other integrations, and we clearly have a little bit more challenges because of it.

Vishal Shreedhar

Okay. And just lastly here—and I figure I'll just give this a shot—and I know you prefer not to give too much forward-looking information, but just my thinking of the way that this would work, given that you're putting the training teams in, should we expect or at least I'm thinking that the margin deterioration cadence in gross margin should soften through the fiscal year? Does that sound like a reasonable way to think about it?

Marc Poulin

Well, clearly we'll see more improvement along the way. I'm not—it's not something that's going to be difficult and then switches over time. It's going to improve as we go along, but I'm not going to give a prospective statement because I'm not allowed to do so.

Vishal Shreedhar

Okay. Okay. Understand. Thanks for your colour.

Operator

Your next question comes from Chris Li with Bank of America. Your line is open.

Chris Li — Bank of America

Hi. Good afternoon. Last quarter the Company took about $100 million of restructuring charges related to the distribution facilities and back office streamlining. Is it reasonable to assume that the expected cost reductions from these initiatives will be at least equal to or better than the $100 million charge that you took last quarter?

François Vimard

We didn't mention how much it was, Chris, and as we said, it's going to start mainly in F '17.

Chris Li

Yeah. But—

François Vimard

Clearly the point is to have a good return on capital we're investing on those.

Chris Li

And typically what is the payback period from these type of initiatives? Is it two or three years? Or shorter than that?

François Vimard

It depends, but like we said in the past, for automation usually it's in a range of three to four years.

Chris Li

Yeah.

François Vimard

But each project is a bit different, depending on the size of the project and depending of how many people are affected.

Chris Li

Gotcha. Okay. And I guess maybe just follow-up to Vishal's question on just the gross margin. I mean before the issues happened you were achieving about high 24 to low 25 percent gross margin. This quarter clearly was impacted by the issues. But once you get these issues resolved, is it reasonable to assume that you can go back to those type of margin? Or is there anything structural that you're seeing that might make that more difficult going forward?

François Vimard

At this stage, as I say, there's nothing structural, but clearly the gross margin always changes depending on the promotional activities going on in the market. So forecasting for the future is always tough, but clearly the message for this quarter is we should have been better than the last few quarters.

Chris Li

Okay. And then just maybe a couple of quick modelling-type questions; your depreciation expense for this quarter, is this a reasonable run rate for the rest of the year?

François Vimard

It's going to be in line with the capital plan, and you know the capital plan we have for this year. So it should be a good, good prospect for the year.

Chris Li

Gotcha. And then under your Investment and Other Operations I think your corporate expense was roughly about just 1.4 million this quarter again. Can we just kind of times that by four for the rest of the year?

François Vimard

That's a good example. There were nothing really special in the quarter.

Chris Li

Gotcha. Thank you.

Operator

Your next question comes from the line of Keith Howlett with Desjardins Securities. Your line is open.

Keith Howlett — Desjardins Securities

Yes. I wanted to ask, did the Sobeys stores in Western Canada get impacted at all from the integration issues at the Safeway stores?

Marc Poulin

No. We're still in a world where we're running parallel Sobeys and Safeway right now.

Keith Howlett

And then just in terms of private label, how would the Safeway private label penetration in Western Canada compare to your own Compliments' Sensations penetration in your Western stores?

Marc Poulin

I'm not in a position that I want to reveal those numbers for competitive reasons, as you can appreciate.

Keith Howlett

And then just in terms of the personnel, am I to understand that the—are you closing a head office in Edmonton and Vancouver and opening something in Calgary? Or...

Marc Poulin

Well, we already have a head office in Calgary, which was the home base of Safeway. We have a head office in Edmonton, and we have a small team in Victoria to manage the Thrifty business. And we are consolidating a number of positions into Calgary, which will—positions that will be filled by people from all three locations.

Keith Howlett

And have you had any issue with people not wanting to relocate from Edmonton or Victoria? Or not really?

Marc Poulin

Actually, obviously not everybody's willing to move, but we've been pleasantly surprised by the willingness of people to be part of the journey and accepting the consequences of having to move to do so. So I'll take advantage of this to thank the employees who've decided to make the move because we're really appreciative of the personal sacrifices that will come with the move, but are very happy that they're willing to join us for the following phases of this integration.

Keith Howlett

And then just finally on the automated distribution centre, is that opening in fiscal '17 or calendar '17?

François Vimard

It's forecast for calendar '17.

Keith Howlett

Calendar '17. Great. Thanks very much.

Operator

Your next question comes from the line of Kenric Tyghe with Raymond James. Your line is open.

Kenric Tyghe — Raymond James

Thank you, and good afternoon. I wonder if you can provide a little bit of colour how the Air Miles program is resonating relative to the old Club Sobeys program in Ontario. And then just staying focused on Ontario briefly just how that loyalty—how the currency is impacting your promotional activity or efficiency in the Ontario market, given that your Sobeys business at the core was sort of flat to positive, as you highlighted.

Marc Poulin

We're very pleased in the way the Air Miles program has performed for us in Ontario. The implementation of one loyalty program across the business delivered synergies on the cost side, so that's always pleasant. But more importantly, customers' response to our Air Miles offer in Ontario has been positive, so we had quick pick up of the number of customers using the card that currently exceed what we had under Club Sobeys.

And we're also very pleased about the ability that Air Miles and the links have given us to co-promote with other retailers that are part of the coalition. So, for example, you may have noticed that we have a cross-promotion currently going on with Shell, between Sobeys and Shell, and that had positive impact on our business. So overall, very good on this front.

Kenric Tyghe

Thank you. And then just a follow-up; if we look across your business nationally with a single currency now in place, could you give some idea either directionally or absolute numbers what your loyalty attach rate is in the average basket? If not in percentage terms, even just directionally how that has trended or trending?

Marc Poulin

Trending up, but clearly I'm not going to tell you the number. That's one that I don't want my competitors to have knowledge of.

Kenric Tyghe

Fair enough. Worth a try; I'll leave it there. Thanks very much.

Operator

There are no further questions at this time. I will turn the call back over to Mr. Chernin.

Ken Chernin

Thank you very much, Connor. Ladies and gentlemen, we appreciate your continued interest in Empire, and look forward to having you join us on our second quarter fiscal 2016 conference call on December 19th.

Thank you and good bye.

Operator

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

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