FINAL TRANSCRIPT

Empire Company Limited

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 would 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 Limited

Thank you very much, Sarah. Good afternoon, and welcome to Empire Company Limited's second quarter fiscal 2013 conference call.

Our comments today will focus primarily on the financial results for the second quarter ended November 3, 2012, after which we'll be pleased to answer 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 from Empire Company Limited, Paul Sobey, President and Chief Executive Officer; and Stewart Mahoney, Vice President Treasury and Investor Relations. From Sobeys, we have Marc Poulin, President and Chief Executive Officer; François Vimard, Executive Vice President; and Paul Jewer, Chief Financial Officer.

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.

This morning we released Empire's financial results for the second quarter ended November 3, 2012. Empire reported consolidated sales in the second quarter of $4.4 billion compared to $4.04 billion last year, an increase of $367.8 million or 9.1 percent. Excluding sales of $257 million related to the acquisition by Sobeys of 236 retail gas locations and related convenience store operations in the fourth quarter last year, consolidated sales increased by $110.8 million or 2.7 percent.

Net earnings, net of minority interest in the second quarter was $93.3 million, $1.37 per share, compared to $78.1 million, $1.15 per share in the second quarter last year, a 15.2 million or 19.5 percent increase.

Consolidated adjusted net earnings, net of minority interest were $85.7 million or $1.26 per share in the second quarter compared to $74.9 million or $1.10 per share in the second quarter last year.

Items not considered indicative of underlying business operating performance, which impacted after tax net earnings during the second quarter this year and last year included, first, gains on the disposal of assets of $7.9 million versus $1.5 million last year. Second, Sobeys' organizational realignment costs of $700,000 compared to $2.9 million last year. Third, Sobeys Quebec distribution network restructuring cost reversal of $400,000 versus a cost of $500,000 last year. And finally, dilution gains of $5.1 million in the second quarter last year. There were no dilution gains in the second quarter this year.

Empire's liquidity remained strong with consolidated cash and cash equivalents of 390 million at the end of the quarter and unutilized bank lines of $669 million. And our debt ratio continues to improve with debt to capital at the end of the second quarter equal to 21.5 percent versus 25 percent at the start of the fiscal year.

I'll now turn the call over to Paul Sobey.

Paul Sobey – President and Chief Executive Officer, Empire Company Limited

Thanks, Paul. Good afternoon, everyone. We are pleased with the second quarter performance. And during the second quarter we continued to execute our strategic initiatives, which resulted in profitable growth despite a highly competitive marketplace.

Sobeys continued to be the driver of our improved performance. During the second quarter, Sobeys' sales increased 356 million or 9 percent to 4.33 billion. Sobeys' same-store sales grew by 1.3 percent in the quarter in a slightly deflationary environment in aggregate.

Sobeys' second quarter EBIT contribution to Empire increased 17.9 million to 127.7 million. Sobeys' contributed net earnings, net of minority interest of 85 million in the quarter, an increase of 16.6 million over the 68.4 million contribution last year.

Net earnings contributions from our investment in other operations in the second quarter was 8.3 million versus 9.7 million last year.

Crombie REIT contributed equity earnings of 4.2 million in the second quarter compared to 4.8 million last year, with cash distributions received from Crombie REIT in the second quarter of 8.2 million versus 6.8 million last year.

At the end of the second quarter the market value of our 43 percent ownership, 40.8 percent on a fully diluted basis, was 570 million on a carrying value of $184 million. For detailed information on Crombie REIT's performance, please see its latest quarterly release dated November 13th.

On the residential property side, in the second quarter, Genstar contributed equity earnings of 4.6 million versus 2.9 million last year.

Other operations, net of corporate expenses, generated second quarter operating earnings of 4.4 million versus 8.3 million last year.

Operating income last year included a dilution gain of 7 million associated with a change in the Company's ownership interest of Crombie REIT.

With that I will turn the call over to Marc who will provide more detail on Sobeys' performance and also provide an update on Sobeys' key initiatives.

Marc Poulin – President and Chief Executive Officer, Sobeys Inc.

Thank you, Paul. First, a few comments on Sobeys' financial results. During the quarter, Sobeys' sales increase of 356 million included sales of 257 million related to the acquisition of 236 retail gas locations and related convenience store operations. Excluding these sales, Sobeys' sales increased 99 million or 2.5 percent.

Gross profits increased 46 million with gross margins declining 91 basis points to 23.00 percent from 23.91 percent last year, due primarily to lower margins in the fuel business. Including the impact of lower margin fuel sales, gross margins were 24.26 percent compared to 24.11 percent last year.

Sobeys' Q2 EBITDA was 216.2 million versus 193.7 last year, a 22.5 million increase. EBITDA margin was 4.99 percent compared to 4.87 percent last year.

Sobeys' Q2 adjusted net earnings contribution to Empire increased 7.3 million to $77.4 million.

Sobeys' property and equipment purchases totaled 122 million during the quarter with 12 new stores opened, acquired, or relocated. One store was expanded and two stores were repatterned or redeveloped.

At the end of the second quarter, Sobeys' square footage totaled 29.5 million square feet, a 2.1 percent increase over last year.

After including proceeds of the disposal of properties, Sobeys' generated free cash flow of 45 million in the second quarter, and our debt to capital ratio continues to improve to 21.8 percent at the end of the quarter versus 28.1 last year.

Now an update on our key initiatives. First, we continue to be pleased with FreshCo. Sales remained very strong in the quarter and in an environment of continued and intense competition. In the second quarter, we opened an additional three FreshCo stores with one Price Chopper to FreshCo conversion, bringing the FreshCo store total to 74 at the end of Q2.

SAP in our Quebec IGA operation business unit has been successfully deployed. The fresh go-live was completed in the first quarter and the grocery go-live was completed this fall.

At Terrebonne, Quebec automated distribution centre continues to be on plan and we are scheduled to be fully operational by spring of 2013.

We completed the second full quarter of operations with the newly acquired Shell retail gas location, which results are as expected. During the quarter, we conducted another pilot program to cross-promote our Shell fuel offering with our food offering and this promotion was very successful.

We remain committed to improving our cost structure and productivity while further enriching the shopping experience of our customers. This will include further enhancement of our full service format offering and we will keep you posted on the progress on that front.

Over to your Paul.

Paul Sobey

Thanks, Marc. So a good quarter driven by improved Sobeys' operational performance and we remain committed to our food focus strategy, which is resonating with more and more of our customers.

We are happy now to respond to your questions.

Q&A

Operator

At this time, I'd 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 World Markets. Your line is now open.

Perry Caicco – CIBC World Markets

Thanks. You mentioned the environment was slightly deflationary and I was just wondering was that pushed down by certain regions? Or by certain categories? Or by certain formats?

Marc Poulin

I'll take this one. It's Marc. Yes. It was uneven around the country for sure, the deflationary pressure, but on an overall basis we were deflationary. And the trend was stronger as we move into the quarter on that front and it's–part of it is–it's mixed space and the consumer appetite for certain products that are–and part of it is commodity price based. So it's an impact that you can see of lots of fronts.

Perry Caicco

And you know, the relationship between deflation and your sales number, I mean would it be fair to say that your sales in the west and Quebec were a little stronger than in Ontario and that Ontario may have suffered a little more from the deflationary trend?

Marc Poulin

Well we don't give numbers on the per region basis, so I think it's difficult for us to answer this question, given our practice.

Perry Caicco

And what impact would FreshCo be having on same-store sales? Would that be a positive impact?

Marc Poulin

We're very pleased with the FreshCo results and we're clearly gaining share with this offering. It's a program that resonates more and more with consumers and we're very pleased with the results.

Perry Caicco

And again on the sales, would it be fair to say the basket was up more than traffic?

Marc Poulin

Yes. Clearly that's the case. And that's in line with our strategy of building a loyal customer base and we've been successful on that front.

Perry Caicco

And have there been any material changes to your sales trends in the first five or six weeks of this quarter?

Marc Poulin

Well it's five or six weeks. We're in Week Five if I'm not mistaken so you're basically asking for a preview of Q3. It's a little bit early to tell anything on that front. But it's clear that the market, you know, let's not kid ourselves, we're approaching Christmas and being grocers, you know what happens around Christmastime. The competitive pressure heats up and it's just normal practice for grocers to experience that competitive pressure at the beginning of the holiday season.

Perry Caicco

All right. That's good for now. Thanks.

Operator

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

Michael Van Aelst – TD Securities

Thank you. Just before I move onto my question, can you just clarify your answer on the deflationary environment and how it trended through the quarter?

Marc Poulin

Well it started–the deflationary tendency was getting stronger as we moved into the second quarter. So it's–is that what you wanted precisions on? Or do you want it...

Michael Van Aelst

Yeah. So it was more deflationary at the end of the quarter than at the beginning.

Marc Poulin

Yes.

Michael Van Aelst

All right. Thank you. And I know you don't give profit by region, but can you at least give us an idea if profit trends–if profit grew in all regions of the country?

Marc Poulin

Well we don't do that and besides we're not looking at our business by regions anymore since we restructured around the lines of the IGA business unit and the Sobeys multi-format business unit. We look at it more on sub-business units and, therefore, it's not even a number we're looking in the same fashion as we used to in the past.

Michael Van Aelst

All right. There was also a $3.8 million gain on conversion of the Crombie convertible debentures and I'm curious why you didn't adjust for that in your EPS and your adjusted EBITDA.

Paul Beesley

When we do adjusted EBITDA, the 3.8 million, there's a question around whether it's material, we viewed it was an investment gain. And we were also clear in terms of disclosing it so that if you want to adjust for it, you certainly have the option of doing that. So we were comfortable with how we treated it.

Paul Sobey

And as well when you look at the Crombie release, they repurchased about $100 million of mortgages from a European financial institution at a very, very favourable rate. And they took an approximately 3 million overall charge in the quarter, and our ownership interest of 43 percent was recorded in our operating earnings.

Paul Beesley

Which would have been an offset.

Paul Sobey

Yeah.

Michael Van Aelst

So you would have had a partial offset to that 3.8.

Paul Sobey

Yeah. That's correct.

Michael Van Aelst

All right. Thank you.

Operator

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

Peter Sklar – BMO Capital Markets

Sorry. I'm back on the retail inflation discussion. When you say slightly deflationary in aggregate, I assume that you're including your fuel sales in that description. Can you talk about what retail inflation was like if we just limit it to grocery?

Marc Poulin

It's only–the comment only applies to grocery. On the gas side of things, we are–actually it's very difficult for us to figure out whether it's inflation or deflation because we don't have last year's numbers. As you know, we were not operating those stores at the time.

Peter Sklar

Okay. Just an accounting question. I noticed that your minority interest is highly volatile from quarter to quarter. So this quarter was substantially less than it was in the first quarter. Can you just review again what are the entities that are–where the minority interest is derived from? And could you explain why it's so volatile from quarter to quarter?

Paul Jewer – Chief Financial Officer, Sobeys Inc.

Yes. So certainly at the Sobeys level, the minority interest entities are the variable interest entities or SPEs as they're called under IFRS. Those are franchisees that we had to consolidate in our results. And there's, as you can imagine, some seasonality in that business and in those results. So that's why you will see some variances when you compare one quarter–a different quarter at a different time of the year. If you look at the number on a year-over-year basis, it's actually, this quarter, relatively consistent with what it was a year ago.

Peter Sklar

Right. Okay. And lastly I wanted to ask when you start up your second automated distribution facility this spring, is there a typical ramp period where the launch of the new facilities–where the launch of the new facility is actually hurting you in costs until you get it—the tweaks worked out? Until you get up to a certain level of operations? Or when you launched in Ontario did it proceed pretty smoothly during the launch?

Marc Poulin

Well when we launched in Ontario it did proceed smoothly. That being said, there are costs associated and we're currently experiencing some of those costs. So the automated facility in Terrebonne is currently receiving stock from the suppliers so we're building up the inventory in this warehouse. And as you can imagine, we have employees doing so in the facility but we're still shipping to and receiving to our customers the goods we need to receive and ship for the Christmas season. So there's kind of a double load of work occurring right now.

And as we start fulfilling the customers' orders in January, we will not do all the customer base at once. We actually will have a quite extensive period where we will be adding customers to the Terrebonne facility and removing them from the traditional warehouses that we currently operate. And that process is a process that takes on for a number of weeks and that will occur starting in January of next year. And once that process is completed, well we have warehouses that have stock in them that we will be consolidating into the–consolidating those stocks into the Terrebonne facility so that also carries costs. So yes, in the Q3 and the Q4 period there will be costs associated with doing all of this, and it's part of the business plan, but it's–it would be honest to say that it doesn't go without costs.

Peter Sklar

And it wasn't clear to me in all that time description you offered. When does the facility start shipping out to the stores?

Marc Poulin

The facility will start shipping to a number of stores in January of 2013.

Peter Sklar

And so up until that point, would you not be capitalizing all the costs associated with the activity at the facility?

Marc Poulin

No. Some costs are—associated with the operation are just expense.

Paul Jewer

We expense them, yeah.

Peter Sklar

Okay. Thank you for your comments.

Marc Poulin

Pleasure.

Operator

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

Jim Durran – Barclays

Yeah. I'm just interested in getting a handle on what happened with SG&A in the quarter in the Food Retail business. I assume that part of what went on was related to the Shell piece, but like how much was your SG&A in the core food business actually up? I don't know if you can give us a dollar number or not?

Paul Jewer

I can give you a rough basis points number. So if you exclude the Shell business, SG&A would have been up between 18 and 20 basis points and nothing in particular that we'd highlight there. As we've said before, there's always some ebb and flow between quarters. On a year-to-date basis, SG&A percentage is actually down.

Jim Durran

Okay. And as we all know, the Walmart side of the equation, they were opening up a disproportionate number of stores the latter part of your most recent quarter. Can you give us any indication as to what your experience has been with those store openings in terms of the impact they've had on your stores?

Marc Poulin

The impact of Walmart stores so far has been similar to the impact the Walmart stores that opened in the years prior. We're not seeing anything that's strategically or tactically very different from prior openings. But it is true that there were numerous ones and additional square footage was higher than is usually experienced in a normal quarter.

Jim Durran

And Marc any difference in terms of how they are doing in Quebec versus Ontario from the experience you've had?

Marc Poulin

The experience in Quebec so far has been very dependent on the location of the stores and not–and obviously dependent on where our own stores are located. We're quite pleased with the performance of the IGA Extra stores and how they compete against the Walmart offering. And to be honest, Walmart opening its additional square footage in the marketplace but other competitors do also add square footage to their discount offering in the marketplace, and when that occurs we can see that the IGA Extra offering resonates differently with the consumers than what the discount shopper is looking for and, therefore, we are in a very good position to compete against such an offering.

Jim Durran

Okay. And can you give us some colour on when you'll start supporting Target in terms of shipments?

Marc Poulin

Well once Target starts opening stores.

Jim Durran

Are you going to be providing us with any commentary on what your expectations are on that front? Or are we just going to sort of live with it quarter by quarter?

Marc Poulin

Think we'll live with it by quarter by quarter because we're totally dependent on the customer's role in that one and it's Target's schedule, it's Target's plans, and therefore it's not for us to announce what their plans are.

Jim Durran

Okay. Thanks, Marc.

Marc Poulin

Pleasure.

Operator

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

Keith Howlett – Desjardins Securities

Yes. I wanted to ask on the new FreshCo openings, it sounds like three were new builds. I'm not sure, there are a few locations, perhaps maybe it's London, Ontario, I'm not sure where they are, but can you speak as to whether there'—the size of the store and if there's much change in the format from the original versions you opened?

Marc Poulin

The FreshCo openings in terms of size depends–when it's a fresh, a brand new opening and not a Price Chopper conversion, it tends to be a little bit bigger than the average because in some of the conversion of Price Chopper, we took the space that was there, but when we can build a new prototype it's a little bit bigger than some of the older Price Chopper locations.

In terms of the prototype store, every time you open a new store you examine what works and what doesn't work and we're making minor tweaks to them. So you could argue that it's pretty much along the lines of what we've been opening, but it's more like version 1.7 rather than version 1.2 so there are little enhancements that have been made to the offering, especially on the–we're trying to get our fresh meat to show up better for the consumer, and we've been making lots of effort in this category to–and I have to admit the consumers are responding well to it. We've done some adjustment also in the look and feel of the store in terms of how much product we were putting on over-racking versus–and we've put–we've created a more airy environment for the customers to shop in, put more signage into there.

I think the biggest change in FreshCo though has been in the way we make our price stand out at store level. We've done an advertising campaign this quarter that was signaling to the customers how good our prices are, and we've made special effort at store level to show up our pricing at store level and consumers are responding very well to these efforts.

So overall, we're very pleased with the new prototype. I think we're continuously improving the offering. The execution at store level is getting better and better because employees are really embracing the offering and control the game they're playing a lot better. So it's a business that we're very happy with.

Keith Howlett

And would you–I know some of the FreshCos had pharmacies, I think 'cause they inherited them from the prior Price Chopper, but what's your attitude on pharmacy in new build FreshCos?

Marc Poulin

It's a market-by-market decision so we will put more pharmacies where–obviously you need additional square footage to do so, so we need to–the site must allow for it, but the market must also allow for it. So it's not a given that in any new FreshCo there will be a pharmacy. We're making the decision on a market-by-market basis.

Keith Howlett

And then in terms of the residual Price Choppers, is it pretty much all of them will be eventually be a FreshCo by the end of the, I guess, calendar of 2013 or...

Marc Poulin

Roughly. We're still working on finalizing the plan, at least you could say fiscal 2014. That's clearly the planned calendar, hopefully. That's the objective. We want to–we clearly want to exit the Price Chopper banner as fast as we can. But every site that's left under the Price Chopper has a history to it and obviously these are the cases that are a little bit more complex to resolve that are left under Price Chopper.

Keith Howlett

And then just on the customer, the loyalty program and the customer or data mining plan that's in place, how is the progress there?

Marc Poulin

Well we're very pleased with the partnership we have with Aimia. We're right now–we've done some very successful pilots with some manufacturers that–and we're currently in the process of educating all of our current (phon) management teams on the tool and on the best usage of the data so that when we are ready to roll out full blast on it, everybody will be able to execute properly what's available through the software. So that's the stage we're at and we're still collecting good data at this stage. So it's clearly an area where we will see lots of development and lots of future opportunities for us.

Keith Howlett

And then just finally, in the press release it mentioned that the Company is looking at improving cost structure and productivity. I was wondering, does that refer to any specific sort of initiative underway? Or is it more of a broad statement?

Marc Poulin

It's a series of small initiatives. I mean we have lots of things ongoing, either at store level through the operations. If you're looking for one big project, obviously once the Terrebonne, the DC will be fully operational that will obviously have a significant impact positive on our cost structure as you can imagine. So if you want one big project, I'll volunteer that one. That being said, the SG&A is a constant battle for a grocer and to move the needle on that front you have to work on multiple initiatives. And it's not one silver bullet that gets it done. It's a series of small moves and optimization on the things we're currently doing.

Keith Howlett

Great. Thanks very much.

Operator

Your next question comes from Perry Caicco of CIBC World Markets. Your line is now open.

Perry Caicco

Yeah. Thanks. I just want to chat a bit about gross margins. Your gross margins were up over last year despite a little more intense promotional environment and a bit of a deflationary environment. Just kind of wondering what contributed to that gain in gross margin. Was it mix? Or was it improvements in cost of goods sold?

Marc Poulin

Well, Perry, as we've said, most of the sales growth was coming from increase in basket size, and usually increase in basket size is a result of greater customer loyalty, and greater customer loyalty generally results in better gross margin.

Perry Caicco

Great. And just a general question, Marc. You've got a lot of things going on in the business, but I'm just kind of wondering what you see as the two or three biggest opportunities for you in your new role. And also wondering if there are any specific opportunities for improvements in the purchasing area.

Marc Poulin

I didn't catch the last...

Perry Caicco

Yeah. I…

Marc Poulin

Part of your question.

Perry Caicco

The last part was specific to purchasing.

Marc Poulin

Okay.

Perry Caicco

But in general, I was interested in what you see as the two or three biggest opportunities for you.

Marc Poulin

Well this is, as you can appreciate I'm sure, it's a company with plenty of opportunities, and we're very confident that we have the potential to grow this company profitably for the future. Clearly the full service offering in the Sobeys store, we have good opportunities to develop new programs that will resonate even better with the consumer, and we're currently working very hard at bringing this kind of innovation in their food experience for our customers in the full service.

The FreshCo banner business in Ontario is going very well, and we're very pleased with the results. But we see that this banner resonates very well with the consumer and it keeps resonating every day even more. We're getting more understanding of the uniqueness of FreshCo in the discount environment in Ontario from existing customers, but from new customers as well. So we're very optimistic about the growth prospect for that business.

And generally speaking, across the country we see that we have possibilities to expand the offering we have at store level to greater levels. So that's on the consumer side.

From a cost perspective, we see opportunities, like the investment we've made in our distribution centres still yielding results today and we see, therefore, there are opportunities to get costs down on that front. We have a very good logistics system that we want to build upon. And so that's another element of growth for us in terms of potential outlook.

So overall, this company has lots of opportunities. That being said, we're cognizant that it's a very competitive market right now and we will have to fight for every single customer and we will keep doing so, but it's not a market that you can be complacent.

Perry Caicco

Thanks very much.

Operator

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

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

Jim Durran

Yeah. Just to follow up on the Shell business. If I've got my numbers right, it looks like the percent margin was quite volatile this quarter versus last quarter on the downside. Is that correct? And what was the major driver to that?

Marc Poulin

Well obviously the fuel business is one that's volatile by nature, so obviously the margin continuously changes depending on the condition. That being said, we made some major investments in the Shell business this quarter and continuing–we will continue into Q3 where we are bringing new capital into the stations by changing pumps, and when we do that you have to close stations for a few days. So that has an impact on the litreage coming out of those stations.

We also did significant investment in our–and still doing so in the car wash business of those fuel station and that also created some disruption in the business. So it's kind of–it's a business right now where as we are integrating the Shell business, we are investing into it, and if some of those costs you can capitalize and some of those costs will go into maintenance. So it has an impact on the bottom line as well.

Jim Durran

Okay. Great. Thanks, Marc.

Operator

There are no further questions queued up at this time.

Paul Beesley

Thanks very much, Sarah. Ladies and gentlemen, we appreciate your continued interest in Empire and look forward to having you join us for our Q3 fiscal 2013 conference call to be held on March 12th. Goodbye.

Operator

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

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