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FINAL TRANSCRIPT

Empire Company Limited

Second Quarter 2018 Results Conference Call

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PRESENTATION

Operator

Good morning. My name is Sharon, and I will be your conference Operator today. At this time, I would like to welcome everyone to the Empire Company Limited Second Quarter 2018 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, press the # key. Thank you.

Katie Brine, Director, Investor Relations, you may begin your conference.

Katie Brine — Director, Investor Relations, Empire Company Limited

Thank you, Sharon. Good morning, and thank you for joining us. Our comments today will focus primarily on the financial results of our second quarter ended November 4, 2017. Following our comments, we will then be open to your questions.

This call is being recorded, and the audio recording will be available on the Company's website at www.empireco.ca.

Joining me on the call this morning are Michael Medline, President and Chief Executive Officer; Michael Vels, Chief Financial Officer; Lyne Castonguay, Executive Vice President, Merchandising; Jason Potter, Executive Vice President, Operations; Pierre St-Laurent, Executive Vice President, Quebec; and Rob Adams, Senior Vice President and General Manager of FreshCo.

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Today's discussion includes forward-looking statements. We caution 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 Michael Medline, who will discuss operations. Mike Vels will then provide a review of our financial results.

Michael Medline — President and Chief Executive Officer, Empire Company Limited

Thanks, Katie, and good morning, everyone. I am pleased with the improvements which came through in our Q2 results. We are six months ahead of where I thought we would be when I joined from a results perspective. Empire Company is stabilizing and beginning to turn the corner.

We again achieved positive same-store sales. I thought the comp gains this quarter were a little better than the consolidated total looks. We saw very healthy sales gains in our conventional banners, and I would especially call out sales growth at our Safeway and Ontario Sobeys stores.

This was somewhat offset by weaker comps in Quebec, which is totally understandable, given that they were anniversarying the launch of Mosaik last year.

Overall, we have more confidence in our sales this quarter compared to Q1.

We saw continued slight growth in inflation. Our own internal inflation was 0.7 percent, while CPI food purchased from stores was up by 0.6 percent. So we pretty well held our own in

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overall market share during the quarter, and likely grew market share in conventional grocery outside of Quebec.

Encouragingly, we saw both a slightly positive transaction growth and positive growth in bought basket size. Now I think that's pretty good, as we were all still in the very infancy of our growth initiatives.

In Q2, our store operations continued to improve over last year, and we saw some healthy improvement in supply chain service levels emanating from some initiatives we have undertaken.

We were comping over some soft results last year, as you know, but there has been progress. We did see competitive intensity heat up in certain areas of the country beginning at the end of the quarter. Also we were pleased with our results, given the amount of change we're instituting, especially on our category managers and field operations teams.

The quarter also saw continued strong control over our margins and our costs. Margins were up 90 basis points over last year and normalized SG&A as a percentage of sales improved by 30 basis points. I would be remiss, however, if I did not caution that we are early on in our transformation.

One of the financial analysts who covers us had a great headline on one of his reports last week. The headline was: Empire Company, Moving from Darkness to Early Dawn. I found it amusing, but also accurate.

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We still have a long way to go until we reach high noon here. I want to reiterate that all of our future quarters may not be as strong as this one, and that our inevitable top-line and bottom-line improvement is unlikely to be a straight line.

As I've basically said now for four quarters, this type of company-wide transformation isn't easy and certainly doesn't occur quickly. Over the last year, I think we've done a good job stabilizing the margin. Now we're starting to take out costs.

As I always say, getting at the customer brand piece is going to take the longest time. You have to change customers' perceptions, and that just doesn't happen overnight.

I think we're on the right path to grow our sales, but my experience is that it takes some time. We have put up slightly positive comps the last two quarters, but our goals to grow comps and get back our market share are a heck of a lot more aggressive than that, and that's what we have to generate.

With that prelude, I'll organize my comments once again around our four key priorities. First, reorganizing our organizational structure and our people.

We continue to be right on plan. As of the end of November, almost every employee knows their role going forward with a very small amount of design to be completed in January. More than 800 positions have been reduced since the end of the last calendar year. Over half of people in these roles have already left the Company. The rest will mostly transition out over the next four months.

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This is a significant reduction, but the real improvement will be in our switch from a regional to a functional structure in clearer roles and accountabilities. Decision-making, consistency, and innovation have already improved as we transition.

With this, we are now substantially through the first phase of Project Sunrise, which was resetting our foundation. We continue to work on phase two, unlocking our scale.

Regarding our second priority, we are right on track to take out at least $500 million of costs. We have quickly been able to get Project Sunrise launched and in execution mode.

The first tranche of savings will result from our restructuring. The very initial savings will start to show up in Q3. And Mike will go through this in more detail in his remarks.

Third, our work on our brand, understanding of our customers, and our marketing. As I said earlier, we are seeing some improvements in executing on our brand promise, but still have a ways to go.

I'm pleased to say that the marketing team is starting to get going. We are all here proud of our secret shopper Santa brand spot on television and digital, which was beautifully conceived of and executed by our marketing team, and has been very well received by customers; a real step in the right direction on a long journey to reestablish our emotional connection with our customers.

Now I want to take the most time today talking about our fourth priority, fixing the West. We have seen some improvement in the region resulting from our early efforts. We have experienced immediate improvements in margins and sales improvements.

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Results are, however, still below where they need to be. And our merchandising, marketing, and operations teams still have a great deal of work to return all of our stores to stronger levels of profitability. We are encouraged by the early progress in store execution as Jason Potter and his ops teams are working to toughen up our standards and execution.

On recent store tours we were still seeing too much inconsistency store-to-store that we are addressing and will fix. As we assess our store network, we believe that certain stores will not be able to return to the levels of return that we require, and expect that there will be a limited number of stores that will need to be closed. So much more work to do, but encouraging progress on this important priority.

But when we discuss the West, we also need to talk about our store formats. And since I joined Empire, we have been talking on these calls as to whether we would expand our discount business outside of Ontario.

We have conducted detailed customer and market studies, examined the white space for discount across the country, the performance and areas of improvement available to our FreshCo discount banner, the financial implications, whether such expansion would pose a distraction to us; all to say we've done the work, we owe you an answer, and the answer is yes. We intend to expand our discount offering to Western Canada, and let me unpack that a bit.

When I joined Empire, I was skeptical about whether we should expand FreshCo. As I mentioned on the last quarterly call, I have been won over by the facts and all the work we have

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completed. This is a very attractive, strategic, and financial opportunity for us. It will grow our market share in a profitable way, and the way we're doing this the risk is low.

I also want to underline that in the end, our current mostly conventional stores will be our driving force for top- and bottom-line growth for at least the next five years.

Now the absence of a large discount banner has put us at a structural disadvantage. Discount grocery is the fastest-growing segment of the bricks-and-mortar market. Low-cost formats today comprise about 44 percent of Canadian food retail. Empire is significantly under-indexed in discount. Eighty-seven percent of our stores participate in the conventional sector of grocery.

FreshCo is currently the number six discount banner in Canada by sales. We need to participate to a greater degree in this higher-growth segment, which is important to Canadian grocery shoppers.

We've chosen to expand in Western Canada as a geography for two reasons. First, the market is fertile ground for discount. The current level of intensity of discount in Western Canada is much lower than Central Canada. There is a lot of white space, especially for the size and format of store we have in mind.

Our customer research shows that our small-box format will resonate well with Western consumers. I think most of you know we have excellent store locations in the Western provinces. We just need to better fit our format to the market.

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Second, we have a number of unprofitable Safeway and Sobeys stores located in the markets that are far better suited to a discount store. Over time, some of these stores would close if they are not converted to discount.

We expect to convert up to one-quarter of our 255 Western province Safeway and Sobeys stores. We will do so in an organized measured fashion, starting out slowly and aggressively ramping up.

Our current intention is to convert all of the identified stores within four years of converting our first tranche of Western stores.

We will predominantly convert Safeway stores, although this initiative will also involve some Sobeys stores. The stores will be franchised, just as FreshCo is in Ontario.

This expansion of discount will take a little time to initially roll out. We need to have conversations with affected employees, and we'll need to work with the relevant labour unions. We will also need permitting plans to renovate stores. The banner will roll out under the FreshCo name. And we have learned a lot operating the FreshCo banner over the last few years.

On launch, the Western FreshCos will have evolved branding, product offering, look, feel, and marketing to reflect the learning we have had in Ontario. As well, some locations will reflect the ethnic formula that is working so well in our Ontario FreshCo stores.

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The financial returns for such conversions are extremely strong. We expect the conversions to be slightly dilutive to earnings for the first two years, but accretive after that. The IRRs are strong due to the fact that we are converting our weakest-performing stores to discount.

Let me address the amount of capital this initiative will require. First, we are committed to being tough arbiters of capital allocation. This year we expect to come in at or just below the $350 million that we promised you.

We expect our capital spending to grow in future years as we find better-return projects and look for ways to grow the business. Even with this multiyear commitment to expanding our discount business, we will control our capital spending. At a store level and properly paced, the expansion of discount is a relatively capital-light initiative, given its potential returns.

We expect store conversions to cost on average about $4 million each. When we converted Price Choppers to FreshCo almost eight years ago, each store cost about $2 million. However, in that case we were converting discount stores over to discount stores, and the size of the stores were analogous. We will need to downsize many of the former Western province conventional stores to fit the smaller-sized FreshCo stores.

In addition to the anticipated capital costs, we will also incur employee-related costs as we convert conventional stores to discount. This expansion will not deflect us from our strategic goals to execute Project Sunrise, greatly improve our conventional offer, bolster our brand, and grow our industry-leading market share in e-commerce.

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As we have seen, we have stabilized our business, our results are gradually improving, and Project Sunrise is well underway and on track. The way we are currently structured, expanding FreshCo to Western Canada, will not distract our leaders who are focused on growing our conventional store business.

And Rob Adams, our General Manager of FreshCo, provides us with excellent leadership and experience in discount food retailing. In addition, Rob announced internally this morning that he has brought on Mike Venton to help him grow FreshCo and roll out the conversions.

Rob and Mike worked together at another food retailer. Mike brings strong, very strong operational and merchandising skills, and most recently ran the No Frills banner; obviously, a great additional to a strong team.

I hope you will understand that we don’t want to discuss further where we will convert our first stores, the exact timing, the pace of rollout, or the changes that we will be making to execute our Western FreshCo format. We do anticipate some reaction to our move by competitors, so we don’t want to give them all the details on our plan to take some of their market share.

So to summarize, another quarter and another step along our journey to put real numbers up on the board here at Empire.

And with that, over to Mike.

Mike Vels — Chief Financial Officer, Empire Company Limited

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Thank you, Michael. Good morning, everyone. As previously mentioned, our same-store sales for the quarter, excluding the impact of fuel, increased by 0.4 percent from the same period last year. Excluding our Quebec results, sales from conventional banners showed healthy growth, higher than the consolidated increase of 0.4 percent.

Our gross margin of 24.5 percent improved by 90 basis points over the same period in the prior year as a result of improved store execution and promotional strategies, and a continuous focus on stabilizing and improving our margin rates. Our focus remains on maintaining stable margins within an acceptable range, which is reflected in our positive margin rate and total returns compared with last year.

We will continue to be disciplined on pricing while ensuring that we remain responsive to the market.

Selling and administrative expenses as a percent of sales was 24.9 percent for the quarter. However, if we exclude the onetime Project Sunrise expenses from SG&A, this reduces the amount to 22.6 percent, a small improvement over last year.

We did experience some modest benefits from Sunrise cost reductions this quarter, but the more significant positive effects will be reflected beginning in the third quarter.

Due to the improved results year to date, we have recorded an increase in incentive compensation costs that largely offset the modest positive effect of the Sunrise benefits that arose in the second quarter.

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In June, the Company estimated that it would incur approximately $200 million in onetime cash costs associated with severance, re-location, consulting, and minor systems developments. As the initiative has progressed to conclusion, we have finalized our estimate of onetime costs, and expect at this time that onetime costs for the initiative will not exceed $240 million. The remainder of these costs will be booked in the second half of the year.

I do, however, want to note that this amount does not include any possible changes to office facilities and any related closure or sale of redundant real estate related to the reorganization. We are considering whether it makes sense to rationalize our back office facilities, but no decisions have been taken at this time. Should we decide to adjust our office space, noncash charges related to property write-downs or non-productive leases may be required, but the overall impact on cash earnings would be neutral or slightly positive.

I would like to make some brief comments on our real estate operations. During the quarter, Crombie REIT contributed quarterly earnings to Empire of $8.9 million, broadly consistent with last year. The Genstar Partnerships contributed $6.5 million compared to $13.6 million last year. The decrease is primarily due to a sale of development land by Genstar in the prior year.

As noted previously, these partnerships have been very successful for Empire and are expected to wind down over the next several years.

The effective income tax rate for the quarter of 31.3 percent is higher than our estimate for the full year of 26 to 28 percent. The increase over both our estimate and the prior year's

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quarter is primarily due to the significant expenses related to Project Sunrise that impacted the mix of earnings between legal entities and tax jurisdictions, resulting in a higher average effective tax rate.

Excluding the effect of these Sunrise expenses on the average rate, the effective income tax rate for the quarter would have been 27.4 percent, consistent with our estimate of 26 to 28 percent.

Free cash flow generated for the quarter was $117.4 million, an increase of about $99 million from last year, which was primarily due to lower capital investments, as we've intentionally reduced our investments this year as we work to improve our capital allocation processes.

At the end of the quarter, our funded debt to total capital ratio improved to 33.1 percent due to lower debt balances. The Company's credit metrics and financial profile continue to improve due to stronger operating performance and stable financial leverage.

We continue to focus on our balance sheet and cash flows, as well as our top line and cost base, with an expectation that we will re-establish the Company's investment-grade credit rating over time.

Project Sunrise, as Michael said, is on track and we continue to anticipate that the transformation will yield at least $500 million in cost reductions on an annualized basis by the end of fiscal 2020. The organizational change from a regional to a national structure is virtually

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complete, as with our recent announcements most of our employees know their roles going forward.

System parameters and data harmonization necessary to enable consistent reporting continues to progress to plan.

We're beginning to leverage our purchasing scale and build a national indirect sourcing function. We recently completed RFPs for significant volumes of store supplies on a national basis and are encouraged by the early results, and expect benefits from these and other purchasing initiatives to be reflected in our results in the second half and into fiscal 2019.

The work on store operations, labour standards, and other operational processes is progressing well, and is a significant element of our efforts to offset the minimum wage increases.

I would note that although, as Michael said, we have now completed our organizational designs and many employees have left the business, we are transitioning a significant number of employees over the next six months as we enable an orderly hand over of processes and work. As a result, we experienced modest improvements in cost this quarter, but will experience the remainder of the organizational cost savings through the rest of the year as our employees transition.

Our estimates of cost reductions to this point are on plan, and we expect that the organizational design initiatives will meet or exceed our expectations.

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Our three-year plan, as we said before, can be divided into three buckets. The first, organizational redesign, as I said, is complete and our savings will mostly be at expected run rates by the end of fiscal 2018. But more importantly, our new leaders and teams are now in place and ready to execute on the next two phases and the remainder of our strategic plans.

The second bucket, operational benefits, including indirect sourcing, replenishment improvements, operations cost reduction, and process improvement, are all in process and beginning to yield solid improvements. And we expect the benefits of these actions to begin to accrue and compound through the rest of this year into fiscal 2019, reaching close to run rate estimates by the end of fiscal 2019.

The third and largest bucket is cost of goods sold. We've benchmarked against our competitors and we pay a premium on our costs, mostly because we've not used our scale and don't have the systems in place to track our all-in supply cost and performance. This is the largest bucket, the one that'll take the longest to recognize.

Our current structure, systems, and processes are not good enough yet, and have caused confusion between us and our supplier partners. We have simplified our structure, we've centralized our merchandising, and by extension our procurement, and we are now changing how we collaborate with our partners while leveraging our national scale. We'll consolidate current pricing structures in our systems and align with our partner systems, which will give us the basis for negotiation and transparency on our cost of goods sold.

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This is a very significant amount of work. We've allowed for two years of significant discussion with our partners while making the necessary improvements in our systems. Although we can expect some early wins, the majority of savings will be seen in the third year of Project Sunrise.

I'd make a few brief points on minimum wage and health care reform. On November 22nd, Ontario passed the Fair Workplaces, Better Jobs Act, 2017, otherwise known as Bill 148. As noted last quarter, we estimated the unmitigated financial impact of the minimum wage increases in Ontario and Alberta could be up to $25 million in fiscal 2018 and $70 million in fiscal 2019.

These estimates represented only the wage increase for people in the business earning less than the anticipated new wage rates and did not assume any changes in the compensation of other wage bands. As we review Bill 148, other potential impacts, including wage parity, could increase the potential impact by up to $20 million in fiscal 2019. We are developing plans to mitigate the immediate impact of the minimum wage and Bill 148 increases, and we do expect that these plans will offset the effective increases in fiscal 2018.

We continue to work on further plans to mitigate the full year impacts for fiscal 2019, but there is some risk that we may not be able to fully offset the effects on earnings, considering the short transition period of the cost increases.

Regarding health reform, we expect continued health care reform to put additional pressure on the pharmacy reimbursement model, which will impact pharmacy results across the industry. The exact impact and timing are not clear at this time.

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Our pharmacy business is a relatively small component of our overall operations and not as large as our major competitors. We continue to monitor developments in the industry.

In summary, although we are very satisfied with our progress and momentum that our teams have on our transformation initiatives, in the next two quarters we will be progressing through a very intense period of transition.

We consider this to be the riskiest time period of our transformation, and we are very focused on ensuring that we maintain control and execute flawlessly. However, these transitions involve significant disruptions for our merchants, including delivery of new processes and systems to help them execute on a national basis. As such, although we plan to execute well, our progress through the next few months could result in some volatility to our costs or impacts on our margins or sales.

Thank you, and we'd be 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 Michael Van Aelst from TD Securities. Your line is open.

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Michael Van Aelst — TD Securities

Hi. Thank you. So first question has to do with the top line, actually. The cost performance has been very strong. We can see the margins recovering, and it seems like you're well-structured on Project Sunrise to get those savings. But on the top line you're expressing confidence that you're going to gain back some market share, but can you give us a little bit more comfort as to how you expect to get there? Is the FreshCo rollout the key trigger for that? Or what can you tell us on the conventional side as well?

Michael Medline

Hey, Michael, it's Michael. Thanks for the question. No, FreshCo is not the key trigger in terms of our plans over the next number of years to grow our comps. And by the way, I didn't think we'd be where we are with two positive comps a little while ago. I think sometimes when you're coming off soft prior years, people think that that's an easy one to comp. In fact, my experience is it's always easier to comp when you got momentum. And we got a little bit of wind in our sails right now, but not quite enough for what we need.

I'd say that there's two main ways that we'll see same-store sales grow the way we want to, which is more than 0.4, 0.5 percent. And I'll exclude inflation from this. Inflation will be what inflation will be. First is blocking and tackling. Okay? And this Company has not been as strong at the basic retails as we would like. And I'd say that the first 11 months I've been here that we've been putting almost all our efforts on that basic retailing blocking and tackling, and we have seen

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improvement, and I think that improvement's showing up in positive same-store sales. And that can be anywhere from our service levels, which I pointed out on our script are much increased, materially increased, especially in Ontario over the last year. That can mean consistency in the store that I mentioned, and in terms of having the products people need and having them on the shelf and mainly the basics that we need to have.

So blocking, tackling, getting the basics right, that is so important, and will be the main driver of our improvements over the next year or two.

And then those who know me know I'm going to talk about the emotional connection to the customer, which we were missing. We have to have a compelling reason to visit our stores. And I'm starting to see the makings of that strategy and the beginnings of it. But that takes a long time.

I'll tell you, it's a lot easier to turn away customers than it is to win them back. And that's why I'm actually more optimistic than ever that we're on the right track because some of the basics are coming through and we're winning them back, and we got positive sales, positive comp store sales. But in many areas, especially the area I'm most concerned about, which is the West, we're gaining market share. And that is through just hard work and a lot of detail and a lot of plans. And I got to tell you the Sunrise work, which is making us look at our business in a whole new way, in a far more detailed manner, is helping as well.

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But I don't believe in Hail Mary's in retail. We will increase our sales. We will gain back market share. But it takes a while to get those customers back and for them to trust us. And that is a lot of different things coming together.

Michael Van Aelst

All right. Thank you. And on the FreshCo rollout, you mentioned that the way you're bringing it to market is low risk. Can you explain what you mean by that?

Michael Medline

Yeah. I think that the … what I meant by that is in terms of the pace of the rollout and the fact that we are not green fielding any of the sites; that they are conversion sites. And we do a lot of, as you can imagine from some of our past experiences, we do a lot of work on risk and being able to model risk and look at different scenarios, and we have chosen a way to expand and serve our customers and grow our market share in a very balanced manner.

The other thing is we do not want to—we want to have our capital very tightly allocated, and the way we're going to do this over the next five years allows us to do that. So a quarter of stores is a lot, but it's over a longer period of time where we can also have some learnings.

We're also putting in place, as I said on the script, we had a lot of learnings in Ontario. The biggest learning is from my perspective when you're in retail, you got to go for it. You got to play to win. You got to play your own game. And I think we have not allowed Rob to be as aggressive and fight a discount fight as aggressively as we can.

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So as we get out there, Rob's gloves are off. And he's bringing on some more talent to add to a very talented team in the form of Mike Venton.

Mike, did you have anything more to add?

Michael Van Aelst

All right. Thank you.

Michael Medline

Okay.

Michael Van Aelst

And just a short follow-up. You didn't talk about employee-related costs for the conversions, but have you had any initial discussion with the unions on this? And what's the initial feedback?

Michael Medline

Yeah. Of course, we are always in discussions with our unions. I think you can imagine what the feedback is like. This will be a bit of a discussion. And we're currently at different stages of talking to the unions in different Western provinces.

This is the way to go, especially for our employees in these stores, to make sure that these stores are viable, running, and profitable for all of us. So at the end of the day, we'll get there because I know that our employees and our unions will be reasonable in that way.

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But we've got a lot more talking to do. And communications started in earnest this morning, and will continue.

Michael Van Aelst

All right. Thank you very much.

Operator

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

Vishal Shreedhar — National Bank

Hi. Thanks for taking my questions. Just taking a couple steps back on the competitive landscape, you noted that it's heating up a little bit. And even in this competitive landscape, which has lasted for quite some time in Ontario particularly, I see independents popping up; quite a few of them; many of them with ethnic kind of slants to them. And they seem very competitive on price. They seem to have very unique offers. And just wondering why that's the case in this competitive environment? And why the grocers with such scale seem to be allowing this white space? Is it the offer? Is it pricing? Maybe any perspective you can offer?

Michael Medline

Yeah. I mean we've been doing real well in Ontario since I've joined, actually, and especially in this last quarter. And you're always going to have people popping up and competing, and good competition's good.

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We are good at FreshCo in terms of our ethnic offering. I'd say that in the rest of the Company, we can do much better. And I think the reason that competitors pop up is because there's a need by customers. And if you're not filling that need, there's going to be competition. So we've got to get better at our own game. We've got plans to do that.

But I think it's a good point. And I've been touring some of these stores especially in Ontario lately and taking a look at them, and they're doing a good job. And there's no reason we can't do a better job. And I think that a lot of the learnings from FreshCo can be taken to our other banners.

I'd also like to point out that IGA does a good job as well in a lot of their stores.

Vishal Shreedhar

Okay. Thanks for that colour. And maybe you can offer some more perspective on these layoffs or job reductions. Obviously, you've been talking about them for some time, but it's a pretty significant number. Empire has had some challenges with employee hand-off in the past. Do you think we're in a period of probably more risk as these hand-offs happen? And if not, what have you done to mitigate that?

Mike Vels

It's Mike here. So as I mentioned in my remarks, you are correct. As any company transitions and restructures in the way that we have, there's a need for a great deal of focus to be

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placed on the transition and ensuring that new employees in new jobs have the tools and the training and the capabilities to be successful.

And you're also correct that many companies at this point, having going through the heavy lifting of working through their new designs, selecting employees, really fail to put and redouble their efforts on the transition efforts and making sure that they manage the risk.

So Michael and I have both been through processes like this. Our teams identified this as the largest risk that our business would have is working through the transition period right after we reorganize the Company. So we absolutely agree and would see this as one of the sort of heaviest lifting periods, if you want to call it that, for our organization.

Having said that, we've planned for it. We have a very long transition from merchandisers. We have some extremely strong training in transition and hand-over plans. We are being aided in that by some very able external consulting help. And we have the plans in place to execute successfully. But as you correctly pointed out, we need to do that, and that's our plan over the next six months.

Vishal Shreedhar

Okay. And maybe just one quick one here; in terms of goods not for resale and traditional COGs for resale, the way that those savings come in over the next few years, do you anticipate the goods not for resale to come in quicker than the other negotiations? Or is it about the same cadence?

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Mike Vels

No. As we've said, the indirect sourcing is anticipated to start bearing fruit as we move through the rest of 2018. We have an RFP out initially for store supplies, which we're encouraged by. 2019 I think is when that will really begin to find some momentum. And then the non-indirect benefits, like cost of goods sold, we anticipate they'll be towards the end.

So that's correct. We expect the indirect sourcing to be sort of in the middle period of the three-year plan.

Vishal Shreedhar

Thanks for your colour, guys.

Michael Medline

Thanks, Vishal.

Operator

Your next question comes from Mark Petrie from CIBC. Your line is open.

Mark Petrie — CIBC

Hey. Good morning. With regards to the gross margin performance in the quarter, could you just provide some more detail about the relative magnitude of the factors you've outlined? And then I guess related to that, how comfortable are you with your relative price position today? And are there regions where you think it might be more likely that you need to invest?

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Mike Vels

So in terms of margin improvement, Mark, the Sunrise benefits are mostly reflected at this stage in our SG&A because it's organizational change. A little bit of operational improvements as well would be a very small element of some of that margin increase.

But as we've said, the primarily reason for our margin improvements are the stability—the expectation of stable margins, and the expectation of disciplined pricing that Michael identified, I suspect, in his first week on the job here. And it's something that we've been very, very focused on ever since. And that's probably one of the most significant and material impacts of the margin improvement, is just getting some discipline back into our pricing.

In terms of where we are positioned in the market, Michael, do you want to make a comment to that?

Michael Medline

Yeah. I mean, I don't think it's changed since … in the last nine months or whatever. About 18 months ago, as you know, Mark, we realigned our pricing to be far more competitive. And there's been some fine tuning of that to make us even more competitive since then. But generally across the country—and I'm not going to talk SKU by SKU because you can't do that—but generally we are in good shape from a conventional grocer's point of view in terms of pricing.

We are always looking to make sure that we're competitive, and we will be competitive in pricing across all regions of the country, and so that's not an issue to a great extent. I think that

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there is some perception out there even that we're more expensive than we are. When we look at perception versus actual, it's a much better deal to shop at Sobeys, Safeway, and IGA than even people know from the work we do. And it takes a while to change that perception, as I said.

At the same time, price of entry into a business is value proposition, being able to woo your customers, and make them excited about shopping. That's where the big prize is. But I think we're going to watch pricing. We're starting to see some inflations. We'll watch that. And we'll be competitive.

Mark Petrie

Okay. Thanks. And then just following up, with regards to your comments around competitive intensity, is that focused or is that more intense in any particular region? And you seeing that more on the promotional side? Or in incremental square footage coming into the market?

Michael Medline

No, we're not seeing it on the incremental square footage right now. It's on the promotional side. And I'd say—I'll give you a little bit of colour—I thought it heated up in the West and it heated up a little bit on the East Coast.

Mark Petrie

Okay. Thanks. And then just, sorry, last follow-up was just with regards to your comments about the approach for FreshCo into Western Canada and maybe didn't feeling like you didn't go for

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it enough in Ontario. Was that just a comment about sort of the approach out of the gate with FreshCo with regards to its launch? Or about your positioning over the last year or so?

Michael Medline

I think it's mostly on the launch that when you go and you open new stores, you don't go with—you go with everything you got to build market share. And I'm not just talking price. I'm talking with the whole value proposition of what you mean to consumers. And I would say that that's most of it, but I would also say that there's things right now even in Ontario that we're looking at to be more competitive and that we can do a better job in serving Ontario families.

Mark Petrie

Okay. I appreciate that. Thank you.

Michael Medline

Thanks.

Operator

Your next question comes from Irene Nattel from RBC Capital Markets. Your line is open.

Irene Nattel — RBC Capital Markets

Good morning, everyone. Guys, you've mentioned a couple of times sort of this notion of stable margins. So we should we look at the current gross margin rate and think that this should be more or less the rate on a go-forward basis?

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Mike Vels

It depends how you define go-forward, Irene. Certainly as we start to get traction on our top line, there's always leverage related to that. We are reducing our operational costs, so we anticipate to see some improvement on that front. And certainly as we move into the last elements of Sunrise, which is the cost of goods sold reductions, we expect that margin to widen.

So in the short term, I'd probably say fairly consistent, but we have ambitions to widen that margin through both the impact of our top-line improvements and our cost of goods sold reductions.

Michael Medline

And the only thing I would add to that is in grocery you've also got to watch quarters that some quarters are higher margin than other quarters and higher sales. So Q2 is a big sale. The one we're just was a big sales, usually a pretty good bottom-line quarter, whereas Q3 historically if you look back years and years, is a smaller quarter. So that would be the only thing I'd add to that.

Irene Nattel

Yeah. That's very helpful. Thank you. And yes, I did mean kind of, sort of the underlying growth rate. I want to talk a little bit, if we can, just about what's going on in Quebec, which historically has been a real sort of stronghold for Sobeys for the IGA brand. Can you talk about the competitive dynamics in the province? And also seems to me that there's been a step-up in

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marketing spend, but with messaging that's less focused on pricing and more focused on inside store proposition and what you guys are offering. Can you speak to that as well, please?

Michael Medline

Yeah. I'm going to talk, and then I'll turn it over to Pierre because you should hear from Pierre because he's a great leader in Quebec. First of all, IGA is a stronghold and continues to be a stronghold. And I'm sure they didn't take it very nicely that I threw them a little bit under the bus in Q2 because they were anniversarying against Mosaik because they're very proud of the business we've built up there.

I'd say in terms of competitive intensity that we are so strong in conventional there and we're up against a lot of discount and that we're more than holding our own there. And that Quebec is so far ahead of almost every grocer —our IGA is so far ahead of almost any grocer in the country in terms of emotional connection to its customers.

As I've always said, we do more work than anyone else on that, and they are starting from a point that is further along than anyone else in the country. And that allows them to do different things that Pierre will talk about in a second in terms of really be able to have an emotional connection with a customer.

At the same time, I think we're actually seeing a little bit of lessening, a tiny bit of lessening, as some of our competitors are closing stores in some key markets, and we plan on gobbling up any market share that's out there.

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So I think, over the last quarter, Pierre, it's fair to say just in a little way that it's always competitive, but intensity with a few closures that are coming was nice news for you.

Pierre St-Laurent — Executive Vice President, Quebec, Empire Company Limited

Yeah. You're totally right. We're back on what we're really good. So we're promoting more the overall value in our proposition. And we have so much to promote in terms of service, variety, and we try to thrill customer with the overall value, not only price.

Our prices are quite fair. We did a major improvement in the past two years on the pricing on regular prices, but our real strength is the overall proposition; the involvement of our dealer in their community. So all of these emotional connections, variety, local product, it's what we promote actually to gain the heart of customers.

Irene Nattel

That's very helpful. Thank you.

Operator

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

Kenric Tyghe — Raymond James

Good morning. Michael, a two-part question on FreshCo; one would be just with respect to the identified stores could you give us just some indication on average square footage? And the second part would be has the FreshCo expansion given you any reason to rethink your approach to loyalty or perhaps a revisiting of loyalty and loyalty in discount on a go-forward basis? Or is this just

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a little too early? And am I getting ahead of myself there sort of revisiting the loyalty discussion at this juncture?

Michael Medline

Yeah. The stores will be approximately the same size as the stores in Ontario. And you're probably not getting ahead of yourself because we're always thinking of all these topics ourselves, but right now we're just fine with our loyalty program.

Kenric Tyghe

Great. Thank you. And then if I could just follow up a further one on gross margin. Could you sort of speak to your share performance in fresh and perhaps your share and shrink performance in fresh as it relates to your gross margin performance? Or any other colour you can provide on your performance in fresh in the most recent quarter? Or perhaps how it's been trending more broadly, if not speaking to the most recent quarter?

Mike Vels

I think I'd colour our entire business with the comments we've made so far, which is we're satisfied with the improved discipline and the promotional activity that all of our merchants have since we have been monitoring it very carefully. So we're comfortable with our fresh and grocery business at this point.

Kenric Tyghe

Great. Thanks very much. I'll leave it there.

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Operator

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

Patricia Baker — Scotiabank

Good morning. I've got three questions. First of all, Michael and Mike, and I really appreciate that you're both calling out a lot of caution with respect to when we're heading into the third quarter and the next few months as you transition to the new team and everybody has new responsibilities, et cetera, et cetera, and certainly understand that this is a very high-risk period. But in many respects, given the real important strategy that you first laid out there, Michael, to turn around the Company is a critical piece of getting the profitability at Sobeys where it needs to be is, in fact, having that reduced structure. So in many respects, this particular next few-month period really sees the two of you really being measured on the strategy and what you can execute here.

And I'm just wondering when I think about that and look at that, is it fair to think that you will do everything you can which could involve putting in more people, more hours, or spending a few more dollars if, in fact, it looks like this transition will impact anything at the store level or anything that will impact the customer? And that's where we might see a little bit of a risk in where the profitability will lie in the next quarter?

Mike Vels

It's Mike here, Patricia. Thanks. I think you covered a lot of ground in that question, but I think in terms of the first part is where do we think the risk might be, it's really new people in new

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roles. And making sure that people are covering the entire country now have a really solid and enough understanding of how they're pricing and what they need to do in each of the categories.

In terms of store experience, we've actually had some net-net improvements, I think, because our replenishment is better. We're seeing better service levels. Jason Potter and his team are bringing some consistency to our operations. So on balance, I actually think it's been a marginal net positive for our stores.

Over the next period of time—to answer the second part of your question—if we saw a necessity to add resources or to spend money to make sure that we weren't impacting customer experiences, of course we would do that. We don't anticipate anything at this point, but to your point, we would not hesitate to add some short-term cost to make sure that we continue to preserve our momentum, and make sure that we had good in-store experiences.

Patricia Baker

And, Mike, is it fair to say that you, Michael, and Jason are on massive high alert to look out for any issues that people who are now covering the entire country versus what they were doing before or people in new roles to try and do—to really be on high alert to make sure that the execution is as good as it could possibly be?

Mike Vels

Yeah. Actually the person that I would add to that would be Lyne as well.

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Patricia Baker

Right. Sorry.

Mike Vels

Yeah. We're all on high alert, I guess would be the short question, the entire executive committee. We probably dream about the stuff at night. But yeah, the merchandising group is going through a materially change. At the same time, the operations group has been adjusted, and their new operational roles have actually resulted in a better store coverage. So we, in fact, have more DOs and local people in market managing less stores than they used to before so they can give them more focus, which was an important element of improving our store performance and our store consistency.

So yeah, we're all on high alert. I'd say merchandising at this stage would be the one that we're watching the most carefully.

Patricia Baker

Okay. Fair enough. And then my other two questions. First of all, Michael, you referred to the fact that you are taking a very good look at the fleet and there will be store closures. Some of the stores that are not profitable will be converted over time to the FreshCo. But when it comes to the store closures, two things; if I understand you correctly, that's not confined only to the West? And then secondly, at what point in the next coming quarters will you be able to share with us how many store closures? Or will it just occur when it occurs?

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Michael Medline

Yeah. I think it'll occur when it occurs. And every retailer's looking at store closures here, right? You're always looking at whether you have a store that's not going to be as profitable and it's better to not have it.

But I would say that in this case what we're talking about is predominantly in the West, in the Western provinces. And I want to also underline again the word limited.

Patricia Baker

Okay.

Michael Medline

And please don't ask me to define limited. But it's a limited number of stores to make us stronger.

Patricia Baker

No, fair enough. And then I'm not surprised to have you in your remarks discuss the fact that there still seems to be this stubborn gap between where your pricing is and the perception on the part of the consumer, and this does take time. But would I be right in assuming that that's one of the big mandates for your new sort of—the marketing effort and the new marketing under Deirdre Horgan that trying to close that gap will be a priority?

Michael Medline

Absolutely.

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Patricia Baker

Okay. Thanks a lot, Michael.

Michael Medline

Thank you. Thanks, Patricia.

Operator

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

Jim Durran — Barclays

Morning. I just wanted to go back to the changes on merchandise and the IT support. At what point in time do you feel that the merchants will be able to come into the office in the morning and be working with the go-forward IT platform?

Lyne Castonguay — Executive Vice President, Merchandising, Sobeys Inc.

Good morning. This is Lyne. I would say we're working on a short-term solution and perhaps also a longer-term solution because we want to have best-in-class tools for our merchants. And so I think in the last call we talked about the fact that we are going to have a staircase approach to this.

Shorter term it'll be the merchants will come in and they'll have perhaps more systems than they should and more tools than they should because we're still working on the consolidation. And then we will actually then facilitate it through different tools with IT, and we're working extremely close with IT to get to what will be a shorter-term solution when we transition in the next

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six months. And then after that, we'll be working on long-term solutions for our merchants to get the best-in-class tools.

Jim Durran

And with respect to the actual team, like how much of it is now in place?

Lyne Castonguay

So we have from a category management perspective we have announced all of our new merchants as of the end of November. We are working right now on a very, very stringent training and transition plan, which will take the next about three months to ensure that we are training them on banners, different regions that they may be picking up, and the new categories.

The team is working very hard. And I'm very proud of the training program that they've put forth. I think Mike touched on it a little bit earlier. But we are making sure that we're touching every aspect of the business to provide them with the right tools. And we didn't shorten our time on this.

We made sure that they were trained well.

Jim Durran

From a regional-local market standpoint, how are you making sure that you're still tailoring the offering to the local market?

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Lyne Castonguay

Yeah. So we're approaching it two different ways. The first one is from a merchandising perspective. We've put in place what we call a field merchandising team, and they're aligned with Jason's team in operations. And so we're making sure that they're staying close to the local markets, local events, and so that's their primary focus. And so they're the liaison between operations and merchandising to ensure we stay local.

The second one is we've also announced in marketing a field marketing team. And they're also going to be aligning with the operations team and the merchandising team to ensure that we cater to local events, local sponsorships, et cetera, local marketing.

So I think we're covering that very, very well. I'm very excited of the fact that we've put this together in our restructure.

Jim Durran

And are those teams located in Mississauga? Or are they across the country?

Lyne Castonguay

They're across the country. And it was very important for us to have some folks locally aligned with our local operators so that they know and live in the market, and they know what's going on in the market.

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Jim Durran

Great. Thank you. Just wanted to talk about branding and digital strategy. You've got an e-comm platform in Quebec. Metro's obviously now rolled out their program to I think it's about seven stores now, which they're saying is going to reach about 60 percent of the Quebec population. Is your e-comm business in Quebec still growing at a good pace? Have you noticed any effect by Metro's home delivery availability now? And then second part of the question is, any colour you might be able to provide us on what your thinking is about e-comm for the total store network across Canada in terms of availability of e-comm offering outside of Quebec and the potential timing of that?

Michael Medline

Hey, Jim, it's Michael. A question close to my heart. We are still growing very aggressively our sales at e-comm in Quebec. So far we haven't noticed any change in that from any competitor. And so that's the answer in Quebec.

In the rest of the country, as you can imagine, we've been relatively busy working on stabilized margins, getting our brand going, Sunrise, turning around our conventional banners and FreshCo expansion. However, one of the most important things that we'll now be working on is an e-commerce strategy to win the day. And I think you know how important I believe that is. We are in the throes of working on that right now, and we believe in delivery to home.

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And we have a good head start in learning from our Quebec, but we have a long way to go to have an innovative great solution so that we can win the day and battle Amazon.

Jim Durran

That's great. Thank you. Appreciate it.

Operator

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

Peter Sklar — BMO Capital Markets

Thanks. So a question on FreshCo; like my sense from the comments you're making this quarter, Michael, and previous quarters, that while FreshCo is profitable, it's not generating the returns it should in Ontario. And if so, if you agree with that statement, can you talk about what are the kinks that need to be worked out, whether it's price perception and otherwise? Because I would think you really want the banner humming before you roll it out to the West.

Michael Medline

Yeah. That's right. And I'm happy with FreshCo, as I said, over I think every quarter in terms of their performance. I do think, though, that we could be growing quicker and taking more market share and have a better perception among our customers. And I think it's clear and I think you understand that our pricing is excellent at FreshCo. And I don't think we get, actually, the credit we should get; I don't. So we have debates over whether some of that's because we were later to

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the game; whether the name or the way we market ourselves isn't correct; or where there other ways to do things.

And I don't think I'm giving away the farm, Rob, to say that we will be, as we are planning on rolling out the first FreshCos in the West over next year, that we will and already are experimenting with different things in Ontario to be sharper. But we have an opportunity here to start again in a market and get it completely right.

So I think FreshCo is great. I think the returns are fine, but they're not as strong as we would like, and we have had a lot of learning. And that having stores opening up and trying things in the West will help us learn in Ontario, but we are trying things right now and thinking about it. But we have a few months to go before we need to make final determination on every single thing.

Peter Sklar

And, Rob, are you satisfied?

Rob Adams — Senior Vice President and General Manager, FreshCo, Sobeys Inc.

Yeah. I think it's just natural. We've been in the market for seven years plus. Every brand evolves, and we do see opportunity to get stronger and better and resonate with our customers. So the decision to expand out West is just a natural time for us to reflect and make sure that we do get better with what we launch out there for our customers, so it's great timing for us.

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Peter Sklar

Okay. And, Michael Vels, I have a question for you. The $129 million charge during the quarter, is that apples-to-apples comparable to the $240 million you were talking about? Because the $240 million is a cash charge, and I thought there might be some component of the $129 million that are noncash charges. So just wondering how we can look at this apple-to-apples?

Mike Vels

No, it's very consistent; totally apples-to-apples. You need to take the amounts that we charged in the fourth quarter of last year—these two first quarters—and those are all cash charges, and they're all very consistent with the $200 million original estimate. What we've said this quarter is as we look towards getting to the end of our restructuring and our organizational redesign and the related costs of that, we still have a short transition period to go through, but we don't believe that those costs will exceed $240 million.

Peter Sklar

Okay. So the $129 million, then, is a pretty big number. Can you talk about what is in there? Is it largely severance?

Mike Vels

Sure. Okay. So you're wondering why so much this quarter. As we mentioned, we let everybody know down to the lower levels of our organization, with the exception of some very small groups—real estate and marketing which have still got a little bit of design left—but we let

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everybody know towards the end of the quarter and just after the quarter what their new jobs were. So everybody has their jobs, and we knew at that point with certainty the majority of people who would be leaving our organization.

And we took the charge related to the severances for those people in our second quarter, and that's why the amount is so large. The actual cash payments—and maybe this is what you're getting at—that'll be disbursed related to that provision will be made over the severance period for those employees.

Peter Sklar

Okay. And are there any other significant charges in the $129 million other than the severance?

Mike Vels

Yes. Our consulting charges, which we've, as you know, we've been using external consultants to help us work through the organizational redesign, so their fees would be in there as well.

Peter Sklar

Okay. Thank you.

Operator

Your last question comes from Keith Howlett from Desjardins Securities. Your line is open.

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Keith Howlett — Desjardins Securities

Oh, yes. Thanks very much. I was wondering if any of your pharmacy operations across Canada are using private-label generic drugs?

Michael Medline

Yes.

Keith Howlett

And would that be in Lawtons in the Maritimes? Or Safeway? Or across the country?

Michael Medline

Across the whole country.

Keith Howlett

Across the country. Thank you. And then just on the e-commerce strategy, how does the Thrifty's e-commerce business do, say, relative to the iga.net, which has been going for many, many years?

Michael Medline

It would be analogous in terms of its growth. It's obviously a much smaller market and a much smaller banner, but the reason we don't talk about Thrifty's, just smaller, but we're very proud of that e-commerce offering. And it's been going for a long time, and it has some really unique properties that we'll be building on.

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Keith Howlett

And then just finally, without discussing things that you're probably not ready to discuss, how are you thinking about the banners in Western Canada where you have Thrifty's and Safeway and IGA and Sobeys and you'll be introducing FreshCo, do you have sort of some long-term idea of where your banner strategy would end up?

Michael Medline

Yeah. It's a good comment. But I mean I think the last thing we want to do right now as we're turning the corner is to mess around with banners and dislocate customers, and have to put a lot of expense and effort into that. And each of them does resonate differently with different customers.

There is a great similarity in terms of the customers in the value proposition and brand proposition going forward between Safeway and Sobeys. Thrifty's is different. But I don't think you should anticipate us consolidating banners. That's just not on the radar right now.

Keith Howlett

Great. Thank you very much.

Michael Medline

Thank you. Thanks very much.

Operator

At this time, I will turn the call over to the presenters.

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Katie Brine

Thank you, Sharon. Ladies and gentlemen, we appreciate your continued interest in Empire. If there are any unanswered questions, please contact me by phone or e-mail.

We look forward to having you join us for our third quarter fiscal 2018 conference call on March 14th. Goodbye.

Operator

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

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