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PRESENTATION

Operator

Good morning. My name is Sharon, and I will be conference Operator today. At this time, I would like to welcome everyone to the Empire Company Limited Third 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 of Investor Relations, you may begin your conference.

Katie Brine — Director of Investor Relations, Empire Company Limited

Thank you, Sharon. Good morning, and thank you all for joining us on our third quarter conference call. We will provide some short summary comments on our results, and leave as much time as we can for questions.

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

As well, there's a short summary document outlining the points of our quarter available on our website.

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; and Pierre St-Laurent, Executive Vice President, Quebec.

Today's discussion includes forward-looking statements. We caution that such statements are based on management's assumption and beliefs and are subject to uncertainties and other factors that could cause actual results to differ materially. 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 on our financial results.

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

Thanks, Katie. Good morning, everyone. We continue to see improved results this quarter.

In Q3, our adjusted EPS was $0.33, up 150 percent from last year. Against a backdrop of restructuring the Company, we have generated 77 percent more adjusted EPS in the first three quarters this year than the same period last year.

We are committed to doing everything it takes to make our company successful. We will make the tough decisions. We announced the closure of 10 underperforming stores in BC, cut CapEx this year to $350 million, and had to let go a lot of good people in our offices in order to be efficient.

We announced a decision to expand discount to the West. We invested in a partnership with Ocado to build the best e-commerce solution in Canada.

In the quarter, same-store sales grew 1.1 percent. The last time we saw comps greater than 1 percent was 10 quarters ago. Inflation helped. So did execution. I want to explain something.

We are far more interested in stabilizing our margins right now than chasing empty calorie comps. We witnessed a fairly aggressive industry promotional environment in Q3 and that has continued into Q4, especially in Ontario discount. We're expecting to see increased pressure on sales in Q4 as those curious gift cards from our competitor begin and continue to hit the market.

But we're more interested right now in margin and basket size than simplistically pursuing tonnage and inflating same-store sales. We need to earn comps through execution and our strategic initiatives.

Having said that, we had good comps this quarter as we benefitted from inflation and better execution through better blocking and tackling. We had a solid holiday period, better service levels from our warehouses to our stores, improved store execution, creative merchandising, and our ad campaign are worth calling out here.

This quarter, we continued to stabilize our margins. We've previously mentioned that Q3 and Q4 would be the riskiest time period of our transformation, and we may see volatility.

However, in Q3 margin was actually up 30 basis points over the prior year even with Sunrise distractions. Of course, we're not out of the woods yet. We're still in the riskiest phase of the transformation, but the long-term gain we're looking for is well worth any short-term bumpiness.

And with that, I will organize a few additional comments around the four key priorities that I set out a year ago.

First, reorganizing our organizational structure and our people. At this point, I am happy to report that we have completed the organizational restructuring. We have some merchants still transitioning, but for all intents and purposes we are complete.

Second, we remain on track with our Sunrise program. With a strong foundation laid in the first year, we are pleased to see benefits reflected this quarter that align with our expectations. However, it is still early days, and the quarterly results only reflect slightly less than 5 percent of our full target of $500 million, with benefits expected to ramp up over the next two years.

Third, we are seeing improvements on executing on our brand promise, that as I always say, this is the piece that is going to take the longest. We've made great strides in understanding our customers and are in the process of finalizing our customer brand strategy.

I'm am actually a little surprised we have already had three positive comp quarters after the free-fall we were in. Brand strategy, of course, is not just determining the look and feel of ad campaigns; brand is the sum of everything we do that touches the customer, the net impression of who we are, and what we offer.

A game-changing e-commerce offer is part of bolstering our brand, and that is exactly what we announced this quarter. Our exclusive Canadian partnership with global e-commerce leader Ocado will give us the best strategic and sustainably profitable e-commerce infrastructure in Canada, positioning us to thrill our customers and take customers from our competition.

Leveraging Ocado's state-of-the-art robotics and end-to-end proprietary systems, we plan on rolling out home delivery to customers in the GTA in the spring of calendar 2020. We've secured a location for the first customer fulfillment centre and it's in Vaughan, a few hundred metres from our existing automated distribution centre.

Now on to our fourth priority, fixing the West. The progress we've made has been encouraging in this early going. We are seeing positive same-store sales and improvements in our margins.

We are making the difficult decisions necessary to turn around our business in the West. We've closed stores; we're renegotiating many provincial labour union agreements; we're converting stores to discount; we're improving DC service levels and store standards.

Recently, we reached a settlement in Saskatchewan with our labour union that keeps us competitive while allowing us the flexibility to run our business. Now we are in the hottest-point negotiations with our Manitoba union. We hope to reach a mutually beneficial agreement, but we need to be competitive in the market.

So to summarize, only nine months into a three-year transformation, I am very pleased with the progress we've made on our journey to turn around our company. Again, we will make every tough decision we need to in order to win.

We are changing the culture at Sobeys. Our leaders are expected to deliver Sunrise results, and strengthen our company to win in the future. No excuses.

With that, over to Mike.

Michael Vels — Chief Financial Officer, Empire Company Limited

Thank you, Michael. Good morning, everyone. As Michael said, same-store sales for the quarter, excluding the impact of fuel sales, increased by 1.1 percent from the same period last year, and an internal inflation number of 1.6 percent.

A gross margin of 24 percent improved 30 basis points compared to the prior year, reflecting our continued focus on margins and improved promotional strategies, as stable margins continues to be our priority.

Selling and administrative expenses as a percent of sales was 23 percent for the quarter, but excluding onetime expenses is 22.3 percent, a 70 basis point improvement, in part reflecting early benefits of Sunrise, although partly offset by increased incentive compensation costs.

In January, we announced the closure of 10 underperforming stores in British Columbia and recorded $20.9 million in expense related to the closures, including asset and inventory write-offs and severance.

Last quarter, we finalized our estimate of onetime Sunrise-related costs comprising severance, relocation, consulting, and minor system developments, noting it will not exceed $240 million. We have expensed $16.3 million this quarter mostly comprised of severance and consulting costs.

The real estate operation contributions for the quarter increased significantly due to a higher level of activity this quarter in the Genstar Partnerships, which contributed $20 million compared with $10.9 million last year. Lot sales in Western Canada and a bulk sale in the United States accounted for the elevated contribution this quarter.

As I've mentioned before, timing plays an important element in these sales, and this quarterly result is not necessarily indicative of an increasing continuing trend.

The effective income tax rate for the quarter of 28.1 percent is at the top end of our indicated range of 26 to 28 percent. Free cash flow for the quarter was $269.4 million, a strong increase of $241 million from last year due to stronger earnings and lower capital investments. We continue to expect that capital expenditures for this year will be at or slightly less than $350 million.

Since the beginning of the transformation, the Company's balance sheet has strengthened considerably, driven by consistent operating cash flow improvements and cash and investment controls. Liquidity continues to improve, and all of the Company's significant credit metrics are moving in the right direction.

For example, debt-to-adjusted EBITDA improved to 1.8 times compared to 2.2 times a year ago, and adjusted interest coverage has grown from 2.9 times to 6.5 times over the past year. This supports our continued expectation of reestablishing the Company's investment-grade credit rating over time.

As Michael said, Project Sunrise 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 transition of our merchandising staff will occur over the next six months, and the speed of this transition will determine the rate of benefits realization for the next and the following year.

As Michael said, we did realize benefits in the quarter, mostly reflected in SG&A, but as he said, it's still early days and only slightly less than 5 percent of our total target is included in results this period. At the end of our fourth quarter, we expect to be in a better position to provide expectations of the rate of realization of benefits over the next two years and the impact on our EBITDA margins.

The three-year plan, as we said before, can be divided into three phases. The first, organizational redesign from a regional to a national structure, is complete.

The second, operational benefits, is gaining traction. Activity related to improving store operations, labour standards, and other operational processes is progressing well, and is an important element of our efforts to offset minimum wage increases.

The third and largest, cost of goods sold, will take the longest to be recognized, and will mostly be realized by year three. Our current structure, systems, and processes are fragmented and cause confusion between us and our supplier partners. Discussions are ongoing with our partners, and we're making necessary improvements in our systems to harmonize information across our company and with our supplier partners.

Health care reform and minimum wage continue to be hot topics in the industry today. On January 29th, additional health care reform was introduced that will come into effect on April 1, 2018. We estimate the impact of these changes, prior to any mitigation, may be to reduce our income before taxes by up to $40 million.

This quarter, we had our first month that was impacted by the new minimum wage increases most of which, I'm pleased to say, we were able to mitigate through Sunrise and other initiatives. At this time, we continue to be cautiously confident that we can offset the full year fiscal 2018 impact of $25 million.

We continue to develop plans to mitigate the full year impact of minimum wage and Bill 148 increases that will arise in fiscal 2019, but there is risk that the Company may not be able to fully offset the result—the effects on earnings, considering the short transition period.

In summary, we're pleased with our results to date and the early traction on Sunrise benefits, although we have a significant amount of work in front of us as we return the Company to its full earnings potential.

And with that, Katie, over to you for questions.

Q&A

Operator

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

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

Mark Petrie — CIBC

Hi. Good morning. Just wanted to ask, I guess, first with regards to the competitive environment and, Michael, you mentioned that Ontario discount seemed to be particularly intense in terms of the promotions. But maybe you could just comment broadly, by geography, what you've seen from a competitive perspective?

Michael Medline

Yeah. I mean, I don't want to overplay it. It's not intense. But we've seen more promotional activity from our largest competitors in Ontario and in the West than we've seen in the previous 12 months. So we're dealing with that. You can see that we were able to deal with it in Q3. And what I said before is we'll stabilize margins, but we will remain competitive.

Mark Petrie

Okay. And then just in terms of your own same-store sales performance, I think last quarter you kind of said that Quebec was sort of the weakest region, and the rest of the regions were performing quite well. Has that trend continued? Or how would you describe Q3?

Michael Medline

Q3 was strong across the board. Quebec was mad at me for saying that last quarter, and they responded very well.

Mark Petrie

Okay. And then just last, I guess, you talked about the minimum wage increases and offsetting it through Sunrise and other initiatives, but how would you characterize the reaction in the competitive environment so far in 2018? Have you seen people sort of begin to react to the increases in the markets most affected?

Mike Vels

Mark, it's Mike. Our observation, although imperfect, across the market would seem to indicate that the initial actions by most of our competitors would be to reduce costs and do their best to mitigate prior to increasing any prices. So I think that's been the primary activity at this point in time.

From our perspective, we had a lot of costs to take out. That's clearly a benefit for us, and we did benefit from that in the first month. We are working on our labour standards, and have made some adjustments in store hours and other actions within our stores. So that, I think, given that it's really just the first month or so that it's been impacted, it probably makes sense that people would look to costs first.

Mark Petrie

Good stuff. I'll get back in the queue. Thank you very much.

Michael Medline

Thanks, Mark.

Operator

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

Kenric Tyghe — Raymond James

If I could just touch on the gross margin discussion and specifically the expansion, you highlighted improved execution promotional strategy. Is there any positive mix impact you could speak of on sort of share recovery in select categories? I'm just trying to understand if there's sort of a second leg to the story here that we should be thinking about?

Mike Vels

No, I don't think so. As Michael said, we're focused very much on making sure that our strategies are rational from a promotional perspective. We're putting a high premium on keeping our margins in a range while remaining competitive in the marketplace. And at this time, that's the priority for us as opposed to chasing after sales that are potentially transitory.

We have a lot of work to do, as Michael said, on improving our stores, execution, delighting our customers, improving our marketing. And over time, that will have impacts on sustainable top-line growth. At this time, that's not as much of our focus.

Kenric Tyghe

Sure. Thanks, Mike. If I could just switch gears quickly then to the store closures in-quarter; where there any surprises in the either the number or were these stores sort of the perennial underperformers that were flagged for closure early on in your review process?

Mike Vels

I'm not sure what you mean by surprises. We felt, as Michael said, as we fix the West in addition linked to our expansion of discount, there's a number of stores we felt would be better closed and would have a positive impact on our Western results.

But having said that, certainly the number that was closed is to some extent related to the fact that we do believe that those stores may at some point be able to reopen, assuming we have appropriate labour agreements, as discount formats.

But it is a part of the scan and the review of our operations and specifically related to fixing the result in our Western unit.

Kenric Tyghe

Great. Thanks so much. Congrats. I'll get back in the queue.

Operator

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

Jim Durran — Barclays Capital

Yeah. Just wanted to go back to tonnage. So with respect to tonnage—and while I know it's not a focus, it's obviously an important metric over the long term—right now you're just saying that there have been previous promotion practices, I guess, that were less than ideal in terms of their payback, and so you're not chasing that business any longer. Is there any other factors that are impeding your ability to get back to even modest traffic and tonnage growth?

Michael Medline

Well, traffic, we're seeing better traffic. We're seeing better basket size. At this point, I look for how's our margin doing and are we growing our comp. And I think we are helped by inflation. We're helped by some better execution.

I think it's not right to expect us to be vastly growing market share until we put into place more of our strategic initiatives. So although we've improved our store standards, although we've improved service levels, and our branding and advertising is better than it was, I do not want the team chasing market share at the expense of being strong, getting Sunrise savings, and being strong in the long term. Obviously, as we execute our conventional strategy, get discount up and running, open our e-commerce, improve our stores and our service, we are going to grab back our market share.

And that's inevitable. I just do not—and I've been clear since I started—I do not what to get this out of order because it will not help us to do so.

Jim Durran

That's helpful. And within the context of your inflation number, like what are the primary drivers to that recovery and inflation by category? Or how much of it's really just you not being as aggressive on price promotion?

Mike Vels

Hard for me to give you an exact split of that or any really useful colour. It's certainly a combination of both. We are clearly different this year from last year in terms of how we're pricing and our strategy in the market. At the same time, we have seen some element of increases across some of our categories, so hard for me to give you a split. It would be a combination of the two.

Michael Medline

I think a lot of it's just doing things smarter. I've seen our flyers are more exciting for the customer at the same time as we're seeing slightly better margin growth. I think we're just … I think we're pricing competitively, our promotions are hot and focused, and I think we're just doing some things. We're just executing on that better.

And that's what we should do with the big game, and margin will come as we get … as Lyne and the team get at that cost of goods sold.

Jim Durran

Okay. And for the cost savings in the quarter, just want to be clear. So the 5 percent of the $500 million or $25 million, was that a run rate established towards the end of the quarter? Or was that a fully realized number in the quarter? And what was the potential dollar value of the compensation increase offsetting some of the benefit of the savings?

Mike Vels

So to your first question, the amount would have been fully realized in the quarter. We're going to try and avoid talking run rates because it's confusing. And the compensation increase would have been a relatively small percentage of that, but not a number that I have right at the tip of my fingers.

Jim Durran

Okay. Thanks, Mike. I appreciate it.

Michael Medline

Thanks, Jim.

Operator

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

Irene Nattel — RBC Capital Markets

Thanks, and good morning, guys. Noticing that here in Quebec you've stepped up the communications with consumers around e-commerce. Could you just talk a little bit about that?

And also, could you walk us through once you get your first—I guess once you get up and running in 2020 with e-commerce how you expect to get back some of the ground that you may have lost between now and then, as your competitors kind of ramp up their initiatives in the GTA?

Michael Medline

So Pierre will say a couple of sentences on Quebec e-commerce and how we're ratcheting that up, and then I'll speak on the second question.

Pierre St-Laurent — Executive Vice President, Quebec, Sobeys Inc.

Our e-commerce, the news with Ocado is really interesting for dealers because we have a quite good result with e-commerce in Quebec. So by implementing Ocado in Quebec, we'll improve our cost in-store because we'll move from store pick to central fulfillment, so our dealers are expecting that as soon as possible in the province to more efficient and to get savings from that.

Michael Medline

And generally on e-commerce, I see this as a marathon and we're in the first 100 metres, and I say that often internally. We made a strategic decision to have the best arsenal at our disposal and the best assets and systems and store-pick, although really the best that's available in Canada right now—and we did, I think, the best job in Quebec and out in BC with our Thriftys—is not in the end in the next five to seven years sustainable, profitable, or the best way to serve your customers.

And so we made the decision to go for the win rather than a short-term answer. So I'm not—look, I'd rather be up and running with our system today, but I don't want to put mediocre systems across the country when there's much more modern ways to win over the customer.

Irene Nattel

And just to be clear, when do you expect to have the Ocado system available here in Quebec?

Michael Medline

Well, right now we've said that we are concentrating on the GTA and getting that up and running because that's a market we need to and will win. And there are three or four other markets in the country that we need to look at. If you look at it, a handful of markets covers over three-quarters of the customers in the country. I think it's quite clear which markets I'm referring to, and that the question then is just timing over a period of time because we've got to watch our capital expenses overall in the Company, and we're, I think, getting very good at it in terms of capital allocation. And we need to time when the CFCs open.

But our main priority for the next while will be the GTA. And then we'll look at, as Pierre said, we're talking to our dealers about what the correct timing could be in Montreal or in other regions across the country.

Irene Nattel

That's certainly understandable and helpful. Just sort of conceptually, would it be sort of one a year? Would it be sooner than that? Less than that? Longer than that?

Michael Medline

Well, because I'm not going to commit to one a year or one every two years or whatever, I'm not going to commit to that because right now we're working through the GTA. Having said that, because of the lead time of two years to open up, you've got to factor that in.

As we're working through even further with Ocado and we've been meeting with them, well, constantly, since we announced the deal and as we look at the market, we're more and more confident that this is a good strategy. But we will put it in, and we'll allocate capital in the correct manner and we'll phase this. And we will not be announcing a bunch of CFCs at the same time.

This will be in a measured, focused way. And right now, the big prize we're going to capture is the GTA.

Irene Nattel

That's great. And just one other question if I might, please. You did call out from a competitive perspective the discount side of things. But what are you seeing in, I guess, the sort of conventional segment? And also, what are you seeing from the smaller ethnic banners?

Michael Medline

I called out the discount because I think we've seen much, much more promotional behaviour from our discount competitors, especially in Ontario, over the last couple of months, few months. And it's always competitive. So I hate to whine about competition.

And I was just touring stores in the United States; you want to see competition. So I don't like to whine about it. I would say that in the face of some competitors, especially on the ethnic side, that we continue to grow our comps. So we will respond. We have so much upside to be able to grow our comps, we can do that in the face of competition. I expect more competition.

Irene Nattel

That's great. Thank you.

Operator

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

Michael Van Aelst — TD Securities

Hi there. I just wanted to touch on a few things. Just wanted to start off by clarifying again on the cost savings for Project Sunrise, so that $25 million give or take was actually saved in the quarter? It's not an annualized rate?

Mike Vels

That's right, Michael.

Michael Van Aelst

Okay. Thank you. And then if we look at the same-store tonnage trends, I know it's not your immediate focus, but you started to show some improvement and then it slipped a little bit the last couple of quarters. At the same time, the gross margin is up year over year, but it's about 50 basis points lower than it was the last three quarters, so we've seen some slippage there. I'd assume it's still with a band that you're comfortable with, but can you describe kind of what happened in the quarter with respect to gross margin? Did you—was that a reflection of investing a little bit to try and protect the market share? Or was there some other factors?

Mike Vels

I wouldn't point to any particular factor, Michael. It's within a range that we're comfortable with. We're not—it's not going to be dead flat, obviously. There are also some seasonal impacts. As Michael said, we had a good Christmas or holiday outcome, and we certainly drove higher sales through that. On average, those tend to come at slightly lower margins, but still accretive.

So there's a mix impact. So I wouldn't look at any particular factor or any systemic change or anything that we're doing differently. It's within a range that we're comfortable with.

Michael Van Aelst

Okay. And with respect to the headwinds from minimum wage and health care reform, in the past I think you've said that you'll try to mitigate the fiscal 2018 $25 million amount for minimum wage without dipping into the Project Sunrise savings. When you look at the numbers into fiscal 2019, are you expecting to have to dip into that $500 million of savings to offset it? Or do you think you can do it over and above?

Mike Vels

I think realistically, particularly when you layer on the wage parity and other impacts, Michael, I think what we've said is we're lucky that we have—not lucky but fortunate, I guess, that we have an ability to reduce cost at a higher rate than our competitors. So yes, to fully offset it in the absence of any increased prices in the market, Sunrise is going to be a partial offset for those minimum wage increases.

Michael Van Aelst

Okay. Thank you. And you did talk about a new labour deal with Saskatchewan and then negotiations with Manitoba. The labour union in BC with respect to those 10 store closures has been in the press lately. What's your progress in negotiations with Western Canada unions for—or BC unions, I guess, for the FreshCo banner?

Michael Medline

It's Michael. Great question. We're in talks with BC right now, and we're moving along. And it's about on the pace that I and our Head of Labour Relations and HR, Simon Gagné, would have said. Would love to move it faster, but as we said, we will be opening our first stores in about nine months. We're on pace to do that. We haven't said they're going to be in BC. We haven't said where they're going to be in the West. And I don't foresee an issue.

We're also working on the real estate portions of it as well; getting the permitting done as we talk this through with the unions.

Michael Van Aelst

All right. Thank you.

Operator

Your next question comes from Chris Li from Macquarie. Your line is open.

Chris Li — Macquarie

I just have maybe a few questions on the Ocado partnership. Maybe, Michael, first in order for the Company to earn a good return on the investment, can you maybe share with us on a high-level basis what are your long-term assumptions on things like online market penetration, as well as market share for Empire when this is up and running in the GTA?

Michael Medline

We haven't said anything publicly about it, so I'll have to be careful here. But I'd say that our assumptions are that we assumed that we would follow where the US market has grown, and actually we even pared that back to be even a bit more conservative. Our assumptions are—I'm not going to give a number because I haven't said anything publicly—but that we will have a very high market share in the GTA.

But when we ran it, we do very well financially even if we don't hit the number that we have in mind of hitting. So I mean, I think if you don't believe in grocery e-commerce, this is not the deal for you. But we believe that e-commerce will grow. I'll grow in percentage terms fast off a small base, and then next five years is going to grow quite a bit.

The issue for e-commerce in this country, in Canada, is that no one has given the customers a fantastic option. And you can see in the UK where they were given a great option that the growth in e-commerce took off faster than it otherwise would have. So even with the growth as it is on the current trajectory it makes sense for us.

By offering customers something that they just never have seen before, we'll have the highest market share of any grocer. And we'll be competing with you-know-who. So that's the way we're looking at it.

Chris Li

Okay. That's great. And maybe on the flip side of that, I know you guys have done a lot of due diligence on this before signing the deal. I mean, what are some of the key risks do you think that would cause this partnership to not be a good one for Empire? Are there anything that particularly was concerning as you were doing the due diligence?

Michael Medline

No, none at all. I mean, honestly, the thing that you look for is in any of these deals—and I know you guys think it's soft, but it's the most important thing—can you work all truly together. And think this is going to be a super cultural fit.

Chris Li

Okay. And maybe just a couple of ones for Mike. And with just with respect to the $70 million of investment that the Company's making over the next two years for the e-commerce customer fulfillment centre, will most of that be treated like CapEx kind of flowing through the cash flow statement with some depreciation expense flowing through the income statement? Or will there be a SG&A expense component associated with it? Essentially, I want to make sure that I'm kind of capturing the numbers correctly in the earnings forecast over the next couple years.

Mike Vels

Yes. The $70 million that we referred to on capital is the expenditure that we're making both to purchase the software effectively and build the distribution centre, which as Michael said, we've now located and is actually under construction as we speak.

Those amounts will be capitalized as per usual on our balance sheet as fixed assets and depreciated over the useful life.

Chris Li

Okay. And then I think in the past you've mentioned this will be marginally dilutive to earnings in the beginning. Is that still the case?

Mike Vels

Well, it just makes sense that it would be because when you start up a completely new warehouse with very little volume, by definition you're not going to make profits in year one. And then it will improve, and as we've said, at scale these warehouses or CFCs are profitable because of their efficient costs and the very high-quality website and promotional approaches that we have towards on the customer.

So yes, as you ramp it up just by its very nature it's not going to make money on day one.

Chris Li

Okay. And my last question is just on the 10 store closures. Can you give us a sense of what the sales and earnings impact would be from those 10 store closures?

Mike Vels

No. We're not going to disclose those numbers.

Chris Li

Okay. Thank you.

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, and congrats on the quarter, guys. In terms of Project Sunrise, I think management said it's on track, yet in the disclosure materials management now says it's looking like it could be equal to or above $500 million. Just wondering if you can give me some colour on why management feels that it could be above $500 million now?

Mike Vels

Well, we've said at least $500 million. So I guess we've always been positive about our ability to achieve the $500 million. I think Michael and myself have said that we're a competitive team. We're going to as we go along, we anticipate and expect as we put improved systems, talent, and people into our system—into our company, rather, that there's probably other opportunity.

But at this point, we're holding firm to our $500 million number, and we feel more confident about that as our progress continues.

Vishal Shreedhar

Okay. So does management still anticipate that of that $500 million there will be a portion reinvested?

Michael Medline

We've said that the majority will go to the bottom line and some proportion will be reinvested in the Company. But we've also said if we reinvest in the Company, it better be accretive. And so if we see opportunities to invest a little bit of the money and make the Company stronger, we'll do so.

Vishal Shreedhar

Okay. The Company obviously has a lot on the go right now; many initiatives. Is it reasonable as we model—I'm not sure how much colour you guys will give me—but as Empire grows the discount banner and as Ocado starts to ramp up, as we look over the longer term that might be dilutive to margin percentage, although accretive to dollars. Is that a reasonable framework to think about it in?

Mike Vels

Well, I'm just trying to figure how to exactly answer that. So depending on which year you're looking at, as I mentioned to Chris, in the early days the e-commerce online offering will not be immediately profitable. So that would have an impact, for sure, on our average margins just as you factor it in.

But having said that, I think you need to remember that it's still a very small percentage of our ongoing business. It's very important because from a market share perspective and participating in what we anticipate to be growing and vibrant channel for grocery, but still a relatively small impact if you look at the size of the Company.

On discount, as we drive more through our discount channel, from an averaging perspective I think you'll see higher growth rates because we'd be participating in a channel that has a higher growth rate on the top line, but on average those margins are slightly lower than conventional.

Vishal Shreedhar

Okay. Just in terms of you said it's going to be a small percentage, I think you were referring the Ocado partnership— what is the—at least in the next few years, what is the capacity of one of those DCs in sales dollars?

Mike Vels

Well, the only public information that's out there and that people have picked up, I guess, is that Ocado quotes their new facility, which is not entirely dissimilar to the size of the one we're putting into Toronto, as having a capacity of if you translate the dollars to roughly about $500 million.

That doesn't mean that we anticipate that to be our sales number or our sales target. But that'll give you a sense for the capacity of the facilities that Ocado's putting into the UK.

Vishal Shreedhar

Okay. And just going back to a comment that you made earlier; so regarding the minimum wage and the drug reforms, should investors anticipate that those challenges will be met in part from Project Sunrise? And I might have gotten this wrong, but my earlier understanding was minimum wage would have—the initiatives to offset that were independent of Sunrise?

Mike Vels

So on minimum wage, the first year we felt that we had enough flexibility and opportunity in our systems across the country to offset it. And obviously Sunrise is also a potential to offset the larger and increasing cost of that as we get into the second year, so yes for fiscal 2019. We anticipate, as I said, without any increases in prices in the market or any recovery of those in the industry, we will likely require an element of our Sunrise savings to offset it.

Vishal Shreedhar

Okay. And that goes for drug reform?

Mike Vels

Well, drug reform, I think, we've been pretty clear is going to impact our earnings. And we're fortunate in a way that it's not going to impact our earnings close to the amount that it'll impact our competitors, as we're not as penetrated in that area as our competitors are.

But yes, that is an impact on our earnings, and we anticipate that to occur.

Vishal Shreedhar

And when drug reforms kick in, is it an even cadence from that April date that we just assume for the impact?

Mike Vels

Yes. Pretty well.

Vishal Shreedhar

Okay. All right. Thanks a lot.

Michael Medline

Thanks, Vishal.

Operator

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

Peter Sklar — BMO Capital Markets

A question for Pierre. Pierre, you were talking about that your IGA franchisees seem open to the Ocado online distribution model in Quebec. And like what will happen to the click and collect business in Quebec? Will you discontinue that? And are your franchisees, like are they not unhappy that they're going to be losing that business, or that Empire at the least will be competing with that business through the centralized opportunity?

Pierre St-Laurent

First of all, the business in Quebec is a bit different. I mean, it's a partnership with dealers in Quebec. So we own the wholesale business and they own the retail business in general. So it's our job to build the same partnership model with them for e-commerce business. So it's what we're looking for, so there's no danger for them.

As a good partner, they were with us in the last, I would say, 60 years. So there's no reason that it won't work for e-commerce. It's where we are now.

And as we mentioned, it's growing quickly. And this puts pressure on store costs and everything, so they're more than open to find solutions, a win-win solution, between us and them to run that business in the future.

Peter Sklar

I know. But by definition, there's no store retail—like bricks-and-mortar store retailing, so how do your IGA partners participate in the Ocado model?

Pierre St-Laurent

It's not defined yet. So it's a work-in-progress that we're working with them.

Peter Sklar

Okay. Then I just have one question for Mike or Michael. Like you talked—like earlier in your comments you talked about the competitive backdrop. I believe you said that in Q3 and carrying into Q4, it was a little more promotional, particularly in discount in Ontario. And I'm just wondering how you reconcile that statement with the fact that both yourself and the entire industry is reporting pretty decent inflation numbers. I think, Michael, you said your internal inflation was positive 1.6 percent.

Michael Medline

No. Our internal, yes, is at 1.6 percent. Sorry, so your question is how are we saying it's more promotional and we're seeing inflation? Well, we're seeing some of the costs going up, but we're seeing our competitors in their flyers becoming—and I think if you looked at some of the flyers in Ontario over the last few weeks of the competitors, you'd see a much more promotional than you would at any time over the previous year. So we haven't gone out and reconciled to all those kinds of numbers.

Peter Sklar

Okay. Thank you.

Operator

Once again, if you'd like to ask a question, press *, then the number 1 on your telephone keypad.

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

Patricia Baker — Scotiabank

Hi, everyone. I have two questions. Michael and Mike, you both referenced in your opening remarks the fact that with respect to the organizational restructuring that you still have the merchandising piece to complete. And, Mike, I think you said that depending on how quickly that gets done, it will impact the pace of some of the achievement of the benefits of Project Sunrise. So I'm just curious about what exactly is left to do? What are the particular challenges associated with restructuring the merchandising? And is there any specific risks associated with how that proceeds? And just broadly, when do you think you will complete it?

Mike Vels

So — I'll have Lyne provide some colour commentary on this, but the point we're making, Patricia, is that the organizational restructuring is now done. Everybody's in their new seats, everybody has their new jobs, they know what their task is, and they know that they're accountable for a significant amount of benefit related to Sunrise, which is mostly going to come from improved cost of goods sold and better category management.

So having now completed the first phase, that category group is now working through the rate and the pace at which they can accomplish these benefits.

So, Lyne, if you want give a little bit of colour to what that looks like, how you feel about it, that'd be great.

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

Yeah. Patricia, good morning. It's obviously a really big transformation and impacts the entire company. So our category merchants have been now announced since the end of November. We transitioned to their new positions a few weeks ago, so we now have transitioned officially through a national merchandising team.

They've been through extensive training, and they've been able to hit the ground running now with the transition. So they're working right now on our merchandising transformation to harmonize our supplier price files, and to begin to rationalize our categories across the Company and to reduce the cost of goods sold, obviously.

We're very pleased with the team's progress. We've seen some national buys and some good opportunity buys that has helped us with some of the margin that you're seeing. And so it's a complex time for the team, obviously, but because we're simplifying the structure, it's actually making things progress well.

And our supplier partners are starting to see that simplification in our structures and the number of people that they deal with. And this will continue to improve.

So we're pleased with the progress that we're making in that area.

Patricia Baker

Thank you very much, Lyne. That's very helpful. And, Michael—

Michael Medline

Sorry. I've just got one thing. Sorry, I just want to say something. I was ruminating on Peter's question a little bit more, as I'm apt to do. Just three quick things, Peter, on your question in terms of discount margin. I mean, there's a lot more going on in a margin, as you know, than just the promotion. And I referred specifically to discount Ontario and a little bit of discounting in the West.

And two—or three is we're seeing if you don't think that people giving away some free groceries for whatever reasons with gift cards impacts everybody in market, it does. To what extent is, you can't measure it. But it would theoretically make sense. So there's a little bit of noise right now.

But I think what you were implying too is, look, there's always promotional. There's always some competitiveness. I was saying for three quarters that I didn't see a lot of promotional intensity. We're starting to see a little bit of promotional intensity.

Sorry. Patricia.

Patricia Baker

Okay, Michael. I have a question for you then, Michael. I'm just curious, the location of the CFC in Vaughn, there may or may not be anything here, but is there any advantage for you having it located in Vaughn?

Michael Medline

Yeah. There's a big advantage, especially in the start-up phase where you can bring over some product from our automated DC in Vaughn over. I think when we're up and running at any sort of capacity, you won't be using the Vaughn facility per se, unless there was some sort of urgent need to do so, which we wouldn't foresee.

The beauty of that site wasn't so much that it was near the Vaughn DC. The beauty was we were looking at 13 sites. This one was number one by a mile. And the reason being it was perfect size. It had been zoned and permitted already and the walls were already up, but they weren't so far along in the building that we couldn't retrofit for the technology that we're putting in place.

So we have a great landlord there. We were very pleased to be able to make that deal.

Patricia Baker

Okay. Great. Thanks, Michael.

Operator

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

We do not have any questions over the phone. At this time, I will turn the call over to the presenters.

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 fourth quarter fiscal 2018 conference call on June 28th.

Goodbye.

Operator

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

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