Empire Company Limited

Fourth Quarter 2019 Results Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Empire Company Limited Fourth Quarter Fiscal 2019 Results Conference Call. At this time, all lines are in a listen-only mode.

Following the presentation, we will conduct a question-and-answer session. If at any time during this call you require assistance, please press *, 0 for the Operator.

This call is being recorded on Thursday, June 27, 2019.

And I would now like to turn the conference over to Katie Brine, Director, Investor Relations. Please go ahead.

Katie Brine — Director, Investor Relations, Empire Company Limited

Thank you, Joanna. Good afternoon, and thank you, all, for joining us for our fourth quarter conference call.

Today, we will provide summary comments on our results and a further update on the pending changes related to the new IFRS 16 leasing standard. We will 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 empireco.ca.

There is a short summary document outlining the points of our quarter available on our website as well.

Joining me on the call this afternoon are: Michael Medline, President and Chief Executive Officer; Michael Vels, Chief Financial Officer; and Pierre St-Laurent, Chief Operating Officer, Full Service.

Today's discussion includes forward-looking statements. We caution that such statements are based on management's assumptions 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.

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

Thanks, Katie. Good afternoon, everyone. And as I think it's clear to see from our results this quarter and throughout fiscal 2019, Empire is not the same company it was just two years ago.

We are stronger, more customer-oriented, more innovative, and poised for growth. Our team's strategy and focus on execution have improved across the board; having said that, we realize that the heavy lifting over the past two plus years is only the beginning. We have much work to do to execute even more effectively and innovate.

Our potential to thrill our customers, grow market share, and greatly improve our bottom line is still in its infancy. We are hard at work on finalizing a strategy, detailed roadmap, and financial goals for the three years post-Sunrise. Significant customer and financial prizes can now be attained because we have our infrastructure and disciplines more firmly in place.

Robust sales momentum continued in the fourth quarter. Same-store sales were 3.8 percent, the strongest in a decade. Food same-store sales, which exclude pharmacy and fuel, were 4.2 percent. Internal inflation was 2.2 percent for overall tonnage of 1.6 percent, our fourth consecutive quarter of positive tonnage and the strongest in almost nine years.

Customer count was up, basket size increased, and sales were up in all regions across all banners. In fiscal 2019, we increased sales by almost $1 billion. The majority of the improvement in our sales numbers can be attributed to sharper in-store and marketing execution and the early success of category resets.

Farm Boy also played its part, contributing about 20 percent to the sales increase.

These weren't empty calorie sales either. Gross margin rate was 25.4 percent, up 70 basis points from Q4 last year and 120 basis points over Q3. This quarter, we continued to see the beginnings of category reset margin improvements hit. This will progressively amp up over the next four quarters.

EPS was $0.46, 2.5 times higher than our Q4 fiscal 2017 EPS when we announced Project Sunrise.

On top of that, our adjusted EBITDA margin of 4.8 percent this quarter is up 70 basis points over the prior year. We are closing the gap on our competitors. Most of the current gap to our major competitors is not structural, and we intend to close that gap significantly going forward. EBITDA margin is now our most closely watched number.

Mike and I have talked a lot with you about capital allocation. We've worked hard to cement a disciplined approach to capital allocation, and we're investing in better projects that generate solid returns for you, our shareholders.

Last year at this time, we announced a capital target of $425 million, and we came in at $427 million, excluding Farm Boy's capital expenditures. We refreshed a number of our stores, continued construction of the Voilà CFC in Vaughan, converted three stores to FreshCo with 15 more on the go, opened two new Farm Boy stores, and 10 new stores across our banners.

For fiscal 2020, we will increase our capital spend to $600 million, which includes capital estimates of approximately $70 million related to the expansion of the Farm Boy store network in Ontario. More and more, our base capital will be deployed to renovate and refresh current stores and invest in advanced technology, including data analytics. Mike will walk you through this in more detail.

Our strong results and capital spending discipline this fiscal 2019 have put us in an enviable free cash position. As a company, we have a strong belief in returning the appropriate cash to you, our owners. To that end, today we announced a 9 percent increase in Empire's quarterly dividend per share from $0.11 per share to $0.12 per share, commensurate with our strong cash flows and confidence in the business.

Our company also believes that share buybacks are a useful additional tool to utilize excess cash. We will file and execute on a normal course issuer bid with the intent to repurchase up to $100 million of Empire shares in fiscal 2020. We expect that share repurchases will be a key part of our capital allocation arsenal over the coming years. We do not expect that the dividend increase, nor the share buyback, will impact the timing of regaining our investment-grade rating.

Back to the business. We are seeing very good progress on our major strategic initiatives: Project Sunrise, FreshCo expansion, Farm Boy, and Voilà. We are more than two-thirds of the way through our Sunrise transformation, and this initiative is progressing better than we originally anticipated.

With $200 million of Sunrise savings achieved in fiscal year '19, we can now confirm that we expect to exceed our Sunrise savings target up to $500 million, which Mike will discuss further in a few minutes.

Category resets, which will drive a large portion of our Sunrise savings, are well under way. Our merchants have nearly completed our negotiations with our supplier partners. In parallel, our teammates in our stores have done a great job relining our stores tranche by tranche, ensuring our shelves are stocked with the items customers want most.

We are especially cognizant of the customer experience as we reline our aisles. All of our reporting and customer feedback to date indicate that in-store execution of resets has been well received.

In April, we launched our FreshCo banner in the west, opening three stores in British Columbia and two stores in Winnipeg to date. It is still early days, but we are extremely pleased with how the stores are performing and with the customer reaction.

Our expansion of FreshCo to the West allows us to participate in the growing discount segment by converting 25 percent of our poor-performing Safeway and Sobeys stores to FreshCo stores in markets that are better suited to discount. We remain on track to open two Chalo FreshCo stores in British Columbia in July and 11 additional FreshCo stores throughout the remainder of fiscal 2020.

Our strategy to grow share in Ontario, where we have historically had a low market share, continues to progress well. We are now seeing stronger results in our existing Sobeys, FreshCo, and Foodland banners, and we continue to see improved sales and customer metrics as we convert all FreshCo stores to the new FreshCo 2.0 model.

Our acquisition of Farm Boy gives us a winning format that will allow us to accelerate our growth in urban and suburban markets in Ontario. We continue to build on Farm Boy's industry-leading operational and customer metrics, and progress against our plan to double the size of the business in the next five years. Much of this growth will be in the heart of Toronto.

Farm Boy, coupled with Voilà, our game-changing e-commerce solution, will position us beautifully to expand our presence in the GTA. Voilà is on track to test and soft launch in the GTA about a year from now.

In May, we announced that we would be opening our second CFC in Montreal in 2021, which will serve major cities in Quebec and the Ottawa area, building on our already successful iga.net home delivery service.

The world is moving quickly, and we have the exclusive rights in Canada for the best e-commerce technology in the world. We want to put it to work. But Voilà is not the only innovation happening in our business.

As we shift from defence to offence, we are focused on positioning the Company to innovate for the long term. You know, shopping in a grocery store looks pretty well today as it did 50 years ago when my mother was pushing me around in a cart, and that needs to change.

We are putting in place the teams, tools, and culture that we need to drive innovation in our business and to win the next generation of grocery retailing. Empire, at its heart, is an innovative company, and now with much of the heavy lifting of Project Sunrise behind us, we are able to focus our attention in innovation.

Our vision is to be the most innovative retailer in Canada. This won't happen overnight, but we have a focused roadmap to achieve that goal. We are not innovating for innovation's sake. We are focusing on a few innovative projects that will drive the most impact for our business and thrill our customers. At this time, we are keeping these projects close to the vest, for obvious competitive reasons.

I am really proud of my teammates and what they have accomplished in fiscal 2019. I would like to especially congratulate Pierre and Mike on their well-earned new responsibilities. More than ever now, I believe that we have the structured disciplines and team in place to perform at a very high level.

And with that, over to Mike.

Michael Vels — Chief Financial Officer, Empire Company Limited

Thanks, Michael. Good afternoon, everyone.

We're very pleased with our margin performance this quarter. Margin dollars increased due to the strong sales, and just as importantly, our margin rates are up by 70 basis points. This 70 basis point improvement is even better after some mix impact related mostly to higher sales in businesses that have lower structural gross margins, such as Quebec, Discount, and Wholesale.

Excluding approximately 25 basis points of this mix impact, we were actually up by almost 100 basis points on our gross margin line. The two most significant drivers of this improvement are Farm Boy, which has a higher margin rate than the rest of the business and impacted the rate by approximately 40 basis points, with the remainder accounted for by an approximate 60 basis point improvement related to category resets. In conclusion, we grew our sales and banked the positive impacts of our category reset project.

The strong sales this quarter pushed our variable SG&A expenses up, mostly in store labour. SG&A as a percent of sales were flat to last year at 22.9 percent. We accomplished approximately 45 basis points of Sunrise savings in SG&A this quarter, largely through indirect sourcing cost reductions and continued improvements to store operations. This was partly offset by Farm Boy's higher labour cost model impact, increases in store and back-office incentive expense accruals, and some increased investments in marketing expenses.

Combined, we have approximately $80 million of savings reflected in our earnings for the quarter just related to Sunrise. For those of you keeping score at home, you'll note that we exceeded our public estimates for the year. I am pleased to say that on a cumulative basis, we are now ahead of where we thought we would be at this time by approximately $50 million.

Looking forward, we are targeting to earn approximately $250 million of incremental earnings through Sunrise in fiscal 2020. These amounts will be spread roughly evenly across the year as category resets are executed in store, and we also continue to reduce our cost base through indirect sourcing and store improvement projects.

Equity earnings contributed strongly compared to last year. This is principally the result of increased earnings from our investment in Crombie. The Crombie results were impacted in the quarter by gains recorded on their disposal of a parcel of assets, Empire's share of which accounted for $8.4 million of the $12 million increase in equity earnings over the prior year.

Crombie recently announced a further significant sale transaction, the impact of which will be recorded in our second quarter 2020 results. These gains from Crombie had an approximate $0.04 after-tax impact on our earnings per share, although this was offset by a higher effective tax rate during the quarter.

The tax rate of 25.5 percent was significantly higher than last year, accounting for about a $0.04 impact on earnings per share compared to last year, which itself was positively impacted by an internal reorganization that we undertook last year to simplify our corporate structure.

For fiscal 2020, excluding the impact of any unusual transactions or differential tax rates on property sales, we're estimating that the effective tax rate for the next year will be between 26 and 28 percent.

Our cash flow for the quarter and the full year continues to be strong. During the quarter, increased capital expenditures, principally due to timing and a sale of properties to Crombie last year that didn't reoccur, accounted for lower free cash flow compared to last year in the quarter.

For fiscal 2019, excluding Farm Boy, we invested $427 million in capital expenditures, which was in line with our public estimate of $425 million dollars. For next year, we expect to invest approximately $600 million in capital. This estimate includes approximately $70 million for Farm Boy, with the rest of the business accounting for the remainder, which we have said should over time maintain at a level of approximately $500 million.

For the capital spend in fiscal 2020, we expect to accomplish a great deal, including an aggressive store renovation program, spending of approximately $65 million for 13 FreshCo conversions, continued investments in our Voilà e-commerce business, and increasing investments in information technology and innovation.

In Farm Boy, we will be under construction on a number of new stores and one Sobeys Farm Boy conversion, with the expectation that three of these stores will open in fiscal 2020 and the remainder early in fiscal 2021.

Looking to future reporting, we have an update on IFRS 16 in our financial statements. Last quarter, we gave you an estimate of the expected impact of IFRS 16 and noted at that time that the discount rate was a key assumption and would be finalized on our transition date of May 5th.

Since that time, we updated our discount rate to reflect changes in market discount rates, as well as some new leases and lease modifications. The expected impact on our balance sheet of IFRS 16 is the inclusion of $4.6 billion to $4.8 billion of liabilities, which are largely new lease liabilities, and 4 billion to $4.2 billion of additional assets, primarily right-of-use assets. Final numbers are expected to be within these tighter ranges, and will be recorded in our first quarter.

In the statement of earnings, current rent expense will be replaced by depreciation on the right-of-use assets and interest expense on the lease liabilities. There will be no change to the amount of cash exchanged related to lease transactions, but now these cash amounts will be classified as financing cash flows rather than operating.

To help you out, we have disclosed in our MD&A that in fiscal 2019, we paid approximately $500 million of net cash rent. This gives you a sense of the material impact this will have on the calculation of metrics, such as EBITDA and free cash flow.

Once again, however, I'll stress that these are accounting and measurement changes only and will have no effect on our cash-generating ability, and we do not expect any material change related to debt ratings or financing costs. We expect that in the short term, DBRS and S&P will monitor the effects on their issuers, including us, and continue to use their own metrics in the short term.

Our own assessment is that the effect of IFRS on our statements will align our credit metrics very close to both agencies, and we therefore expect little to no impact on their assessment of our credit quality related to these IFRS 16 changes.

Regarding the impact of our bottom line, we continue to estimate that adoption of IFRS 16 will not have a material effect on earnings per share.

We will be hosting another very exciting conference call in July to further discuss the impact on the IFRS 16 adoption on Empire.

Lastly, we have several large initiatives happening in fiscal 2020, and we know it's helpful for our shareholders to have a bit more insight into how these initiatives may impact our future earnings.

Firstly, FreshCo expansion in the west. We recently announced six Safeway stores that will be closed and converted to FreshCo stores. These closures incur closing costs and will be charged to earnings in the first quarter, and have an impact on that quarter of approximately $12 million before tax, or about $0.03 per share after tax. These costs are made up of inventory write-offs, severance, and fixed asset write-offs.

We further expect that later on in fiscal 2020, we may announce one more tranche of store closures. However, we are not yet ready to fix the timing or the quantum of these right now, but will update our communications and disclosures as these actions are finalized.

As Voilà ramps up to its soft launch in spring 2020, we estimate that there will be a relatively immaterial impact of about $0.01 per quarter impact in fiscal 2020 as the team grows and we incur the costs of putting a new business in place, with the potential for increased marketing costs over and above that in the fourth quarter.

In fiscal 2021, with our CFC and GTA launch, and beginning to ramp up design and construction of our second CFC in Montreal, we do expect further earnings dilution for fiscal 2021, and we will update our estimates closer to the launch.

Our strong top line, margin discipline, and success in capturing the benefit of Sunrise on the bottom line, coupled with disciplined capital management, has created a new level of strong, consistent cash flow generation. This has provided us with the flexibility to spend on our growth and innovation agenda, look after our store fleet, fund our growth initiatives, and still consider the opportunity of returning cash to our shareholders.

In addition to the dividend increase and share repurchase, we will also retire some debt during the year.

And with that, I will hand it over to Katie for questions.

Katie Brine

Thank you, Mike. Joanna, you may open the line for questions at this time.

Q&A

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. Should you have a question, please press the *, followed by the 1 on your touch-tone phone. You will hear a three-tone prompt acknowledging your request. If you are using a speakerphone, please lift the handset before pressing any keys.

And your first question is from Jim Durran from Barclays. Please go ahead.

Jim Durran — Barclays

Good afternoon. Just looking at the fiscal ‘20 and ‘21 outlook, it sounds like you remain confident that you can get to a sustainable 5 percent EBITDA margin through a number of the initiatives, but you’ve also mentioned that you feel confident that with new programs coming into play over that time frame that you thought that you could get higher and close the gap versus your competitors. Beyond Farm Boy, which obviously has higher margins, right, what are the kind of initiatives that you could talk about do you see driving you towards that successful outcome?

Michael Vels

Thanks, Jim. It's Mike. So you're right. That is a message that we have to bank some more Sunrise savings in 2020. They're not immaterial. And as we've said pretty consistently, our expectation is that the bulk of those should fall to the bottom line, and that's certainly going to help the EBITDA margin.

But we've also said pretty consistently that that's not going to get us all the way there, and we still need to improve our cost base, both cost of goods sold and our SG&A. And we think there continues to be opportunity to do that, and we'll keep working on it. That's an element of further closing that gap.

And we need to improve our top-line productivity, our sales productivity, and that's going to come through a variety of initiatives which we're working through, and we'll certainly shed some more light on as we complete our strategic scans and start to think forward to 2021. But those include getting even better at price and promo optimization, improving our marketing, presentations in the stores, improving our customer experience, becoming much more of a destination store, et cetera. So it's a relatively long list, but realistically when you think about it, we've just reset our foundation. That's given us a lot of immediate benefits.

But the very exciting thing about it is it gives us a tonne of opportunity going forward. And those are some of the items that we're referring to when we conclude that this is not even half over, and we have a lot of improvements left.

Jim Durran

Okay. On the comp store sales, a very strong year. Obviously, inflation was an assist, but you had very strong real comp store sales, and while we don't have the exact numbers, certainly some transaction and traffic growth, which I assume resulted in some repatriation of market share that had been lost in the past. You're now going to be entering a year where you're up against some much-improved numbers on the top line. I assume that there's some benefit that could be taken from category resets. Was Farm Boy included in comp store sales for this quarter? Do you plan on reporting it that way over the course of the time?

Michael Vels

Yes we do, Jim. It was included in this quarter, and we're going to continue to do that. It had about a 0.1 percent impact on the same-store sales number for this quarter.

Jim Durran

Okay. So again, I guess there's going to be some stuff you're not willing to talk about, but how should we be thinking about fiscal '20 from a comp stores sales standpoint? There's still a belief that I think generally inflation will slow, although the May printout of CPI was strong. How do you feel about continuing to be on the offence, as Mike mentioned earlier, and gaining more volume growth through 2020?

Michael Medline

I think we feel pretty good about our experiences that when you have some momentum, it tends to carry over. It's harder to turn the ship when you're not doing so well.

We believe that our execution in all areas of our company and from supply chain to our marketing, in-store, digital is so much better than it was even a year ago. And we have plans for all of that. We won't get all the way where we want in the next year, but we're going to get quite a fair way.

Yeah, we're going to be trying to stack some good quarters. It's hard to call what inflation's going to be, so our goal is to grow tonnage and grow market share, smartly. And earn it, and still keep a strong margin.

And we're very optimistic that we will continue the strong path we're on. I would like to see some summer, personally and business-wise. And I'd like to sell some more popsicles and cold drinks – it's the first time I've ever mentioned weather here at Empire, and it's hopefully the last. But we just keep doing our job. And I'm really, really optimistic about our chances to grow that market share.

Jim Durran

Mike, up front you mentioned about innovation. As we think about fiscal 2020, both on the branding, positioning of the conventional business, marketing initiatives, including digital component – should we be expecting a big splash? Or are these initiatives going to come in spread out over time and sort of just build towards what we'll call a new conventional offering?

Michael Medline

Yeah, as I said, it's not innovation for innovation's sake. I think the biggest change we've made over the last six months is we're gearing up to be able to use data analytics and AI in a way we've never done before. And I don't use AI loosely. I think people are using it a bit loosely out there in the business community. I mean, really driving our business to be smarter and test and learn, and especially to be more productive as we go forward.

We have some initiatives right now underway that we're starting, that we expect to see by the second half of the year. We'll start to see some small impact and growing over time. Rather not share that. At the same time, with Sandra leading us in marketing, you're going to see much more personalization, much better use of digital. And you're going to see us testing early on in the fiscal year some things in the store and some things online that we intend, if they work—which we expect they will—to spread across our business.

Innovation is a big word, and people throw it around a lot, as I do sometimes, but a lot of it is the back of the house. It is using data analytics to serve your customer better and to take extraneous costs out. But many times, too—and that's why I talked about how grocery stores have not changed as much as hard and soft goods retail stores in this country—there's an opportunity to thrill our customers, not only online, which we obviously are going to do, but in our stores as well.

And I think we have the team. They're buying into using innovation smart, but in ways that serve our customers better, not just doing it to get a headline here and there.

Jim Durran

Great. Thanks, everybody.

Michael Medline

Thank you.

Operator

Thank you. Your next question is from Michael Van Aelst from TD Securities. Please go ahead.

Michael Van Aelst — TD Securities

Thank you. On the inflation, so I think you said 2.2 percent and CPI was something like 3.5, I think, for your period. So can you talk a little bit about what you're seeing in the store, the degree of trading down, the ability to pass through the full cost of goods sold, and that kind of thing?

Pierre St-Laurent — Chief Operating Officer, Full Service, Empire Company Limited

I think Q4 was a bit higher than Q3. It depends on the category. We need to be extremely cautious on how we are passing cost increases, and we need to remain competitive.

At same time, the comparison with CPI, we need to look at it carefully because the basket is very small and is changing over time. So once again, we need to look at many metrics at the same time to make sure that we pass cost increases effectively. I think we did this, because our margin is much better, and we continue to expand and increase same-store sales.

So the 2.2 of CPI, it's an average with a small number of items. We monitor it very carefully week after week, and that's the average result we have in Q4 versus Q3.

Michael Van Aelst

All right. So are you seeing people trade down or trade out of certain categories?

Pierre St-Laurent

No significant change from over the last four quarters in customer behaviour. Some commodities are rising faster than others, but no significant change in customer behaviour.

Michael Van Aelst

Okay. On Ocado, how soon can we expect to hear about commitments for the third and the fourth potential sites? Like is there a certain window that you have to commit to or risk losing your turn?

Michael Vels

No, not at all, Michael. So when will you hear about number three, number four? The short answer is, I don't know. We're working through Montreal right now and figuring out timing and design for that facility. We just knocked down the building that was on it, as I think you probably know.

That's really our primary focus at this point. We don't have any deadlines, I think is what you're getting at too. That's not what drives us here. It's really going to be about the right business timing for us.

Michael Van Aelst

All right. And then if you look at your EBITDA performance for the food retail side year over year, I think it's up, what, $30 million, $40 million. You had $200 million in Sunrise savings, but then clearly you had minimum wage headwinds. You had drug reform headwinds, things like that. But there was also some other investments. That doesn't account for all of the difference. So what other costs are you seeing that are inflationary that is holding back more of that 200 million from showing up on the bottom line?

Michael Vels

You're talking about the full year, right?

Michael Van Aelst

Yeah, exactly.

Michael Vels

So we referred to a number of items, and certainly maybe Pierre can talk about our early trading. But clearly, minimum wage was an impact. We had very material freight cost increases that we referred to earlier on in the year and then a number of inflationary impacts on commodities and currency that we didn't pass through—I think we were pretty clear about that earlier on in the year—as quickly as we wanted to.

And that resulted in, solely for the first half, lower gross margins than we would have anticipated. I'd say those would be the headwinds that didn't help from a trading perspective. I assume in asking your question that you've already accounted for things like the BC buyback, FreshCo store closures and that sort of thing, so obviously I'm not going to bore you with those details. But those are probably the primary reasons.

Michael Van Aelst

Yeah, so the freight, commodity, and currency that was there in the first half, I mean, are you expecting to be able to recapture all of that? Or do you think that's it?

Michael Vels

I think if you look at our progression here, we've done pretty well in terms of maintaining margins and growing sales. And yeah, we'd hope to continue to expand and make sure that we price for cost increases. But I think on balance, it would be fair to say that we ended up absorbing some of that.

Michael Van Aelst

Okay. And just regionally, I know you don't want to get too specific, but it looks like Quebec operations were quite strong if you just kind of use the non-controlling interest changes as a bit of a guide. What do you think you're doing in Quebec that is really helping you?

Pierre St-Laurent

Yeah. The operation is strong in Quebec, but the rest of the country has also been strong. When we look at the same-store sales, we've got a very good Q4 across the country. And I think the team's working more and more together and they're sharing good practices across the country.

There are good practices in English Canada that Quebec using now, and I think collaboration has been great. And the category reset project has been a very powerful project to bring people together to behave as one big company. And I think there's more to come, especially in fresh.

Michael Vels

I think Pierre's being a bit modest. His team in Quebec have been very good in terms of promotional effectiveness. I think some of the promotions we've had out there in the last four to six months, it would be fair to say have been very effective. And as he says, we were planning to move some of those proficiencies across to the rest of the country.

Michael Van Aelst

All right. Thank you.

Operator

Thank you. Your next question is from Irene Nattel from RBC. Please go ahead.

Irene Nattel — RBC

Thanks, and good morning, everyone. Really intrigued by your commentary around post Fiscal 2021 and beyond and where you want to take the Company around innovation. Recognizing that you're not going to tell us what you're going to do, wondering maybe if you could give us an idea of who you do think is doing in-store innovation in a really good way, both in food, but also perhaps in other categories, or that you might be able to emulate?

Michael Medline

Well, I think a lot of people are doing good work in Canada, but we were just down in the United States looking at some retailers doing a really good job down there. I'd say that the ones that we hold in high esteem in the United States are Kroger and Wegmans and H-E-B. And we're watching a lot of what they're doing, in terms of prepared foods and what they're doing in produce and some of the other areas, but also in terms of at Kroger, where Kroger has become a very innovative grocer. Not all is applicable to us, but I think there's a lot to learn by seeing where they are, and they're probably a couple years ahead of us in terms of some of the innovation, but I think we can catch up a little bit.

We're not as large a company. We're not going to invest as much in some of these projects. We're going to be more selective. You can see that from how we're talking in terms about capital spending and all that. You see what some of these companies are doing behind the scenes, but also in terms of their customers.

Now in terms of e-commerce, I think we've got the best solution, and we'll be the first in North America to have it.

Irene Nattel

That's understood. And that sort of leads into my next question, which is clearly you're investing in data analytics and capabilities. What are you adding? Where are you adding? What is the magnitude? And where do you see the greatest potential impact of that?

Michael Medline

Well, we've done a lot of work as a team and with our head of human resources, who's very strong, Simon Gagné, and we've done a lot of work looking at which companies have done it well and which companies are just spending a lot of money.

We believe we need to be extremely prudent and not gear up too quickly; that it is very difficult for any individual company to staff up right away and have the kind of data engineers and analytics that people talk about and that the best companies out there doing it—many of whom are European—build slowly and concentrate on a few key innovation and AI projects at the beginning and ramp up their capabilities there. And that they don't just have something way off and doing whatever they want. They partner with the operators, and the merchants, and the marketers to make sure it's relevant.

I think we actually have some skills right now, and we're doing some things, especially in merchandising, that are going to pay off in the next year or two and in marketing. But that you've got to be very careful—we did a lot of work to become a more efficient company, and we have a lot more work to close that EBITDA margin gap.

And throwing money around willy-nilly and doing innovation for innovation's sake is not the strategy we want to pursue. At the same time, our goal is to be the most innovative retailer in Canada. But it's not going to be in the next year. We will do it in the right way, as we have benchmarked.

Irene Nattel

Understood.

Michael Medline

Okay.

Irene Nattel

Certainly, as part of the category resets and in general, you've really raised your game on private label. Would you be willing to talk about where the penetration is, where it's coming from, and how important you see that as you move forward?

Michael Medline

I'm turning to Pierre, who hates to give away any competitive information at all. So let's see what he says.

Pierre St-Laurent

We know we are under indexed in private label. Once again, the category reset exercise has been extremely positive in identifying specific growth for private label. And so far, we're seeing very encouraging results on the categories we executed on at store level.

So we are expecting to have faster growth in private label, just because we are under indexed. And now in some categories, private label will have a specific role to play. And in some categories, private label won't play a role, because there's no room for private label. So category resets was a really good exercise to identify these opportunities. And so far, we're catching them and we see positive results.

We're expecting to increase our penetration with private label going forward.

Irene Nattel

That's great. Thank you.

Operator

Thank you. Your next question is from Vishal Shreedhar from National Bank. Please go ahead.

Vishal Shreedhar — National Bank

Hi. Thanks for taking my questions, and congrats on the quarter. In terms of the new efficiency program, call it Project Sunrise 2.0, do you anticipate that the efficiencies from that will offset the costs that you have related to all of these growth initiatives that you have going on? Or is it something more than that, something substantial like what we saw in the first iteration?

Michael Medline

Well first of all, I'm going to say it's not going to be called Sunrise 2.0, but that is—I don't know how you know it—our working title right now. But it won't be the final title.

Michael Vels

Well, I think it would be fair to say that as we said, early days working through it. We also still have to bank a big number for 2020. That's what most of our operating people are focused on. But as a management team, we're focused on aggressively growing our bottom line. So one way or the other, wherever we point this business at in terms of strategic direction, we have to eat today and grow tomorrow.

So I think you can expect that we will have aggressive goals in terms of growing our year-over-year earnings numbers. How that works out in terms of combinations of dilution we'll take on our discount expansion versus improvements in promotions, et cetera – that's our job to balance it, but certainly we're not going to take a vacation from growing our bottom line.

Vishal Shreedhar

Okay. Thanks for that colour. And just in terms of how far you are in terms of identifying the opportunity, is this something that you'd say you're pretty far down the road? And you've mentioned the word early days— is it still that we don't know what the opportunities are, we're working on it, we're trying to figure them out?

Michael Vels

Oh, no. We have some strong perspectives. Our strategy sessions and finalizing these things tend to happen just sort of in the early fall, October/ November time frame. That's when our Board of Directors will get a good look at it.

So as I said, still a ways to go. And you can probably expect to see and hear a little more about our thoughts 2021 and beyond as we progress later through 2020.

Vishal Shreedhar

Okay. Thank you for that. In terms of in the quarter when you implemented these category resets, just an outsider looking in, one might imagine that these kinds of initiatives would be very labour intensive and it may have hit you a little on the SG&A line. Maybe you can give me some colour on if that was in fact the case? And do you see that cadence, if I am correct, improving as you move on?

Michael Vels

No. The labour cost impact that I referred to is primarily sales-driven. So we didn't have increases in our store labour that would merit isolating or discussing in the context of our fourth quarter.

Vishal Shreedhar

Okay. And in terms of the category resets, I believe you mention in the script generally satisfied with them right now. How long does it take you to get a good read if the customers are reacting negatively towards them? Does it take one quarter, a few months, a year?

Pierre St-Laurent

The execution of the category resets should end in October. It started in the beginning of January, beginning of February last year. Grocery is, I would say, 70 percent of the execution is done. We're in a good direction. I mean, grocery will be finished at the end of August, and we're going consciously category by category. There's no big disruption in store, so it's a well-organized process because it started in January, and we learned a lot in every tranche.

So there's no major disruption, I think. And the process is going really well. This fall, the remaining categories would be in fresh, and in many fresh categories there's no relining required. So I think the biggest part of relining is behind us. There's still some categories ahead of us, but we're confident to complete that without major disruption and without any customer dissatisfaction so far.

So we're really pleased about that, and that's over our expectations I think.

Michael Medline

We did a lot of prework led by the merchants to go through every category and understand how customers approach it and what they're looking for. We expected a little bit of pushback in terms of some of the relines, just because when you reline, you're changing some of the categories. I think we're a little surprised actually, Vishal, at how well all of this has played out.

I was going to say we've had de minimis effects. I wouldn't even say it's de minimis. It's just nonexistent in terms of the categories. Every single category we've relined, we're pleased with the changes. From a customer point of view and from a sales point of view, we think they're very, very positive going forward.

Vishal Shreedhar

Okay. And maybe just a high-level question here. A few years ago, analysts used to ask the question about conventional and its positioning in the Canadian grocery place, the traditional conventional grocery store and its position and whether it was over-stored from that standpoint of the conventional grocer. Wondering if you have an opinion on that? I know you're growing discount in select markets, but what's your view on just generally conventional grocer and how they have to compete?

Michael Medline

Yeah. We said two-and-a-half years ago that there's a big place in Canada for full service—what you call conventional we call full service—grocery. There's a place for discount. Many customers shop both at different times. We, at that time, thought that the market had matured in a way that there was a good mix of full service and discount in Central Canada. And I think that's the way it's played out.

Two things I'd like to mention. One is that you can see from our results over the last year, I think we've grown tonnage and same-store sales as strongly or more strongly than anyone else in the country, and almost all of that is in full service, so that kind of plays that out. And that we thought that there was a real opportunity in Western Canada, though, in some markets to convert to discount with the FreshCo 2.0, which is playing out great, and we'll take advantage of that.

But I think you build a store, whether it's discount or it's full service, or you put up Voilà, and if it's great for the customer, it does great. And I think right now, I'm happy with the stores we have. And it's our duty to make them even better to thrill customers and keep growing them.

Operator

Thank you. Your next question is from Patricia Baker from Scotiabank. Please go ahead.

Patricia Baker — Scotiabank

Oh, thank you very much. I have two questions. My first one will be for you, Mike. You indicated that you're ahead of plan with Sunrise by about $50 million, and of course raised the goal from $500 to $550. I'm just curious, the extra $50 million where you're ahead of plan, is that primarily related to extra gains that you got from the category resets? Or is it broader than that?

Michael Vels

I think it's broader, Patricia, would be the very superficial top-line answer. So when we originally set out our expectations, we reformulated them a little, if you sort of think about it maybe in this context, as you can imagine, we do drive our internal people to higher numbers because you always worry about missing it. So I think we managed to bank a few of those stretch targets, and that would be really across the board, firstly. And so I wouldn't point to any one particular item or event on that.

Secondly, I think we have said a few times that we actually got going on the negotiations and the category reset work probably at least a quarter earlier than we had originally set out when we set that $500 million target out. So there's a little bit of timing there.

And then lastly, if you think about what we've said here where previously we said we'd be annualizing $500 by the end of 2020, if you look at that math, we'll be almost fully capturing that $500 plus the $50 by the end of 2020.

So those would be the things, probably the things that have caused us maybe to be higher. It's shooting at a slightly higher target, being a little bit ahead of schedule.

Patricia Baker

Okay. Thank you, Mike. That's helpful. And, Michael, if I may, I have a question for you. I was very intrigued to hear you in your opening remarks talk about an innovation agenda, and I know you've already been asked a few questions about it. Fully understand why you're not going to tell us what the projects are, but I've got sort of three little questions around the innovation agenda.

First of all, exactly when in the course of the last year or so did the Company turn to being able to have innovation as part of its strategic priority and started doing the work and thinking about this?

Then secondly, who is in charge of this? Who was spearheading it?

And then thirdly, echoing back something you said on data analytics and the fact that you've got the people who do it right are the ones who take small projects and get their feet wet on those, but importantly involve the operators and the merchants. So would I be right in assuming that this innovation agenda would be projects which would involve all kinds of different areas and operators within the Company?

Michael Medline

Yeah. No, those are great questions. Thanks, Patricia. Now I always thought it would take two years to put the infrastructure in place to really be able to go at innovation. So I'd say about six months ago, we could without taking too much attention away from category resets and from all of the great work we're doing in stores and in merchandising that you can see the results of, that we can start turning our mind to all sorts of innovation, but especially data analytics. And so it was almost right on schedule. After two years, I think we felt that way.

Innovation has to come from the operators and the merchants. It doesn't take hold if it's just the CEO and some crew of strategy and innovation people trying to shove it down their throats.

I've been fortunate to inherit and now grow the team to include people who not only are really tough on execution and really good at it, but they embrace innovation if they see that innovation is better for the customer and better for the bottom line. And so, we're going to bring in a Head of Innovation. We're going to announce that pretty soon. And that person will have to be someone who can collaborate, and work, and can coordinate across our businesses because that person on their own can't do much at all without working across the businesses.

But I am very, very optimistic about the type of person we're going to bring into that role, and even more excited about the executive team we have here to lead innovation.

Yeah. It's important. A lot of people talk about innovation. I talk about it a lot. But it's got to be part of the business. It's got to be planned. Innovation without process, without discipline, just coming up with crazy ideas doesn't do anything. It just spends a lot of money and it just throws you off what you're trying to do.

We're building this into the plan—the three-year plan is going to be about execution /innovation, and in many ways they're going to be inextricable. And much of the efficiency, not only the sales growth and the customer satisfaction you're going to see, is going to be from innovative new ways of doing things. And I can tell you Pierre is becoming quite the expert on AI right now, among other things.

So that gets me excited, and that I know will have a real tangible effect rather than just, as I said, getting some headlines somewhere, which doesn't do anything for us.

Patricia Baker

I don't know who will answer this question, but on sticking with the topic of innovation, but now talking about product innovation. I noticed that at the beginning of the season you guys, Sobeys, kind of led with the Beyond Meat burger on the front page of the flyer for the holiday weekend. Just curious if you could tell me how that went?

Pierre St-Laurent

So we made many changes in our structure when we did Sunrise, and we brought our team new ideas, new teammates, young merchandisers with the combination of experienced people. And you know what? Our young people are big fans of that type of product, and they found that it was a huge opportunity to thrill customers. And we approached that company as one national company, for really the first time. It was our first launch coast-to-coast. We were attractive to that supplier to introduce the Beyond Meat product in Canada.

And that's just the beginning, and the power of working together. We have been able to do that statement on our flyer because we made a good deal with the supplier. And plus, the supplier was happy to do that deal with us, so it's the beginning of a great partnership going forward. Our expectation is to become the best retailer to work with by adding good partnerships and promoting products when we think that it's relevant to customers.

Patricia Baker

Thank you very much, Pierre.

Pierre St-Laurent

Welcome.

Operator

Thank you. Your next question is from Peter Sklar from BMO Capital Markets. Please go ahead.

Emily Foo — BMO Capital Markets

Hi. It's Emily Foo for Pete Sklar. Just a question on the benefits that you're getting in fiscal 2020 from Sunrise, the $250 million. How much of that would be in the category resets? Or vendor asks? And along the same lines of the vendor negotiations, like how are those going? And are they still ongoing?

Michael Vels

A high percentage, more than 50 percent of that would be related to the work we're doing with category resets and vendors.

In answer to the second question in terms of how far along are we, I think Pierre mostly covered that when he said we're probably about 70 percent of the way through in terms of negotiations. Grocery negotiation is pretty well done. Now we're into execution and some fresh negotiations still on the table for 2020.

So I think it would be fair to say that that estimate for fiscal 2020 is based on some very high visibility we have, having completed a very material, in fact, almost the majority of the negotiations that really count.

Emily Foo

Okay. Great. Thanks. And on to FreshCo 2.0, so it seems like the launch is a success. And we're just wondering what in particular are resonating with the customers there? If you've had any lessons? And if you've seen any response from any competitors in the region?

Michael Medline

Yeah, it's Michael. I'll give a bit of an overview, and I'll answer your question. So the stores we've opened to date are doing great. We have five open. We saw strong opening sales, and a very positive customer reaction. As we totally expected, as we go in and take market share from people, they don't like that. And they've felt our arrival, and they're reacting to it. That's what I would do too, but we're going to aggressively compete out there full-on to thrill our customers and take away competitive market share.

So all's been going according to plan, maybe a little better than plan, and we can't wait to get these FreshCo stores open. I think there was a need that we identified two years ago for stores of that size and that calibre to enter these markets and to bring discount prices to markets that, for the most part, weren't getting it.

And I think in this case, if I may be so bold, that before when we would open something, whether it be FreshCo in Ontario or Price Chopper, we weren't aggressive enough in terms of our marketing. We have put together a great marketing program to introduce this brand to these communities, and awareness is extremely high. And when people come in the door, they're being thrilled.

And more and more, we just have process and discipline behind things so that we're just not opening the store—we're making sure before we open these stores that everything, including supply chain is ready to go.

I would say that I've been very, very, very impressed with our FreshCo team led by Mike Venton. Mike's a solid, experienced discount retailer. And I think that, combined with the talent we already had here, has really made a difference.

And so we had a great strategy. We're doing the right thing. And we're making customers happy, so we can't wait to get all 65 open.

Emily Foo

Great. And lastly on Farm Boy, has it been to your expectations?

Michael Medline

Yeah. We're right on. This is a well-run machine. This is run by a fantastic, small and efficient team that cares so much about their customers. For the most part, my job is not to get in their way and to give them all the help that a large company can give, including real estate, without in any way changing their offering to the customer or the brand.

I think we've more than accomplished that, although at the same time I believe that they've brought value to us in their knowledge of customers, brand, but especially in terms of setting up a store to meet customers' needs in an urban market.

I was going to say right on, but I'd say it's better than right on since we've purchased it. It's a great outfit, and that's why we went after it so aggressively.

Emily Foo

That's great. Thanks for your comments.

Michael Medline

Thank you.

Operator

Thank you. Ladies and gentlemen, please note that we do have time for one more question from each analyst.

And your next question is from Mark Petrie from CIBC. Please go ahead.

Krishna Ruthnum — CIBC

Hi. This is actually Krishna Ruthnum on for Mark. I wanted to come back to an earlier question that was asked on the benefits of Project Sunrise just flowing down to the bottom line. So given that we've lapped many of the headwinds that you faced this past fiscal year sort of looking ahead to the $250 million in savings to be harvested in 2020, fiscal 2020, how do you think about your ability to trickle those savings down all the way to EBITDA?

Michael Vels

Well, we think about it the same way as we did at the beginning of 2019, really. Our goal would be to record as much of that on the bottom line as we can, and frankly our senior management is in fact incentivized to do that. The success of doing that is obviously dependent on a number of things: internal execution, market factors, and to some extent some reinvestments in things like marketing and other things that you saw a little bit of this quarter.

So it's our expectation that the vast majority of it will end up on the bottom line in our earnings.

Krishna Ruthnum

Okay. Just moving on to SG&A, so I mean it grew fairly significantly this fiscal year. I just wanted to know if you can elaborate more on the pace of SG&A growth, or maybe just give us some guidance on how you see that evolving from the first half to the second half of the year?

Michael Vels

Through the first half of 2020 to the second half of 2020?

Krishna Ruthnum

Yes.

Michael Vels

Probably not guidance. I mean, we clearly have some more work to do, and a lot of that Sunrise target for 2020 will be in the SG&A line. So at the same time, we do anticipate a full year of Farm Boy to have an inflationary impact, if you want to call it that, on the SG&A line because their service model and their in-store model is more expensive than ours and comes with a higher store labour rate than our full service or our discount stores.

But it is our goal ex-Farm Boy and ex the impact of higher sales – which does drive higher in-store labour – to continue to reduce that SG&A line as a percent of sales. So that's our intention. At the same time, we do have some intentions to invest more in innovation, marketing. At this stage it would be fair to say we don't have a total fix on that number. And that's something that as it occurs, if it occurs, we'll certainly disclose it.

Krishna Ruthnum

Okay. Moving on to CapEx, so just considering the $600 million number, and aside from the $70 million set aside for Farm Boy, can you give us a sense of how that splits out between Voilà GTA, Voilà in Quebec, and then the FreshCo rollout out west?

Michael Vels

I think I gave the FreshCo number in my comments, which was $65 million. That would be an element of it. The largest element of the remainder of the spend is store renovations, which is going to be a very significant focus for us in this year. And the completion of, as you said, the Voilà GTA warehouse and Montreal would be another component.

We’re not in a position to put numbers to that yet. We’re still working on Montreal and timing of that design and construction. As we get closer to that, we’ll be a little more outgoing about disclosing and talking about those numbers.

Operator

Thank you. We have time for one last question from Keith Howlett at Desjardins. Please go ahead.

Keith Howlett — Desjardins

Yes. I wanted to ask about the store renovation budget, if you can quantify that and how many stores you’re intending to touch and sort of what the nature of the projects you have in mind are?

Michael Vels

We’re not disclosing that number at this point, Keith. But some colour on it is we’ve isolated our fleet, and segmented it into a program that’s going to take five-plus years. So this is a long-term and a consistent program that we anticipate to invest in over the coming years. I think it’s a very important part of our brand strength.

Some of these are fairly light-touch renovations. We’re finishing up the FreshCo 2.0 packages in Ontario, and there’s some heavy ones where we’re redoing significant elements of the store. So the cost of each of them is materially different, and how we impact the store is different as well.

It’d be fair to say that if you had to say where most of the spend is occurring, a significant amount is in Quebec, and that’d be consistent with prior years. We will be doing more in the west in 2020 than we have before, so a commensurate decline in Ontario and the east. And of course, we have the conversions, as I talked about, in the FreshCo stores.

Operator

Thank you. That concludes the Q&A. I will now turn it back over to Katie Brine for closing remarks.

Katie Brine

Thank you, Joanna. 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 first quarter fiscal 2020 conference call on September 12th. Talk soon.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating, and we ask that you please disconnect your lines.