FINAL TRANSCRIPT

Empire Company Limited

IFRS 16 Leases Education Conference Call

Event Date/Time: July 15, 2019 — 11:30 a.m. E.T.

Length: 19 minutes

CORPORATE PARTICIPANTS

Katie Brine
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Nicole Battista
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CONFERENCE CALL PARTICIPANTS

Peter Sklar
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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Empire Company Limited IFRS 16 Leases Education 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 Monday, July 15, 2019.

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

Katie Brine — Director Finance, Investor Relations, Empire Company Limited

Thank you, Joanna. Good morning, and thank you all for joining us for our IFRS 16 Investor Education Call. Not the most riveting topic to start off your week, but we thought it would be helpful to give you a better understanding of the impacts of the new accounting standard on Empire.

This call is being recorded, and the audio recording will be available on the Company's website at empireco.ca. There is a PowerPoint presentation on our website we will be referring to on this call, which you should all have access to.

Joining me on the call this morning are Michael Vels, Chief Financial Officer; Adam Sheparski, Vice President, Finance, Treasury and Reporting; and Nicole Battista, Director, Financial Accounting Standards and Policies.

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 Page 3 of the presentation for more information on these assumptions and factors.

I will start with a few brief remarks and then turn it over to Nicole Battista, who has lived and breathed this standard for almost three years now. We will briefly discuss our approach, then walk you through the anticipated impact on Empire's financial statements, give you better insight into our lease portfolio, and note the impact this has on rating agency ratios and bank covenants. We'll finish our session with a Q&A.

Before Nicole starts, as Mike noted on our earnings call last month, these are accounting and measurement changes only. They will have no effect on our cash-generating ability, and we do not expect any material changes related to debt ratings or financing costs. With that in mind, I will hand it over to Nicole.

Nicole Battista — Director, Financial Accounting Standards and Policies, Empire Company Limited

Thank you, Katie. Good morning, everyone. I will quickly go through some background information. If you'd like more detail, we have slides in the appendix to our presentation, and you can review the relevant sections in our fourth quarter fiscal 2019 financial statements and MD&A.

IFRS 16 introduces a balance sheet recognition and measurement model for lessees, eliminating the distinction between operating and finance leases except for short-term and low-value asset leases. Lessors will continue to classify leases as operating or finance leases.

Empire elected to use the modified retrospective approach, which is applied from the beginning of our first quarter, May 5, 2019, with a cumulative effect of initially applying this standard recognized as an adjustment to equity on transition. On Page 5, we give an illustration of how the equity adjustment would be calculated at the beginning of the company's fiscal year.

We chose this approach for a few reasons. The other approach, full retrospective application, is difficult, as you need to obtain historical discount rates, incorporating security and debt ratings while the Company was both private and public for auditor concurrence. As well, where Empire has had many acquisitions in its history, the full retrospective application dates would be based on the same acquisition date used in the modified retrospective approach.

From a cost benefit perspective, the modified retrospective approach allows for the use of several transitional practical expedients, which are not available under the other approach. Also, based on benchmarking with Canadian retail peer companies, the modified retrospective approach is the expected general transition approach.

Lastly, consistent with peers and with the insignificant expected earnings impact, this is the most practical approach.

We have been providing additional disclosure to what is required in both our Q3 and Q4 financial statements and MD&A to give more visibility to the expected impacts on our financial statements in the first quarter of fiscal 2020, which we've summarized on Pages 15 and 16.

In the financial statements, Note 9 gives our existing finance lease assets, Note 15 gives our finance lease obligations, and Note 16 gives the deferred lease obligations. In Note 24, we show the gross and net obligations for operating leases and the minimum lease expense disclosure.

In Empire's MD&A, we noted that the net cash rent for leases impacted by IFRS 16 was 500.5 million. This shows what you can expect as not all subleases with nonconsolidated sites are finance leases under IFRS 16, as shown on Page 11.

As Mike noted in the fourth quarter earnings call, there are two large expected impacts on our balance sheet due to the implementation of IFRS 16.

First is the inclusion of 4.6 billion to 4.8 billion of liabilities, which are largely new lease liabilities. This is measured as the present value of the remaining lease payments using the lease specific discount rate at May 5, 2019. The weighted average discount rate for purposes of IFRS 16 is 4.4 percent. The individual lease discount rates will only be updated when there is a modification to the lease or when renewals are added.

Another key impact of the calculation of the new lease liability is the lease term. Under IFRS 16, lease term is determined as contractual noncancelable period of the lease plus periods covered by an option to renew the lease, if the company is reasonably certain to exercise that option, and the periods covered by an option to terminate the lease, if the company is reasonably certain not to exercise that option. Quite a mouthful.

Essentially, it is when management believes they are reasonably certain they will exercise the renewal, which adds Empire's link to the Company's economic incentives to stay on the lease. To be clear, just because there are multiple renewals that are not added to a lease does not mean that management does not intend to stay in that location. It means that we do not have enough information today to meet IFRS' high threshold of reasonable certainty for the lease renewals, or there is no significant economic incentive for management to exercise those renewals on that location. You can see a visual of the remaining lease term on Page 7.

We have shown a visual of how we arrived at our estimated new lease liability on Page 8. We start with our gross lease obligation pre-IFRS 16, added leases where we were reasonably certain a lease extension will be exercised; adjusted for finance leases, liabilities, and leases with less than a year remaining; and then the negative impact is discounting these obligations to present value.

The second large impact of the balance sheet is 4.0 billion to 4.2 billion of additional assets, primarily right-of-use assets. These were measured as though IFRS 16 had been applied since the inception of the lease. Page 9 shows a visual of the transition lease obligation with adjustments to arrive at our opening right-of-use assets.

The transition asset recalculation has the largest impact. This is where we have recalculated the asset value based on the original term for most leases rather than asset equal to liability on transition. This results in the lease liability estimate being higher than the value of our right-of-use asset on transition. For new leases in the future, the liability and asset will be the same upon initial recognition.

There are a few differences from our peers, which I'll highlight. On the liability side, the initial terms of our leases range from 15 to 20 years, mostly due to our leases with Crombie REIT, which are an average five to ten years longer than our peers.

Our historical off-market leases, which are higher than our peers, have resulted in a longer lease term on related leases where there is economic incentive to renew, increasing both the liability and asset value for the additional term. Also, the off-market lease intangible assets are added to the right-of-use asset for the lease on transition.

If you turn to Page 10, we have our current estimates of the impact of IFRS 16 on our Q1 fiscal 2020 income statement. As you can see, EBITDA is expected to increase significantly. Rent expense is replaced with depreciation on right-of-use assets, and interest expense on the new lease liabilities. However, regarding our bottom line, we continue to estimate that the adoption of IFRS 16 will not have a material effect on earnings per share in fiscal 2020.

Going forward, the treatment of gains on the disposition of real estate per sale leaseback transactions will change in certain circumstances. Historically, if Empire sold a piece of property with a Sobeys store on it to a third party and recorded a gain on that sale, the gain would be recognized when the sale occurred. Under IFRS 16, in this same scenario, if that Sobeys store we're closing at the time, Empire would still record the gain on sale that day. However, if the Sobeys store entered into a new 20-year lease after the sale, the gain would be calculated under IFRS 16 and, in most cases, result in a reduced gain on the transaction date with the remainder recognized as reduced depreciation over the term of the lease.

Page 11 reinforces that while the presentation of the statement of cash flow will change, as these cash amounts will be classified as financing cash flows rather than operating, there will be no change in the amount of cash exchange related to these lease transactions. As we noted previously, we intend to change the definition of free cash flow to adjust for the impact of cash rental payments to appropriately reflect the substance of the metric.

The final numbers are expected to be within these ranges I have discussed and will be recorded and discussed in our financial statements and MD&A when we release our first quarter of fiscal 2020 on September 12, 2019.

Katie, back to you.

Katie Brine

Thank you, Nicole. Two final points. First, in regard to the impact of IFRS 16 on our rating agencies' calculations, we expect that in the short term, DBRS and S&P will monitor the effects on their issuers and continue to use their own metrics.

Our assessment is that the effects of IFRS 16 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 the changes from IFRS 16.

Second, at this time, the Company does not expect the need to renegotiate covenants based on the estimated impacts. However, Empire has the ability to renegotiate within our debt agreements if there is a need to ensure that the Company is not impacted negatively by the IFRS 16 accounting standard change.

Our project team has spent close to three years on the implementation of this standard, looking at thousands of leases, implementing a new national lease management system, and working closely with our auditors to ensure a successful implementation of IFRS 16 at Empire. Thank you to all involved for their hard work.

And with that, 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 *, followed by 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. One moment, please, for your first question.

And your first question is from Peter Sklar from BMO Capital Markets. Peter, please go ahead.

Peter Sklar — BMO Capital Markets

Oh. Hi, Nicole. Just have a question on the lease liability. You talked about the range being 4.9 billion to 5.1 billion. But during your presentation, I thought I heard you talk about a range of 4.6 to 4.8. So if I heard you correctly, what is the difference between those two ranges?

Nicole Battista

Well, the difference is actually the 4.6 billion to 4.8 billion is reflective of the total liability impact on our financial statements. The lease liability is 4.9 billion to 5.1 billion. We do have some other liability impacts that are outlined on Page 16 of the slide deck where you can see we have some provisions, some debt, as well as other liabilities.

Peter Sklar

Yeah. But then the 4.9 to 5.1, wouldn't that reflect all the liabilities?

Nicole Battista

No. The 4.9 to 5.1 is specifically related to the lease liabilities. So there are some offsetting adjustments to other liability accounts that are resulting in a net change.

Peter Sklar

Okay. I understand that. And then the other thing, I don't understand the accounting for it. Why there is such a big difference between the lease in terms of the magnitude of the lease liabilities versus the right-of-use assets that you're introducing into the balance sheet as a result of this new accounting standard.

Nicole Battista

Sure. We have an example on Page 5 of the deck, which basically shows the leaseback in its 6th year upon transition. And so essentially, what is happening is the liability is based on the present value of the future cash flows, whereas the right of use asset is based on the recalculated asset value for the full term of the lease.

So in the case that we've given on Slide 5, it is a 15-year lease, and we've completed six years of the lease. So the liability is based on the future nine years, whereas the asset is recalculated based on our transition discount rate as to what that asset would have been had we applied the full original lease term.

So the difference is largely a result of the fact that Empire has a lot of long-term leases where that original term is much longer than the remaining cash flows that we used for the liability.

Peter Sklar

Okay. And then in terms of the accounting of it, since the two magnitudes are different, where does the difference show up on the balance sheet?

Nicole Battista

The difference will go through equity.

Peter Sklar

Okay. So that's a onetime adjustment to equity in Q1?

Nicole Battista

Absolutely. And so if you take a look again at Slide 16, we do have a retained earnings adjustment because of that difference as well as a few others that we have disclosed, a range of 0.5 billion to 0.9 billion.

Peter Sklar

Right. Okay. And then lastly, could you explain, as the quarters unfold in the current fiscal year, what is your presentation going to look like, because obviously you'll be reporting IFRS 16 numbers versus numbers under the old accounting standard. So how are you helping us compare apples to apples in terms of your financial presentation?

Nicole Battista

Yeah. So one of the first things we've done is we have provided the cash flow impacts for fiscal 2019. You saw that in our Q4 MD&A. And in this slide deck, we have disclosed the quarter impacts for you to have a comparative when you see those cash flow changes in Q1.

What we also intend to include is EBITDA impacts of IFRS 16 specific in fiscal 2020 for everyone to understand what the change is as we work through the transition.

We also are going to be adjusting our free cash flow metric that we have outlined, where we're changing the definition so that it is comparing apples to apples.

Peter Sklar

Okay. Thank you very much.

Nicole Battista

Thank you.

Operator

Thank you. There are no further questions. I will now turn the call 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.