FINAL TRANSCRIPT

Empire Company Limited

First Quarter 2020 Earnings

September 12, 2019 — 1:00 p.m. E.T.

Length: 60 minutes

CORPORATE PARTICIPANTS

Katie Brine
Empire Company Limited — Director Finance, Investor Relations

Michael Medline
Empire Company Limited — President & Chief Executive Officer

Michael Vels
Empire Company Limited — Chief Financial Officer

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

CONFERENCE CALL PARTICIPANTS

Karen Short
Barclays — Analyst

Vishal Shreedhar
National Bank Financial — Analyst

Irene Nattel
RBC Capital Markets — Analyst

Michael Van Aelst
TD Securities — Analyst

Patricia Baker
Scotiabank — Analyst

Peter Sklar
BMO Capital Markets — Analyst

Mark Petrie
CIBC World Markets — Analyst

Keith Howlett
Desjardins Securities — Analyst

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Empire Company Limited First Quarter 2020 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 immediate assistance, please press star zero for the operator. This call is being recorded on Thursday, September 12, 2019.

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

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

Thank you, Joanna. Good afternoon and thank you all for joining us for our first quarter conference call. Today we will provide summary comments on our results and give you insight on the impact of the new IFRS 16 Leasing Standard on Empire. 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 www.empireco.ca. There's a short summary document outlining the points of our quarter available on our website.

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 & Chief Executive Officer, Empire Company Limited

Thanks, Katie, and good afternoon, everyone.

We are again pleased with our results this quarter. Our momentum continues. Sunrise costs are coming out of the business. The team is executing more sharply. Our strategic initiatives are all progressing well and we continue to improve our EBITDA margin. Other than the IFRS accounting changes, it was a pretty clean and straightforward quarter. EPS was $0.49 this quarter, $0.12 higher than last year, and if you remove a few one-time impacts from last Q1 and this Q1, it would be more than a 75% improvement. Sales were up in all regions, across all banners. It is still early days but we are pleased with the sales we are seeing from our seven FreshCo stores in the West. Farm Boy continues to post excellent sales.

Same store sales were 2.4% with customer count and basket size both up. We have lapped the healthcare reform impacts last year, which rendered the impact of pharmacy same store sales immaterial this quarter. Internal inflation was approximately 3%. We saw a dip in tonnage with the slow start to the summer, weather-wise, notably in May, and that appeared to impact the whole market, especially in Eastern and Western Canada. Temperatures were nowhere near seasonal norms and affected summer seasonal categories like cold beverages, ice cream, condiments, and summer fruit.

While tonnage is commonly used as an indicator of market share internally, we have several different data points that we use to look at market share at more granular levels. Based on these additional data points, we held our market share at least steady this quarter, even without counting our Farm Boy acquisition market share gains.

So, all-in-all, I thought our team did a good job on comps and, as you can see from our margins, we didn't buy sales. In fact, we were purposefully a little less promotional this summer, as our promotions continue to become more effective. This gives our customers a great experience with a more relevant offer, provides a good lift for us, and reduces the amount of money we spend on promotions.

Gross margin rate was up 120 basis points from Q1 last year. Category resets continue to expand our margin as anticipated and, on top of that, normal operational margin management by our merchant team was very good. This is our first quarter reporting IFRS 16 – it has created some noise that Mike will explain. I will note that our pre IFRS 16 EBITDA margin increased 60 basis points over Q1 last year – that's apples to apples. We continue to close the gap to our competitors.

As we greatly improve execution and continue to unlock Empire's cash generating potential, we believe that it is imperative to return cash to our shareholders. Last quarter we increased our dividend and announced that we would be repurchasing shares. This quarter we repurchased about 550,000 shares for approximately $19 million, and we remain committed to our $100 million target for fiscal 2020.

We continue to make good progress against our major strategic initiatives. We are in the final year of our Sunrise transformation, and this initiative is progressing even better than we had originally anticipated. We remain on track to achieve a savings target of at least $550 million – $50 million more than what we originally announced over two years ago. In store execution of category resets, which will drive a large portion of our total Sunrise savings, is nearly complete. Our teammates and our stores have done a great job relining our stores, tranche by tranche, ensuring that our shelves are stocked with the items customers want most. All of our reporting and customer feedback to date indicates that in-store execution of resets has been very well received.

We continue to expand our FreshCo banner in the West, and to date have opened five stores in British Columbia, including two ethnic-oriented Chalo FreshCo stores and another two stores in Winnipeg. We are pleased with how the stores are performing and that our customers are excited. Our marketing team has done a great job driving awareness and will continue building the FreshCo brand in the West. Our expansion of FreshCo to the West allows us to participate in the growing discount segment by converting 25% of our poorer performing Safeway and Sobeys stores to FreshCo stores in markets that are better suited to discount. We remain on track to open 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 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. Farm Boy has been part of the Empire family for just over 10 months now, and continues to build on its industry-leading operational and customer metrics. The team at Farm Boy is making progress against our plan to double the size of the business in the next five years. We currently have concrete plans to open another three Farm Boy stores in fiscal 2020, and two in the first quarter of fiscal 2021. Farm Boy’s access to Empire's real estate prowess has allowed us to accelerate development of Farm Boy in high-quality locations. Voilà, our game-changing e-commerce solution, will also position us to accelerate our growth in the GTA. Voilà is on track to roll out testing and soft launch in the GTA, in late spring. Our second CFC in Montreal, which will serve major cities in Quebec and the Ottawa area, is expected to open in 2021.

You know, winning the next generation of retail will require both extraordinary execution and smart, strategic innovation. In parallel with the strategic initiatives we have underway, we are positioning the company to innovate for the long term. Mohit Grover, our new SVP of Innovation and Strategy, will join our executive team at the end of the month. Mohit will elevate the importance of data analytics and AI, and drive innovation initiatives across the company. We are focused on putting in place the lean teams, tools, and culture that we need, in order to drive innovation in our business and to win the next generation of grocery retailing. We are extremely pleased with the momentum we are seeing in our business. We are more customer-oriented, more innovative, and definitely more focused on execution. We are hard at work on finalizing our strategy, detailed roadmap, and financial goals for the three years post-Sunrise to ensure this momentum continues. We see a lot of runway ahead of us.

And with that, over to Mike.

Michael Vels — Chief Financial Officer, Empire Company Limited

Thank you, Michael. Good afternoon, everyone.

As Michael said, we’re pleased with our margin performance this quarter, as margin dollars increased again due to higher sales and, more importantly, we had an increase in margin rate of 120 basis points. The two main drivers of this margin rate expansion were category reset benefits and the inclusion of Farm Boy, which has a higher margin rate than the rest of the business. If we were to normalize for mix-related effects of higher sales in lower-margin businesses like Quebec and wholesale, the impact would be even higher.

Sales were positively impacted this quarter by the inclusion of Farm Boy and inflation. Produce specifically, was a big driver of prices and sales during the quarter. Weather and higher costs increased prices, but also lowered the amount of units available for sale. Excluding inflation in produce, on an apples-to-apples basis comparison, tonnage was marginally positive.

Consistent with last year, sales price variable SG&A expenses were up, mostly in store labour. SG&A as percent of sales after removing the impact of IFRS 16 was 50 basis points higher than last year. This was due to the inclusion of Farm Boy's higher labour cost model, non-recurring impairment reversals in the prior year, and closure costs associated with the announcement of 10 new FreshCo locations and the conversion of two of our own stores to new Farm Boy stores. These closure and conversion costs amounted to $21 million before taxes, related to severance, inventory, and asset write-downs, or about $0.06 per share after tax. These costs are in addition to the $10 million we recorded in the third quarter of fiscal 2019, which aligned with our West discount expansion plan to open 10 to 15 FreshCo locations per year over the next three years.

Project Sunrise is on track and we continue to estimate incremental savings of about $250 million in fiscal 2020, spread evenly across the year. We continue to be on track with about 25% of the incremental benefits recognized in this quarter, split roughly 80% to gross margin and 20% to SG&A. These savings come largely from category resets, indirect sourcing cost reductions and store improvements.

Equity earnings decreased year-over-year, primarily due to the disposal of properties by Crombie in the prior year, which increased our share of their earnings last year by approximately $0.02 per share after tax. As a reminder, Crombie announced a significant sale transaction in May 2019 that will positively impact our second quarter 2020 results.

The effective income tax rate for the quarter was 26.5%, and we continue to estimate that excluding the impact of any unusual transactions or differential tax rates on property sales, the effective tax rate for fiscal 2020 will be between 26% and 28%.

Free cash flow continues to remain strong at $224.2 million this quarter, reflective of increased earnings. The strength of our cash flows has enabled us to reinvest back into the business in a disciplined manner, positively impacting our customers in store, and enabling better technology and processes in our back offices. In the first quarter, we touched over 50 stores through renovation, redevelopment, or conversion. Our strong cash flows, sustainable margin improvements, and improving credit metrics were factors in the decision by DBRS to upgrade Sobeys' credit rating to BBB low with a stable trend, and for S&P to upgrade Sobeys outlook from stable to positive.

IFRS 16 was adopted for the first time this quarter. You'll notice several changes in our external documents; specifically, you can see the impact on key metrics on pages 7, 13, 17 and 18 of the MD&A. Our documents reinforce that this is an accounting and measurement change only, and it had no impact on our cash generating ability. We have provided an outline of the extent of the change on each of our key metrics on page two of the press release as well.

A few key metrics to highlight are EBITDA, EBITDA margin and free cash flow. EBITDA increased by $129 million, mostly due to the removal of rent expense, which was replaced as depreciation expense and net finance expenses, neither of which are captured in this metric. EBITDA margin as we report it was 6.8% for the quarter. Pre-IFRS 16, it would have been 4.9%, an improvement of 60 basis points over the prior year. The free cash flow definition has been updated to ensure comparability with the prior year.

We will continue to show you the quarterly impact of IFRS 16 for the remainder of fiscal 2020 as we start to get used to the new metrics, which will now be the new normal for the Canadian industry, although we will of course continue to have metrics that are inconsistent with US peers who report under US GAAP.

The first quarter was solid, we're off to a good start. The team feels confident about our packed agenda for this year that includes the completion of Sunrise, the continuation of the FreshCo expansion in the West, increasing Farm Boy's footprint in Ontario, and launching Voilà by Sobeys.

And with that, I'll hand the call back to Katie for questions.

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

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 star followed by the one on your touchtone 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.

Your first question is from Karen Short from Barclays. Please go ahead.

Karen Short – Analyst, Barclays

I wanted to just ask about the cadence of tonnage throughout the quarter excluding produce. Obviously I ask because weather had an impact, so wondering if you can give a little colour there. And then I had a couple other questions.

Michael Vels — Chief Financial Officer, Empire Company Limited

Sure. Of the three periods, the first was the weaker, as the summer took time to get going and progressively improved through the next two months.

Karen Short – Analyst, Barclays

So, once we got to the final month, you would have been much more positive, not just marginally, for the entire quarter on tonnage?

Michael Vels — Chief Financial Officer, Empire Company Limited

Well, more positive, relatively speaking. As Michael said, we had a slightly lighter promotions schedule this year, so if you had to pick one of the two metrics, we were probably a little more focused on margin than growing tonnage and sales.

Karen Short – Analyst, Barclays

Okay. In terms of the competitive landscape in light of the high produce inflation, because it sounds like that's continuing into the second quarter, has the environment changed at all in the second quarter from a competitive perspective?

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

We don't anticipate big changes, except the possibility of some commodities seeing higher inflation. When inflation reaches double digits in some commodities, then we can see some change in trends, but in general I think it has been pretty stable, quarter after quarter, in terms of inflation in produce. So, no, we don't anticipate a big change going forward.

Karen Short – Analyst, Barclays

Okay. And then any way you could quantify the impact of Farm Boy and also produce on gross margins?

Michael Vels — Chief Financial Officer, Empire Company Limited

Farm Boy is obviously positive – their operating model is, because the mix in their business runs on a higher margin rate. We have not disclosed the exact basis points, for competitive reasons. But they also run on a higher SG&A percentage. All told, at the bottom line, their EBITDA percentage on an apples-to-apples basis would be higher than the consolidated Sobeys numbers.

Karen Short – Analyst, Barclays

Okay. And then last question for me on data analytics. Would you be willing to just give a little colour on how your approach might change going forward on the analytic front?

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

Hi. It's Michael. We're not going to get overzealous on it. We're going to take it in stride and key on some very important big prizes, especially on the merchandising side behind the scenes and personalization on the front. Any more than that I'd rather not give to you, but I can tell you that we're going to keep the team small and focused and on the big prizes, we're not going to spread ourselves too thin on this.

Karen Short – Analyst, Barclays

Okay, great. Thank you.

Operator

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

Vishal Shreedhar – Analyst, National Bank Financial

Hi. Thanks for taking my questions. I'm wondering if you can provide any early colour on Project Sunrise 2.0, if there are any comments you can share. And if you can't, maybe you can help us on when you might share some of the details on that.

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

Hi. How are you doing, Vishal? It's Michael. We're working through the strategy right now. Our intention this time is to share what we can with you and, as you know, we try to share as much as we can. To be transparent, it'll be in the spring – haven't chosen when in the spring to share that, we're still working on it, but I can tell you that we're not just beginning this work, we're right in the middle of it, and we’re going to have very aggressive goals to grow our year-over-year earnings numbers as we go forward. I don’t want anybody to think that we’re going to take a holiday after Sunrise. Sunrise 2.0, and that’s not what it’s going to be called, will be aggressive.

Vishal Shreedhar – Analyst, National Bank Financial

Okay. Empire has implemented a lot of change in a short period of time and I know you have a lot more initiatives planned and you’ve given us insight into some of them, but just wondering, as you look at the organization today from when you came in, would you say that the restructuring is effectively complete at this stage and you can pull on a lever and understand how the organization will respond to you? Or is there still a higher degree of uncertainty associated with, let’s say, a company that’s running on a normal basis?

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

It’s night and day. And, as I said in the AGM speech, which I would guess most of you didn’t listen to today because you’ve got better things to do and you’re too busy to hear my speech, we put in a rock-solid foundation now. This company, it can execute and operate, and take on more and more projects and be able to have accountability.

The team, the structure works. You know me a little bit, Vishal, we’ll do a little tweaking below the executive level to make sure it works really well across our different functions. We’ve got the people in place, they’re working well together. I am even a little surprised that this team is operating at such a high level at this point. We might be six or twelve months ahead of where we would have thought two-and-a-half years ago. That doesn’t mean that we don’t have work to do, we do, and people are settling into their new portfolios. Pierre, you know, if he keeps doing better, I don’t know where he’ll end up, because I can’t give him much more than this without me leaving right away. But he’s just doing a great job in terms of taking on Quebec and then merchandising and then operations and how he works with finance and marketing and across the whole company. So, couldn’t be happier with the structure and the people, and when we pull the rope it works, as you were asking.

Vishal Shreedhar – Analyst, National Bank Financial

Okay. Thanks for that colour. And just wondering, from a consumer standpoint, a little bit more concern out there than usual, just wondering what you’re seeing and if you’re seeing uncertainty macro headlines permeating to the customer.

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

I think I’ll start and then Pierre is closer to some of that than I am because of his operational and merchandising perspective. We’re not seeing anything as of this point out in the market that would indicate consumer malaise or over worry. Like everyone out there, we’re concerned about some of the things we’re seeing on the horizon and we certainly hope that there won’t be a recession, because that can cost people jobs. At the same time, grocery performs awfully well in recessionary periods, but we’d rather the economy was doing well. But we’re not seeing much and, Pierre, maybe you could give a little bit more colour on it.

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

I think, consumer-looking, the trend remains the same. We need to be more relevant. Society is changing, people have less time, etc, so I think these big trends continue and I think we anticipate no major changes going forward except some economic changes. But, once again, in difficult times, it's always an opportunity to differentiate ourselves and we're ready for it.

Vishal Shreedhar – Analyst, National Bank Financial

Thanks for the colour.

Operator

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

Irene Nattel – Analyst, RBC Capital Markets

Thanks and good afternoon, everyone. Just on the category resets, just wondering, as time goes on, how are you seeing performance evolve or mature of some of the early categories that you did versus the later ones? And as you've taken all those learnings, do you think that you need to kind of go back and do any mini resets of the early categories?

Michael Vels — Chief Financial Officer, Empire Company Limited

I think the short answer is no, because we went through a very rigorous and fairly identical process for all of the rollouts - every category that gets rolled out goes through a pilot store approach as part of its cycle. And as we've got into the stores we, of course, got better and learned from each successive week and anything that we felt could have been improved in the early categories would already have been executed. From a negotiations perspective, that was done in a very compressed timeframe in a number of very tight and controlled waves. We were very satisfied with the outcomes and those are being executed as expected.

As we move forward next year post Sunrise, I think we've said pretty consistently that we did a lot in a short period of time with a new team and now, under Pierre's leadership and more miles in the saddle, there's clearly going to be more fine-tuning and opportunities in all of that category management, and we expect to capture that as we move forward post Sunrise. But it's more business as usual. We're actually very satisfied with the quality of execution.

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

And maybe I'll just add two things – I think we've been really pleasantly surprised with the pre-work we did in terms of understanding the customer and what to do in each category and what products would resonate the most. Our merchants pretty well nailed that. Very, very few changes after we put the category resets in. I can't even think of one off the top of my head because there's so few. The second is Mike's right, that once we're done category resets, we've got to go and find more optimization, and I think a lot of that will come from the data analytics and AI that Pierre is working on right now.

Irene Nattel – Analyst, RBC Capital Markets

That's great. That's really helpful. And I guess that brings me to my next question, which is as you think about whateverr you decide to call it, I don't know, Project Daylight, what are the key elements that you see now that you really, really would like to get at in the next three-year plan?

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

You know, we're still working on it, but I think it's clear, and you guys can do the math, that we've closed the SG&A gap quite a bit on our two major competitors and we have a long way to go. And so there’s a little bit to go on that. Not too much, but we’ll get at that. And I think that we have a large prize in cost of goods sold, even now, even with all the work we put in and the progress we’ve had.

And the third piece that we’re looking at is having more productivity in store and getting that sales-per-square foot up. When we look at our gap to being best-in-class in the country, it’s mostly going to be a combination of COGS and sales per square feet, but it’s not without plans. I think we can go and improve those sales per square feet against our competitors in a very smart fashion while taking out some of the cost.

So, we’ve got some more work to do in terms of the roadmap and which order we’re going to tackle it, and making sure our resources are there and that we don’t overspend, because we ain’t going back to the old days, so that’s what we’re doing. But the prize is there. I think it’s a matter now of prioritizing putting our financial goals clearly in front of us and then having just a roadmap. And I’m a simple person; when something works, you go back to it.

And I think that—while I sometimes refer to it as Project Sunrise 2.0., we couldn’t do everything in a three-year period. Just couldn’t do it. We had to get the infrastructure and the people in place and the cadence and the process. Now we can go, let’s go finish the job. And I think that’s what the next three years will be.

Irene Nattel – Analyst, RBC Capital Markets

And just a final question leading on from that. Do you see any need, from a sort of technology perspective, do you see any need to strengthen the platform, do any significant investments there, or you’re okay for now?

Michael Vels — Chief Financial Officer, Empire Company Limited

Rather than answer the questions in absolutes, I think the short answer is, or maybe a long answer, is that systems are stable and they produce the answers to a large extent that you ask them to do, but it's with some difficulty, and they're not as nimble and as focused towards robust data and analytics as you'd expect from a company of our size and complexity.

So, we will be investing more, and at higher levels than what the company's seen over the last three or four years in IT, but it's not going to be directed at changing the basic infrastructure as much as adding new capability such as artificial intelligence, analytics capabilities, loyalty personalization, much better data arrays so that our merchants can rely on the data and see it on the desktops as opposed to having it put together on a periodic basis by financial people. So, it's kind of exciting investments executed over a period of years but really focused on the insatiable requests and desires of our merchants and others for better analytics and better insights.

Irene Nattel – Analyst, RBC Capital Markets

That's great and helpful. Thank you.

Operator

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

Michael Van Aelst – Analyst, TD Securities

Hi. On the Voilà program that's launching next spring, so you're talking about a soft launch or a test launch in late spring. When would you expect a full complete rollout in the GTA?

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

Hi. It’s Michael. It’s a great question. What we've seen in the past is, you get it right before you go to a large group of customers, so difficult to call. We don’t think the test and soft launch should go for too long a period of time, but if we’re not happy with how we’re progressing, and we expect to be happy, then we’ll slow it down a tiny bit and rollout, but we’re going to roll it out postal code by postal code anyway. So, its what we put in our plans, and it’s always been there, since the very beginning. The work that Sarah is leading, which is going really well right now, will have a Spring test and soft launch. My experience is you go when you’re ready because you’ve got one chance to knock the cover off the ball and thrill the customer and take the eyeballs, or mouthfuls in this case, and that’s what we’re going to do. So, I don’t want to commit to anything other than when we go to customers this is going to knock their socks off. But everything is looking good so far Michael.

Michael Van Aelst – Analyst, TD Securities

But once you figure it out and you say, okay, the test soft launch has gone exactly how you’re expecting and you’ve got it nailed, how long does it take to roll out postal code by postal code?

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

It’ll take a few months.

Michael Van Aelst – Analyst, TD Securities

And the FreshCos in Western Canada, is there any way you could give us an idea of the relative performance to either the FreshCos in Western Canada, or in Ontario?

Michael Vels — Chief Financial Officer, Empire Company Limited

Sure. It's a little different by market as we've rolled out but our investment has been fairly significant in marketing and promotions to make sure that we set the right price impact in customers' minds. There's clearly been some competitive response. Having said that, the sales that we've seen across the system are in fact higher than the Safeway stores which they replaced, pre-opening. So, we've been very pleased about that because it does mean that we've attracted new customers. And in addition to that, the conventional stores that we have in those market areas continue to do well as well. So we've clearly generated net new sales for the company, which was one of our goals.

From a profitability perspective, I would venture to say that, at this stage, it's roughly neutral, and mostly because it's a relatively small number of stores and we didn't expect it, obviously, to be accretive in the early days. So, from the Western perspective, lower margins, because we're ramping up our people. We have more trading. We have more people in the stores, and as they get more effective, more efficient and understand how to run a discount store, we will see those costs coming down. Our promotional intensity as we start to get a little more mature with those stores is starting to lessen and we expect to see steadily increasing margins in the banner.

In terms of your question on the Ontario banners, our sales continue to be very strong in our discount business. We're very satisfied with them. The new formats, FreshCo 2.0 continues to do well. And I think we've rolled it out to something like 45 stores to date. I'm very satisfied with the outcomes. Our franchisees are happy. So, clearly two different markets, Michael, one's a start-up and one's a mature market with some new concepts being rolled out. Obviously, the profitability in the Ontario market is higher than the West at this point.

Michael Van Aelst – Analyst, TD Securities

Okay. And the rollout in Western Canada to the 65 stores or so, do you expect to have that done by the end of fiscal 2022? Is that the timing?

Michael Vels — Chief Financial Officer, Empire Company Limited

Yeah. We're saying over the next three years, so I'd say fiscal 2022 early into the next year. That's the current plan and so far we've kept to the cadence that we had anticipated. We don't see anything at this stage that should slow us down, so I think that would be a reasonable estimate.

Michael Van Aelst – Analyst, TD Securities

Thank you.

Operator

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

Patricia Baker – Analyst, Scotiabank

Thank you very much for taking my questions. Michael, in your opening remarks you referenced the fact that the teams are executing more sharply and certainly that's showing up in the numbers and you can actually see it when you go to the stores. And one area that you referenced here in discussion of the gross margin was in promotional effectiveness and I'd really like you to talk about that, if you don't mind, a little bit more. Where are you in the journey of trying to drive better promotional effectiveness? When did you start? Are you looking at promotional effectiveness now more through a return lens and requiring that the promotions meet basic return hurdles? And, if so, if you are doing it that way, is that a change in your approach? And I'm assuming that the size of the prize of getting to the optimal promotional effectiveness is pretty big for you guys.

Operator

Please stand by while I get the presenters back on the line. Thank you. You may now resume. Patricia, you may ask your question again.

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

Sorry, we're in Nova Scotia, I don't think we can blame the hurricane, but our line suddenly went down. It wasn't because I was nervous about your question I don't think, Patricia, but let's hear it. Sorry about that.

Patricia Baker – Analyst, Scotiabank

Neither do I, Michael. Okay. Sorry and it's a long one and I apologize to anybody who has to listen to it again, but here goes. So, in your opening remarks you talked about the fact that the teams are executing more sharply and you can see that in the numbers. You can see that if you walk the stores. And in one area which showed up in this quarter, you're referenced it in discussion of gross margins, on promotional effectiveness. And so I would really like to talk about that a little bit more, maybe talk about where you are on that journey. When did you really seriously start to get to do the work on promotional effectiveness? And additionally, are you now looking at promotional effectiveness through a return mirror and requiring that promotions actually meet some return hurdle? And if that's the case, is that a new approach?

Michael Vels — Chief Financial Officer, Empire Company Limited

So, not a new approach. While we changed our structure, many merchants and all of their supporting teams – which is just equally important – ended up with new categories, a large job to do through Sunrise. At the same time, we still have many very experienced and very capable merchants who are running complex categories across the country and on an individual and collective basis. They know what they're doing, they understand the necessity to balance margin and sales, and certainly Michael's very clear directive coming in over two years ago was margin counts. It really counts, because that's what they put on the bottom line. And we need to get more discipline and we need to get more focused on making sure that we're making smart decisions. And that message has been reinforced by Pierre, as he has taken over more and more responsibility and now basically controls the merchandising decisions across the entire country except for Farm Boy and discount.

And so I'd say, no, it's not new, but what's changed now is that we are really through the Sunrise rollout. The merchants have access to better tools and analytics than they did two years ago. They've solidified into a new team with a strong leader, and we're turning our eyes towards more maybe day-to-day category management and balancing that sales and margin equation. At the same time, as we've referred to previously, we are investing quite heavily in new analytics and new data models to up our game in terms of measuring and then ultimately helping us with the execution of proportional effectiveness.

So, I guess what I'm trying to say is that it's been a progression. There is not a sudden change. But as Sunrise progresses, matures, completes, we have more material and more tools to deal with and we're going to get even better on promotion.

I don't know, Pierre, if there's anything you want to add to that.

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

Very well said. The only other thing I would like to add is that the category reset exercise provided very good knowledge of every single category to our merchants, so I think they now have better ownership and understanding of every single category or SKU that they have to handle in their promo planning. And, like Michael said, a year ago we were more focused on structural change, and now we're more focused on day-to-day business, so that helps. With good guidelines, the team is more focused and more disciplined than ever. And I think there's still room for improvement for sure, but compared to Q1 last year, the balance achieved between sales growth and margin expansion is a great success in only 12 months. I would like to congratulate the teams – they passed through a big change structurally and now they are more focused on the day-to-day business.

Patricia Baker – Analyst, Scotiabank

That's very, very helpful, Pierre. And just on the category resets, you said that you're almost complete, so will that be completed in Q2?

Michael Vels — Chief Financial Officer, Empire Company Limited

Fully completed in stores probably in Q3, but by the time we get out of Q2 we're substantively done in terms of the store rollout.

Patricia Baker – Analyst, Scotiabank

Okay. And just, Michael, you mentioned the hurricanes, just curious, did you have some store closures in the hurricane and were able to quickly get merchandise back on the shelves? Because I understand there was certainly a lot of people hording product before the Saturday.

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

Yeah, I mean our stores got wiped out in the two preceding days, especially in Pictou County, all up and down where the eye was going to hit. Our customers came to us because they needed to get things and we were there for them. We did a really good job of pre-stocking those stores to carry more water and other items that are essential in those situations. The answer is yes, that many of our stores were closed, some for a short period of time, some for longer.

The good news is very little structural damage to the stores so that it shouldn't have any ongoing impact on us. To restock stores that have essentially sold out in many, many categories, takes some days, although our supply chain and operators throughout the beginning, during, after, have been sensational. Although we sold a lot at the beginning, I think it hurts you actually, on the back end of it because of some of the closures and trying to restock all the products back in the stores. But, all-in-all, I think, compared to a lot of people, we came through unscathed.

Patricia Baker – Analyst, Scotiabank

Okay. That's fantastic. Good to hear. Thanks, Michael.

Operator

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

Peter Sklar – Analyst, BMO Capital Markets

A question on inflation. Your quarter you just report was just facilitated, you had a good 3% tailwind from inflation. Just wondering, now that you're halfway through the second quarter, I assume you're seeing that level of inflation decelerating somewhat. Is there anything you can comment about that?

Michael Vels — Chief Financial Officer, Empire Company Limited

I'm not sure I would go as far as to say it's decelerating. At this point it's really maybe pretty consistent I would say, but too early to tell where the quarter is going to end out.

Peter Sklar – Analyst, BMO Capital Markets

Okay. And then, Michael, I had a question for you. In terms of your brand positioning or your brand messaging of Sobeys in Ontario, I thought I detected a subtle shift on how you're positioning the brand. Like, for example, I've noticed the Gone Fishing advertisements that are little bit different than what Sobeys has typically done. I'm just wondering have you suddenly shifted the brand messaging and was that based on—I know you did some consumer research in terms of trying to understand who Sobeys' customer is.

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

You picked up on a great point and I mean the brand is the brand and you make changes to it. When we did the customer research, the underlying love of a lot of Canadians for the Sobeys brand was there and what we were trying to do is uncover it. I'd say, compared to almost any brand I've ever seen, the level of support, how they think of Sobeys as the family kind of grocery store, the place. And what we weren't doing and we're doing now is we're executing better and living up to some of that brand reputation.

But we're also really honing in on that message which resonates better with our customers and it's really what Sobeys stands for. So I'd say that when you see that fishing ad, I would have pointed that out as absolutely emblematic of what we're going for and that Sandra and the marketing team working with the other executives I think have really nailed with the brand stands for and what we're going to stand for. Great customer feedback on all the measurements to do with that ad. But, as you also see, many of the things that we're going to do in terms of marketing and sponsorship, community activities are going to resonate better with Sobeys.

At the same time, Sandra and her team are doing a lot of work on the brand messaging for Safeway, Thrifty and Foodland. And so I think we're a little further ahead on the Sobeys, but not too far behind on the other banners. So, I'm glad to hear that you noticed that.

Peter Sklar – Analyst, BMO Capital Markets

Okay. Thank you for your comments.

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

Thank you.

Operator

Your next question comes from Mark Petrie from CIBC. Please go ahead.

Mark Petrie – Analyst, CIBC World Markets

Hey. Good afternoon. I just wanted to ask about Farm Boy and just regarding the conversion of other banner locations. Can you talk about the size of the locations you're comfortable putting a Farm Boy in and how the model can adapt as you presumably push the store size higher over time? I understand the recent announcement was a FreshCo, but presumably there are larger Sobeys locations that would be really well suited to a Farm Boy concept.

Michael Vels — Chief Financial Officer, Empire Company Limited

The answer on that part is interesting, Mark. The format has, until recently, been in very small footprints such as the one in the Rideau Centre in Ottawa, which would be the smallest one, at 28,000-30,000 square feet at the top end. But we are looking at some new stores, including one in Ottawa, which is going to test the upper limit of that box size and look at putting some new and innovative ideas into a little more square footage. The great thing about the concept is that it is very flexible. The mix stays the same but the flexibility of the fixtures and the layout is such that it does fit into and is very successful in a wide range of floor plates. So, unlike a Safeway or a Sobeys or FreshCo, we don't have as tight a range for how that format would work as you might think.

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

The only thing I'd add before anyone jumps on me, this was Jean-Louis and Jeff's idea to go in and try different size formats, which they think they can really execute upon, but keep that fantastic brand and everything they're trying to do there. I think that if they were on the call, JL and Jeff would tell you that that the prowess of our real estate team and some of what we had, I mean there's one at Yonge and Eglinton that's going to be a Farm Boy. I think everyone knows that probably already. That was going to be a Sobeys, it'll be a little larger than prototype Farm Boy, but I think that's just situated better to be a Farm Boy store and in that area and we're seeing all sorts of opportunities. But these are being driven by JL and Jeff directing the work and the decision making in terms of what they're comfortable with, to make sure they can be even greater than they have been before, working with our real estate group and our executives. It's working real well.

Mark Petrie – Analyst, CIBC World Markets

Okay. Thanks for that. With regards to SG&A, could you just talk about how you sort of think about the longer term or at least through the course of fiscal 2020 sort of growth rate in SG&A? Obviously, there's no shortage of areas where you do want to spend, particularly on the brand awareness side across banners, as you as you commented, and FreshCo West and Voilà over time, so does that sort of require a pickup in spending or consuming more of the Sunrise savings? Or do you have the ability to shift spending from other parts of the business and sort of keep on the current run rate?

Michael Vels — Chief Financial Officer, Empire Company Limited

I don't think I would walk away with an assumption that we have to ramp up our SG&A spend. So, take out the impact of Farm Boy, the distortion of the last year one-time positive we had in our numbers and the closure costs this quarter, I'd say that on an ongoing basis we're going to continue to be very focused on cost control and I think it would be wrong to say that we anticipate a significant ramp up is in our SG&A activity or spend to support what we want to get done. As Michael said, we still actually think we have some more opportunity and some more capability to close that SG&A gap. Not quite as much as we do in the big line on COGS and sales. So, I think you can expect us to continue to be very, very focused on becoming more efficient on that line, not less, as the year progresses.

Mark Petrie – Analyst, CIBC World Markets

Okay. And then you sort of answered this question, I guess, in a few different ways, but I just wanted to ask you specifically about the regional structure and then the shift of merchandising functions into different offices. I guess that was a year and a half ago now really. But looking back on it now, is there anything you would do differently? And what sort of learnings have you pulled from that experience, either sort of suggesting future opportunity or things that you want to kind of de-risk?

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

I think through the category reset exercise we worked together, all formats, all regions. We have most of our grocery team for English Canada in Stellarton, the fresh team in Toronto, and we kept a team in Quebec. And now we are focusing more on format, so we have merchandizing people across the country to be close to customer needs, which is a good thing, but the teams are working together because they had to execute the resets together. And now resets are over but reviewing each category will be a continuous thing that is in our processes now and we have a national governance for all formats, all regions. So we learned from this exercise—we took the best and we lost the worst. We're working together, we are focused on regional needs, and we kept the best people across the country. So, honestly, it's the best of two worlds. And we are leveraging the size of the company and we remain close to customers.

Mark Petrie – Analyst, CIBC World Markets

Okay. Thank you. Appreciate all the comments, everyone.

Operator

Thank you. Your next question is from Keith Howlett from Desjardins. Please go ahead.

Keith Howlett – Analyst, Desjardins Securities

Yes. I wondered if you could update us on your work on private label.

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

We reviewed the branding, the look and feel of the brand. We used a new look and feel for the new Compliments logo. I think the new logo will fit better in our shelf. Having a better view on these products on our shelf is the goal behind that. And the best thing on category resets – we revised, for every single category, a specific role for our private label. In some categories private label would play a specific role, in another it would play a different role. So I think it's the bigger thing we did over the last year and we're seeing positive results already by having, I would say a stronger joint business plan between our national banners and our private label. Private label has, going forward, a specific role to play in a category.

So, it's where we are. The new image will be finished by the end of this fiscal year. So it's the plan. It's already started and will finish. It's 3,500 products that we need to redesign the packaging and everything for, plus a couple of new products for sure.

Keith Howlett – Analyst, Desjardins Securities

Then I just was wondering on the square footage. In terms of the doubling of Farm Boy over the next five years, how do you anticipate that will break down between conversions of existing Sobeys or FreshCo real estate versus greenfield?

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

Well, we don't really say what percentage is, but I think it's going to be a combination. Most of the square footage will be greenfield but where we see an opportunity where a Farm Boy fits better than a current banner, we're going to make that conversion. And I think that the only thing constraining us from even higher growth at Farm Boy is to make sure that they can handle that kind of growth and there are a certain number of stores in the next couple years that we wouldn't go over, because we just want them to get their feet under them.

At the same time, I think that there are more opportunities, should Farm Boy be ready for them, to greenfield more stores, maybe faster than we originally thought when we made the acquisition, and there are probably a few more stores that could be converted, especially in the densest parts of Toronto, that we're going to go forward.

Keith Howlett – Analyst, Desjardins Securities

And then just on the FreshCo banner, you may not want to speak this but how are the Chalo FreshCos working in British Columbia versus, say, the normal FreshCos?

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

The couple of Chalo's we've opened in Western Canada are—it's hard to say among the strongest, because we've only opened a handful of stores, but if we're happy with the FreshCos, we're extra happy with the Chalos. I think our FreshCo offering overall is differentiated and our Chalos are even more differentiated than that market. They stand out even more than they would in Ontario. In fact, we were just talking about that today, how pleased we are with the Chalo in Ontario and in the West.

Keith Howlett – Analyst, Desjardins Securities

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 — Director, Investor Relations, Empire Company Limited

Thank you, Joanna. Ladies and gentlemen, we appreciate your continued interest in Empire. If there any unanswered questions, please contact me by phone or email. We look forward to having you join us for our second quarter fiscal 2020 conference call on December 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.