Empire Company Limited

Second Quarter 2020 Earnings

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Empire's Second Quarter, Fiscal 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 assistance, please press star zero for the operator.

This call is being recorded on Thursday, December 12, 2019 and 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 second quarter conference call. Today we will provide summary comments on our results and leave as much time as we can for questions.

This call is being recorded and the audio recording will be available on the Company's website at www.empireco.ca. 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 & Chief Executive Officer, Empire Company Limited

Thanks, Katie, and good afternoon everyone.

I'm extremely proud of our team. They have transformed our Company from one which had quarterly adjusted EPS of $0.12 three years ago, to one that earned $0.58, or $0.52 after you back out the impact of the Crombie transaction. That's a 333% increase in EPS in just three years. And most importantly, we've built our brands and improved our customer service over that period.

I'm going to do this a bit differently today and I hope to give you a bit more colour on the business. Today I want to talk about seven topics: our performance this quarter, what we're seeing in the market, our EBITDA margin, Voilà, Farm Boy, our store renovation program, and our ownership position in Crombie. I will leave it to Mike to take you through some of the details of our quarter, the results of Project Sunrise, the Crombie Oak Street transaction, and an update on our capital spending and share repurchases.

Let's start with our performance this quarter. Sales were up in all regions, across all banners, despite a more competitive and promotional marketplace than we have seen in some time. Same-store sales were 2% with both customer count and basket size up. Internal food inflation was approximately 2.4% and our same-store sales were 2%, implying relatively flat tonnage. We also have several different data points that we used to look at market share at more granular levels. Based on these additional data points, we believe our market share held relatively steady during the quarter. We are working hard to thrill our customers with stronger execution and through our strategic initiatives.

As you can see from our margins, we are not chasing empty calorie sales. Gross margin rate was up 90 basis points from our second quarter last year. Category resets continued to expand our margin, as anticipated. We have not, at this point, done what some of our competitors have done when they say they tried to improve the trending of their food sales with margin investments. We are working hard to earn our sales growth through better execution; however, we do intend to protect and grow our market share going forward.

Perhaps I'll just make a few comments about the state of the market and what we're seeing and watching out for. We are monitoring consumer spending and promotional activity closely. Although we had positive tonnage in the last month of Q2, we have seen a slight softening in sales at the end of the quarter and into the beginning of Q3. We think that part of this could be due to the relative health of the Canadian economy, and we are closely watching key indicators like employment and the recent communications of our Canadian banks. We also saw early inclement weather that can be good for some retail, but not so much for grocery. We continue to be very proud of our margin performance, but we think we could have been a little quicker responding to a more promotional marketplace. And so, as I said, we'll be making sure that we protect our sales going forward, while at the same time being smart about it. Just to be clear, we're only talking about a little fine-tuning here.

Second, our EBITDA margin. This is our most closely watched number. Quarter after quarter we continue to chew into the EBITDA margin gap between us and our two major competitors. We are extremely focused on an overarching goal to close the food EBITDA margin gap with them. We're going to finish the job. We don't believe there is any reason for us not to be able to do it so long as we continue to execute and set a strong strategy. I do say "food" retail gap as there are certain structural differences between the three companies. The most important difference is that we have a smaller pharmacy business, which historically has had a higher EBITDA margin than grocery.

On an apples-to-apples basis, our pre-IFRS 16 EBITDA margin is up 50 basis points over Q2 last year when you remove the impact of the Crombie REIT transaction. That's a big move.

Our approach to closing our food EBITDA margin gap is two-pronged. We are focused on improving our cost base and SG&A is pretty well there. With COGS, we had to start with category resets to get us on an even playing field and now we need to be more efficient with our categories. Sunrise was the first step and we have made great strides, but we still have way more upside. We're also focused on our sales productivity. We have great people and great assets and great locations across the country, and we will now optimize them.

Third, I wanted to talk about Voilà, our game-changing e-commerce solution. While most players in the industry are focused on inefficient store-picked models to fulfill their online orders, we are building automated warehouses powered by Ocado's world-leading grocery technology. We'll be able to provide customers with convenient, short delivery windows beginning early in the morning and running until late in the evening. The system is more flexible than you might think. Customers can place orders at night for the next morning, or in the morning for later that same day. This is the only e-commerce model that, at scale, will eventually allow us to profitably deliver an expanded assortment of groceries to over 75% of the Canadian population with only four CFCs.

While our focus is on home delivery, we can also do click-and-collect sourced out of the CFCs if that's what customers want in certain areas. Although, I must add, our data and experience tell us that, when given the choice, customers overwhelmingly prefer delivery to home.

The flexibility of the hub-and-spoke network model, where each CFC is the hub and smaller cross-dock facilities are the spokes, allows us to get closer to the customer, and we have plans to build on this best-in-class Ocado infrastructure. We will build even more flexibility over time to meet customers' needs. There is a reason that many of the best grocers in the world, including Kroger in the US, Casino in France, ICA in Sweden, Kohl's in Australia, Marks & Spencer and Morrisons in the UK, and AEON in Japan are partners with Ocado. The reason being, is that Ocado is the most advanced and continually innovative small-cube e-commerce solution in the world. Frankly, any Plan B is just not nearly as good.

When we study what Canadians are looking for in an online grocery offer, it's quite simple: excellent fresh products at competitive prices, no substitutions, and groceries delivered to their door exactly when they want it. Voilà will deliver on exactly that. At scale, Voilà will offer an expansive selection of up to 39,000 products, which is way more than any other grocery e-commerce business in Canada, and 15,000 more than your average grocery store, including high-quality fresh produce at prices comparable to our bricks-and-mortar Sobeys or IGA stores. An online grocery home delivery experience like Voilà does not exist in Canada. We're going to grow the market. Voilà is on track to test and soft launch in the GTA in late spring. We are so confident in the Voilà solution that we have already started building our second CFC in Montreal with our partner, Crombie REIT. This CFC will serve major cities in Quebec and the Ottawa area and is expected to open in 2021.

Fourth, Farm Boy, which, along with Voilà, is a weapon for winning share in urban markets in Ontario where we are underpenetrated. Farm Boy has been part of the Empire family for just about a year now and continues to deliver on its industry-leading operational and customer metrics. It is outperforming all of our expectations. The phenomenal team at Farm Boy is making progress against its plan to double the size of the business in the next five years. The Farm Boy store count will grow in a mix of urban and suburban communities with diverse store sizes and formats to fit the needs of local customers.

We opened a new Farm Boy store last week in Burlington and have announced plans to open another six stores in 2020 and two in 2021. Most of these new stores will be in the GTA, five in Downtown Toronto, one in Newmarket, one in St. Catharines, and one in Ottawa. The stores will range in size from a 12,000 square foot urban footprint to a 38,000 square foot signature store. This will bring Farm Boy's total announced store count to 37 stores. And this is just the beginning. Farm Boy is in different stages of development on more than 25 new stores in Ontario, a mixture of greenfield conversions and mixed developments. We intend to blanket the GTA and take market share from incumbents. In a market where we have always had low market share, Farm Boy’s aggressive plan for growth is being well supported by Empire’s infrastructure and capabilities in real estate, sourcing, and logistics.

Fifth, our store renovation program. We have an ambitious store renovation program that ensures we deploy capital to most of our bricks-and-mortar stores over the next seven years. We are investing capital at solid returns to revitalize our stores, both discount and conventional. Our renovations will range from a refresh to a full reset of the store, but at a minimum you will see enhancements to décor, facades, and modifications to our key departments to better support our strategy. So far in this fiscal year, we have touched 28 of our conventional stores and we just finished refreshing all of our FreshCo stores in Ontario to the FreshCo 2.0 model. We will ramp full service renovations up as the results of our renovations are very strong.

And finally, something we don’t talk about often, our ownership position in Crombie. Crombie is our largest landlord. We currently own 41.5% of Crombie and we are pleased with this level of ownership. We are working even closer with Crombie REIT’s management than we have in the past to optimize the value of our partnership. Crombie REIT leads mixed use development opportunities, provides capital to facilitate our strong renovation program, and has had a history of sale leaseback of properties, allowing Empire to effectively reallocate our capital to higher growth opportunities in other parts of our business.

A great example of our partnership mutually benefitting Crombie REIT and Empire is our Davie Street store in the heart of Vancouver. Crombie REIT took ownership of our Davie Street store, closed it and developed a mixed-use property. At the end of fiscal 2020, we will be opening a brand new 44,000 square foot store on the property, which features up to 330 residential rental units that will increase traffic to our stores.

We are pleased with the momentum in our business. It is a testament to the growing strength of our team. I want to wish you all a great Christmas and holiday season and if you want to eat really well over the holidays, shop for food at one of our great banners.

And with that, over to Mike.

Michael Vels — Chief Financial Officer, Empire Company Limited

Thank you, Michael. Good afternoon, everyone.

Project Sunrise is on track and we continue to estimate incremental savings of about $250 million in fiscal 2020 as we progress through its final year. Incremental benefits continue to be earned at a rate of approximately 25% every quarter of fiscal 2020, split roughly 80% to gross margin and 20% to SG&A.

Category resets were completed in our stores at the end of October and the incremental benefits will continue to show in our margin line for the rest of fiscal 2020. The increase in margin of 90 basis points this quarter directly reflects those category reset initiatives in addition to the positive effect of Farm Boy.

Adjusted selling and administrative expenses as a percentage of sales was 20.9% this quarter. If you exclude the impact of IFRS 16 and the inclusion of Farm Boy's higher labour cost model, SG&A as a percent of sales was essentially flat. Sunrise savings of approximately 25 basis points positively impacted the rate, largely through indirect sourcing cost reductions and continued store improvements. This was partly offset by lower impairment reversals than the prior year.

Our discount expansion in the West continues as we convert underperforming Safeway and Sobeys stores to FreshCo. This has a temporary impact on sales and gross margin dollars, as the stores are closed for conversion for several months. The first wave of FreshCo stores in the West have now been open for a full quarter and we're so far pleased with customers' reactions and the traffic that we are seeing.

Two years ago, when we first announced the discount expansion in the West, we noted that it would be slightly dilutive to earnings in the first few years. This quarter, the impact was approximately $0.01 of dilution on earnings per share and we continue to believe at this point that the dilution impacts, as we build out the strategy, will be relatively immaterial.

Equity earnings increased year over year, principally due to the sale of a 15-property portfolio by Crombie REIT that contributed an additional $15.1 million to equity earnings plus $6.9 million in deferred gain recognition. In total, this positively impacted our share of Crombie's earnings by approximately $0.06 per share after tax, which we would consider to be an unusual effect that is not expected to recur.

The effective income tax rate for the quarter was 26% 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%.

Our cash flow generation continues to be strong. Year to date, our free cash flow of $253 million reflects the improvements in our operations and has enabled us to reinvest back into the business in a disciplined manner. One example of that reinvestment is the great success we've had retrofitting our stores with LED lighting, which will be in more than 300 stores by the end of fiscal 2020. Of course this is better for the planet, it's also more efficient for our stores and significantly improves our customers' experience in the store. We continue to estimate that our fiscal 2020 capital spend will be approximately $600 million.

Additional benefits of our improved cash flow are the ability to repurchase shares and repay debt, and in the second quarter we repurchased approximately 930,000 shares for $33.1 million and we remain committed to our $100 million target for fiscal 2020. In addition to that, we also repaid $250 million of our credit facilities.

We are now halfway through fiscal 2020. The team has worked hard to earn this $0.52 quarter and there is a lot of excitement building as we get closer to completing Project Sunrise, launching our e-commerce Voilà platform, and continuing to expand FreshCo in the West and our Farm Boy banner in Ontario.

With that, have a great holiday season and 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.

The first question is from Mark Petrie at CIBC World Markets. Please go ahead, Mark.

Mark Petrie – Analyst, CIBC World Markets

Good afternoon. I just want to ask on the top line same-store sales and your measurement of inflation, both slowed modestly from Q1, though I think CPI was relatively consistent. Michael, you talked about the step-up you saw from some of your competitors and that you didn't necessarily follow right away. Was this shift in the competitive environment sort of the driver of that deceleration in the top line or modest deceleration and could you just talk about that dynamic a little bit more please?

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

Yeah, I'll elaborate a little bit more and then I'll ask Mike to talk about CPI and inflation.

Look, I wouldn't overstate it, but we're watching the economy and market very carefully. We're watching whether there's been some deceleration in the economy, particularly in Alberta. We're also seeing whether we need to be more promotional in this market even as we are more efficient in driving for margins. We continue to be focused on growing our margins through improved category performance, but the top line certainly also matters, particularly going forward, when we expect and need to increase productivity in our stores.

And then maybe I'll just touch on a few other things, just some stuff we expected. First of all, we talked about the number of stores we are closing in the West to convert to FreshCo, and as we execute with more velocity on that program we have more square footage out of the market temporarily, and our store performance has also affected us as the stores ramp down, which affects our comps. These are expected impacts and the right thing for us to do. In addition, we're also having some strong comps that we are now lapping in our discount business and also in Saskatchewan where one of our competitors was on strike last year.

I think we're a company that is really pushing through to close that EBITDA margin, to get the margin right, and I think we were in a promotional market where we kept pushing for margin, maybe a little bit too much, but that's certainly fine-tuning and something that can adjust over time. Starting in October and up 'til now, that's the kind of thing we're seeing in the market. So, we're seeing a little bit of a difference, but I don't want to overstate it, Mark. And maybe, Mike, if there is anything you want to say about inflation or if you want to add anything.

Michael Vels — Chief Financial Officer, Empire Company Limited

I don't think so. I think that's right. Inflation is at 2.4%, you know, it's always below the CPI food purchased from stores, just because those indices look at a fraction of the SKUs that we carry. We had, I think, a relatively modest decline from the last period. And, as Michael said, we've been very focused and very consistent for the last three years. Margins are important to us, but equally, we need to be competitive in the market and we'll ensure that we are.

Mark Petrie – Analyst, CIBC World Markets

Okay. Thanks. And I know, you know, obviously improving that top-line momentum is a focus, especially into the next fiscal year, and I guess I'd be interested to hear how much you think that will come from sort of more structural shifts in your business like rolling out FreshCo and sort of being through that noise around conversions, and then obviously the introduction of Voilà into Ontario and how much of it you think will need to come from better execution either on promotions, in-store assortment, et cetera?

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

It's Michael here. I think that's a great question going forward. I don't know if you know, Mark, but I prepared the script beforehand, so they were prepared remarks, so I talked about the fact that you can get fake, kind of false readings, on sales if you want, you can promote, you can hit your margin, you can look a little better in tonnage. We tried to resist that over the last number of years because that gets you in trouble and it's not really sustainable over the long term.

I do think that we could have been a little bit more promotional in the back half of the quarter going into this quarter. But the real prize, like you just pointed out, is to be better at what you do. Be better at executing while the customer builds your brand, and in every transaction, we have to thrill the customer. I think it's clear that in Project Sunrise 2.0 that the customer is going to be even more in the forefront than it was in the last three years. Our plan is to build market share through very organized strategic initiatives, not just trying to buy the customer for a little while. There will be deep initiatives that we will undertake to be able to build up our market share.

And, as you also pointed out, I think that the moves we're making on FreshCo, on Farm Boy, and especially on Voilà, are going to allow us to take market share as we move forward. A lot of the initiatives that we have been planning now for, some of them almost three years, are going to start bearing fruit and as we move into our next three-year planning period, that we invested early on in, which I'm glad we did, that's going to put a little wind in our sales.

So, the things we're worried about, we are on it, but that's strategic and that's long term. We also run for quarters. We remain a little concerned about the economy and what we're seeing across the country, but mostly in Alberta, and how we're going to respond to a more promotional marketplace than we've seen and certainly since I've joined the Company. Is that helpful?

Mark Petrie – Analyst, CIBC World Markets

Okay. Yeah, very helpful. And I guess, just since you brought it up, do you have a timeline in terms of Sunrise 2.0 and when you'll be able to share some of those additional details?

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

Our hope is that this spring, probably May, but we haven't committed to that. We're going to figure out the best way to communicate. We're just finishing up the plan right now and we'll finalize it in the new year, and then we'll communicate it to you and our owners, in probably May, but it could be late April or June. We'll just figure out the timing and when we want to do that.

Mark Petrie – Analyst, CIBC World Markets

Appreciate the colour. Thanks. All the best.

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

Thank you.

Operator

Thank you. The next question is from Karen Short from Barclays. Please go ahead, Karen.

Renato Basanta – Analyst, Barclays

Hi. This is actually Renato Basanta on the line for Karen.

I was just wondering if you could flesh out some of your comments about the competitive environment, specifically if you can speak to where you might be seeing a step up maybe from a geography and/or a format perspective. That would be helpful.

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

We're seeing it across the country. Obviously, there are different competitors in different regions, but we're seeing it everywhere.

Renato Basanta – Analyst, Barclays

Okay. That's helpful. And then just on SG&A, can you help us think about the underlying growth rate? Obviously, some noise with IFRS, Farm Boy, the restructuring cost reversals, but what's sort of the right growth rate we should be thinking about going forward when you sort of normalize for all of those factors?

Michael Vels — Chief Financial Officer, Empire Company Limited

I think looking forward, outside of those factors, which we provided quite a bit of colour on in our press release, we're going to see some positive benefit as we get through the back half of the year, lessening in impact, of course, as we annualize prior reductions. So, we'll see some positive impacts still from Sunrise. Our store labour does increase as our sales improve, but we do get some benefit, obviously, because there's some fixed and some variable elements in there. As Michael said though, most of the work that we had to do on SG&A, it's pretty well there. It's close. So, I think we, as a company, are going to continue to be very cost conscious and we're going to find ways to pare our SG&A down, but we are pretty close to a steady-state run rate on SG&A, if you factor out those one-offs and accounting items that we highlighted in our press release.

Renato Basanta – Analyst, Barclays

Gotcha. That's helpful. And then last one from me. I was just wondering if you could provide a little bit of a preview on Sunrise 2.0. Obviously, you're working through the plan, but if you could give us some colour maybe directionally on the potential size of the program and then maybe just some teasers on what the focus will be with respect to sales productivity and gross margins, that would be helpful. Thank you.

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

I like you. Nice try. But because you were so nice, I will say that, as Mike just said, we're always watching our SG&A, and anybody who knows Mike Vels knows he is watching it all the time, which is good, and we feel like we're in the region of where it's right. I think you can expect far more going at the cost of goods sold, especially in the early years of the plan where there's still so much room to improve that, and we're also going after sales productivity in our stores where we think there are some real opportunities. But I think that that takes a tiny bit more time, so that you'll see us going hard at cost of goods sold in the new plan while improving our sales per square feet across the country. And we've got the room to do that. As I said, there's absolutely no reason we're not going to close that EBITDA margin gap as far as we can to our competitors. We knew we couldn't do it the first three years, but we're going to finish the job.

Renato Basanta – Analyst, Barclays

All right, great. Thanks and best of luck.

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

Thank you. Have a good Christmas.

Operator

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

Michael Van Aelst – Analyst, TD Securities

Thank you, good afternoon. Just on the category resets, so now that you're pretty much done and you've put them all in as of the end of October I think you said, when you look back at them now, how would you rank them on a scale of say one to ten and what kind of things do you think you can circle back to in Sunrise 2.0 to take out additional COGS?

Michael Vels — Chief Financial Officer, Empire Company Limited

Sure. On a scale of one to ten, I'm going to leave Pierre to give you that score, seeing as he was accountable for it and I don't want to create any ill feeling here. But I think we've said pretty consistently that we're comfortable with it.

In terms of the next phase and, as Michael said, what can we do next, and Pierre will provide some colour in a second, but we did this very quickly, if you think about it, and in the midst of a very major reorganization of the company, and even without knowing those facts, you'd think there's got to be a lot more upside when you fine tune that category management, as our analytics get better and as our merchandisers get better. So, that's really what we're referring to when we say there's still some tailwinds that we intend to recapture in those areas.

But maybe for some colour, Pierre, why don't you give us the score and tell us what you think?

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

It's probably the best initiative that the Company has executed over the last several years. A big benefit, I think, is our assortment has never been updated and relevant like it is now, from coast to coast. It is simpler to manage for our team, and it's much simpler to shop for our customers. We gave more space to more efficient SKUs. So, I think the productivity on-shelf is much better.

We revisited and cleaned up the data and everything. So, there is a lot of benefit, internally, for us that we will leverage, because the team will spend more time driving sales over time and we're less complex to deal with for our supplier partners. There's a soft benefit over and above all the hard benefits that we have generated through that initiative, so I'm very proud of our team. I'm pretty tough with my team, but on this one, not giving it a 10 out of 10 wouldn't be fair.

Michael Van Aelst – Analyst, TD Securities

Yeah, I wasn't trying to say whether you did a good job at it, I was just trying to get a sense as to how much was left to improve upon in the second round as you go back and do what Mike said in terms of going back and trying to optimize or perfect the initiative.

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

Customer trends are always changing, we have robust data. We're revisiting our data on a regular basis. So, I think going forward, there will be tweaks in every category with suppliers. We just need to adjust our assortment based on the customer trends.

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

The COGS improvement I'm talking about - very little of that will come from the supplier partners. A lot of that is going to come from our own processes and disciplines and taking costs out and being far more efficient, which I've seen done before, and we have plenty of room to be able to do that.

Michael Van Aelst – Analyst, TD Securities

Okay. Thank you. And then on the CapEx, you said $600 million for fiscal 2020. With the CFCs or Voilà spending next year, or fiscal 2021, and the intention to start renovating your stores, maybe more aggressively, do we see that number go higher beyond 2020?

Michael Vels — Chief Financial Officer, Empire Company Limited

So, we are going to provide explicit guidance on that as we start to close out our year and look at the next one, as we've made a habit of doing over the last couple of years, so I don't want to lead into that, but to specifically answer your question, Michael, yes, it will be higher, but not excessively higher. As Michael and I have said very consistently, we believe that we do need to reinvest in the Company, but we need to do it in a disciplined way and we're going to balance that with our cash flow generation. So, yes, you can see it, I think it's just logical to conclude that it will be higher, but I wouldn't be looking for a major change in our approach or a very significant variation in our investment program.

Michael Van Aelst – Analyst, TD Securities

All right. Thank you.

Operator

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

Vishal Shreedhar – Analyst, National Bank Financial

Hi. Thanks for taking my questions. Just back to the competitive environment and management's desire to stimulate sales amid that environment. When management says we want to stimulate our sales line maybe a little bit more, is it simple enough to say that means gross margin investment? Or are there merchandising tactics that a management can employ to protect that? Maybe some colour on that.

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

It's Michael. First of all, I'm not going to answer it, because I think I've said enough on that. We have competitors. Secondly, I think you should also hear from us that we like having a good gross margin and not flipping it around like we did. We worked three years to improve our gross margin and our EBITDA margin. We're not going to just flip everything on its head. At the same time, obviously, competitors across the country have been seeking sales and we've been maybe a little slower to react to that, which I'm okay with, but we can continue to look for ways to execute across the country, in order to hold market share like we have over the last couple of years.

I mean we're talking fine-tuning here, like I said. It's a fine dance in merchandising in any retail, especially grocery, in terms of balancing sales and margin and doing it in a smart way and making it really attractive for our customers, which is really the smartest thing we can do. But seeking empty-calorie sales is a short-term investment that does not pay off in the long term, so we're going to do things the right way.

Vishal Shreedhar – Analyst, National Bank Financial

Okay. Thanks for that. And maybe you already alluded to this, but you noticed that the consumer backdrop is getting a little bit tougher. Maybe you can just give us your context on, is this very incremental at this stage or are you seeing a meaningful change quarter to quarter?

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

In a short period of time it's so difficult to read and, unfortunately, nobody around this table, I don't think, is trained as an economist, but we did see some changes. I don't want to overemphasize them, but we did see some changes across the country, especially in Alberta. We watch with interest and listen to the large banks and what they had to say in terms of consumer sentiment and I think, like everyone else out there, we are watching it and concerned, but there's nothing to panic about right now. But we're concerned.

Vishal Shreedhar – Analyst, National Bank Financial

Okay. And maybe just changing topics here a little bit, you mentioned that your Ocado partners are getting a lot of interest in their e-commerce solution. Wondering if there's such a thing as too much interest and if you perceive the Ocado support team is maybe stretched a bit thin and if you can, in fact, achieve your goals given that they have so much more to do?

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

No, I don't think they're stretched too thin, because it's all in an order. One of the reasons that we moved to tie up exclusivity in Canada, was because we wanted the best e-commerce solution and we didn't want our competitors to have it. But we also knew that if we moved fast, we would be higher and we knew everyone around the globe was looking at the solution. And I think at that time Monoprix was the only one who had announced before we did and it was only a couple of months before us, so we were in negotiations, and we felt that the way that Ocado was organizing themselves, which I think is very good, would be that if we were too late to the game, it would put us off by a couple of years, because they would have different partners across the globe. But they're very well organized and so obviously we don't have that feeling.

Vishal Shreedhar – Analyst, National Bank Financial

Okay. 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

Good afternoon, everyone. Not to beat this horse to death, but just really on the consumer behaviour piece, obviously there is something going on out there, and you mentioned your robust data and analytics capabilities. When you scrub sort of the customer purchasing behaviour, are you seeing the kind of signs of trade down? Are you're seeing an uptick in private label? Are you seeing anything out there that points to shifting consumer buying patterns, sort of independent of 'we're buying a little bit more on promotion', and are they buying more in promotion?

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

I mean it's such a short period of time that this is all occurring in, and it's tough to see across the country. There are too many other things going on. Like we had bad weather and we had some things that we were doing in terms of closing stores and so much other action. So, on that, that's a great question, but I think we're going to need a little bit more time to see if any of that is playing out. We didn't see any move away from full service into discount or anything like that.

Pierre, are you seeing any indicators on more of a category level or a private label?

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

No, not at this time. And, as we said, we saw that in every format, every region, so it's everywhere. There's nothing specific to some customer segments. So, we're still looking at it, but it's too early. Like Michael said, we need a longer period of time to make a conclusion on that.

Irene Nattel – Analyst, RBC Capital Markets

Thank you. Appreciate that. And then I also want to come back to something that you said around closing the margin gap. So, on a pre-IFRS basis, up about 50 basis points to 5.0%, on reported basis closer to 6.8%, like how far—if in fact we focus on that 5.0%, it would suggest that there's still a nice chunk that we can look forward to. Would you agree with that commentary?

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

We certainly would. We've done the math and we'll share it with you, you've got to adjust for some structural things like pharmacy, a little bit on the real estate, a little bit on the fuel. But as far as we've come, we've come a long way, there's still a huge prize out there, so I would totally agree with you.

Irene Nattel – Analyst, RBC Capital Markets

And it's your determination, Michael, to actually get at that prize.

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

Yeah. I’m not going to commit today whether we’re going to get all the three years or more of it or right on, because we’re still doing the work on that, but I always knew it was a six-year job to be able to close that food retail gap. I think we’ve performed better. I think our team has been better than I could even have imagined at this point, so I’m more confident, and we’re structured right. I mean we couldn’t have done any of this if we were still a regional company. It has only been just over a year that we’ve been a national company.

So, now having all the structure in place, the people in place, the initiatives in place and, by the way, we don’t wait until we announce, we’re already under way on a few things here, I think we’ve got a lot of running start into the new strategy and closing the gap. I’ve always said that we had a long way to go but, on the positive side, we have the most upside of anyone, and we intend to outperform the market. And I think people forget how much room we have, thanks for reminding everyone, and we have ways to go to be able to close that and the upside is very, very large.

Irene Nattel – Analyst, RBC Capital Markets

That’s great. Thank you. And one final one, if I may. So, you talk about excitement and thrilling the customer and, again, you’ve got an awful lot on the go and this is clearly a journey, but wondering if you could just talk about some of the initiatives that you may already have rolled out and what we should be looking for.

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

You saw a couple of things that we announced with the Caper carts, these are good things to thrill the customer. I think over the last three years we spent most of our time organizing ourselves internally and structurally. Most of it is behind us now, and we will put our focus on the stores, and the customers. We have great assets across the country, a lot of square footage, so the team is working together now on a plan to focus on that. I think that's where the fun is at in retail and the team is very excited to bring new things, such as enhancing the food offering, to our customers. Also, we have great partners with us in this company now. We made a very good strategic acquisition with Farm Boy, which we are leveraging. There are a lot of good initiatives in place now.

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

I think the other thing I'm really proud of is when I first joined I would have said to this group that I didn't think that our brands had that brand promise that I really like and that we didn't differentiate between the banners enough. I think that the work that marketing with merchandising and ops are doing, you are starting to see. If you walk our stores today, the Christmas season, and you look at some of the ways that we're differentiating our banners and really bringing those to life, and a lot of the things we're doing around our banners are appealing to our customers. We're not all the way there yet, but we've made big inroads, especially over the last 6 to 12 months.

Irene Nattel – Analyst, RBC Capital Markets

That's great. Thank you.

Operator

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

Peter Sklar – Analyst, BMO Capital Markets

As you talk about your e-commerce business, you talk in the context of having four fulfillment centres, so can you give us a timeline of when you think you would be building number three and number four?

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

No, we're going to open up Toronto. All our attention is on opening up Toronto and we're moving the dirt in Montreal. We're going to open soon. The opportunity is here, we're going to have such a strategic opportunity and such a weapon in Voilà that we're going to have to huddle after we open up Toronto, see how it's going, and then decide on the timing. We've got a pretty full plate. We have a lot of opportunities as well in the store renovations I was talking about. Very excited about the returns on store renovations in a short period of time. So, we'll have to look at that and see what the timing is like, but that will give us a big head start in two of the major markets and then we've got at least two to go, right?

Peter Sklar – Analyst, BMO Capital Markets

Yeah, but Michael, are you committed to number three and four with your agreement with Ocado?

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

No. We're not committed to anything other than having exclusive rights in Canada and to grow at a certain pace. We're growing much faster than the pace that we talked to Ocado about growing at. So, there's no issue in that. There's no hurry. But the thing that's bothering me and why we think about it a lot, is if you've got the greatest weapon and it takes two years to get it up and put it in the market, that's a bit of a delay, and also to be able to exploit it through spokes and micro fulfillment and all the other things we want to do to be able to own the whole market in e-commerce. So, those are all the things we're balancing. But my hope would be to get the other CFCs open in a timely manner, but we're not committed. We would tell you if we were. And I want to have all of our attention on this GTA opening. It is really important to our Company.

Peter Sklar – Analyst, BMO Capital Markets

Okay. On another topic, with the FreshCo rollout out West, I'm sure you do some consumer market research, and I'm just wondering what you're seeing in terms of development of the brand. As you know that there was no brand identity for FreshCo really out West. And I'm just wondering how you're doing when you undertake your market research and other measures.

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

We're probably doing more market research than I've ever seen in terms of opening up a banner and we're doing really well on that. But you're right, you have to consider, this is a new banner to this market so we have to make a big splash when we open and we've got to continue that for a while. Our competitors do not enjoy it when we open and we re-open, because they've had six months or whatever it is in some of the locations to be able to take some market share, which we then take back. They resist. We fight. We get it back. But considering there's a new banner in this market, which we knew, I think that first of all, the FreshCo team led by Mike Venton and the work by Sandra Sanderson and the marketing team has been superb. So, we look at this very, very closely, as you can imagine, in terms of the customer data and the sales data. We're just opening and where we are, albeit early days, we are very, very pleased. We just want to get more open. But you did see some of that. As I said before, you see in some of our same-store sales and our sales numbers that we had some closed doors and that will all work its way through the system as we are opening and closing and doing things like that. But there is some granular level of effect to our comps as we do that, and we ware off inventory and close down stores.

Peter Sklar – Analyst, BMO Capital Markets

Okay. And then just lastly, can you comment how your internal inflation was trending as you exited the quarter and as you got into the third fiscal quarter?

Michael Vels — Chief Financial Officer, Empire Company Limited

It's pretty consistent through the quarter, a little bit of, probably a fall off towards the end, but really not sufficiently material to take note of.

Peter Sklar – Analyst, BMO Capital Markets

Okay. Thanks, Michael. That's all I have.

Operator

The next question is from Chris Li from Desjardins. Please go ahead, Chris.

Chris Li – Analyst, Desjardins Securities

Hi. Good afternoon, guys. Just one question left from me. Just wondering what is your outlook on transportation cost for next year? Dollarama last week mentioned shipping rates are going up because of IMO 2020. I'm not sure if that would impact you guys the same way that it impacts other retailers.

Michael Vels — Chief Financial Officer, Empire Company Limited

I think the best way to answer it is that at this point we don't see that as being a material impact on our company in the next 12 months or so. I may be wrong on that, but that's not a cost pressure that we have in the front end of our radar here.

Chris Li – Analyst, Desjardins Securities

Okay. That's great. That's all for me and happy holidays, guys.

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

Happy holidays. Great to be talking to you, Chris.

Operator

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

Patricia Baker – Analyst, Scotiabank

Thank you very much. I have two questions or two topics for you, Michael, of your seven. So, the first one is Farm Boy, and I don’t remember if it was you or it was Mike who said that you’re at various stages of development or negotiation with, I think, was it 25 properties for locations for Farm Boy? And I’m just curious whether if you look back to a year ago, just after you closed on the deal, being at that level of transactions for Farm Boy. Is that further ahead than you thought you’d be at this time?

Michael Vels — Chief Financial Officer, Empire Company Limited

That’s a difficult one to answer because, yeah, it would be easy to say that yes, we’re further ahead than we thought we would be. But part of our thinking and part of JL and Jeff’s thinking when we combined our two companies was that we could take their rate of expansion that they had in their plans and accelerate them by using the power and the capability and the scale of our real estate group and our access to properties.

So, really what we’re seeing is the successful execution of that belief or that hope. And so I think, well, I know, where we are is accelerated from what the Farm Boy plan was without Sobeys but it is meeting our expectations about what we thought the two companies could do together.

Patricia Baker – Analyst, Scotiabank

Okay. That makes a lot of sense, Mike. And then maybe that's a good segue way to my second question. Michael, you included Crombie as one of your seven topics for discussion on the call and sort of talked about Crombie more than you have on other calls. You opened by saying that you currently have a 41.5% position and you're happy with that. So, I'm assuming what you're saying there is that, for the foreseeable future, there will be no sell down in Crombie and that's an appropriate level for you to own and I'm just wondering if you could expand a little bit further on some of the—you talked about working with Crombie differently, so can just give us a little more information about how that makes Empire stronger as a grocery operator going forward?

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

Yeah, I'll say a few things and I'm going to send it over to Mike. I come from a background where the real estate department worked so well with the REIT at a previous company I was with. It was a really great relationship. And so when I came over Donnie Clow and I, and then when Mike joined, Mike and Glenn and some of the others over there, and now Clinton who's over there, there's just such a great opportunity to work together cooperatively for the best, obviously for the fiduciary duty of each of the different entities. And I would say that, and Donnie would probably say the same, that the relationship between our REIT and our real estate group has been phenomenal, just phenomenal. It's working like, I'm told, in a way that it's never worked together before. And it reminds me a lot of my previous experience when that was working so well. And that just creates so much opportunity.

I think because we've been busy turning around our results here at Empire, we forget sometimes the power of that REIT and we don't talk about it a lot and that we're very pleased with the performance. We're very pleased with the developments. We really like how it returns capital to us and that we can have better locations for our stores. And they like us in many ways too, so its symbiotic relationship, and you think, well, that's always great. I would say that the way it's working, and I would give a lot of credit to our real estate group and to Mike and to the people over there, this is a big upside for us and we're very pleased with the ownership and very pleased with how it's going over there.

Mike, do you have anything? I mean you spent a lot of time as well on that.

Michael Vels — Chief Financial Officer, Empire Company Limited

I'm clearly responsible for ensuring that it works, so I'd just say it's going great. But on a more serious note, the two companies exist for their respective shareholders, clearly, so as Crombie has a strategy, so do we. But we're heavily linked because of the grocery property factor and there's just a long list of opportunities and collaboration that you would, if you were managing it properly, expect to see. So, most of the work is clarifying expectations, installing process, being transparent with each other's strategies and where we could take one and one and make it equal three. So, I think that's just smart business and ensuring that we have the right people properly incentivized and motivated to get that done, really, was how Michael and I went at it and how we made sure that it was as good as it could be.

Patricia Baker – Analyst, Scotiabank

I really appreciate that and I like the notion that you're working on making one plus one equal three, Mike.

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

I never heard Mike say that before. I was excited.

Michael Vels — Chief Financial Officer, Empire Company Limited

Times 42%

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

Thanks, Patricia. Have a great holiday.

Patricia Baker – Analyst, Scotiabank

You as well.

Operator

Thank you. There are no further questions at this time. I will now turn it back over for closing comments.

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

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 third quarter fiscal 2020 conference call on March 12th. Happy Holidays.

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.