



Loblaw Companies Limited

Fourth Quarter 2021 Earnings Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen and welcome to the Loblaw Companies Limited Q4 2021 Earnings Conference Call.

Following the presentation, we will conduct a question-and-answer session.

This call is being recorded on Thursday, February 24, 2022.

I would now like to turn the call over to Mr. Roy MacDonald. Please go ahead.

Roy MacDonald — Vice President, Investor Relations, Loblaw Companies Limited

Great. Thank you very much, Kelsey and good morning, everybody. Welcome to the Loblaw Companies Limited Fourth Quarter and Full Year 2021 Results Conference Call.

As usual, I'm joined here this morning by Galen Weston, our Chairman and President, and by Richard Dufresne, our Chief Financial Officer.

Before we begin the call today, I want to remind you that today's discussion will include forward-looking statements, which may include but are not limited to statements with respect to Loblaw's anticipated future results and the impact of the COVID-19 pandemic.

These statements are based on assumptions and reflect Management's current expectations, and as such, are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from our expectations. These risks and uncertainties are discussed in the Company's materials filed with the Canadian securities regulators. Any forward-looking statements speak only as of the date they're made. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise, other than what's required by the law.

Also, certain non-GAAP financial measures may be discussed or referred to today. Please refer to our annual report and other materials filed with the Canadian Securities regulators for a reconciliation of each of these measures to the most directly comparable GAAP financial measure.

With that, I will turn the call over to Richard.

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Thank you, Roy and good morning everyone.

Our Q4 results continue on the path of consistency we have been working towards in 2021. Stability in our gross margin, coupled with solid sales performance, focus on market share, and careful management of our expenses are our daily focus. Our strong Food and Drug Retail platforms, coupled with our main strategic initiatives, namely loyalty and e-commerce, are adding to our financial performance.

The pandemic continues to impact our year-over-year comparisons. As such, we will continue to share some two-year average data points to help provide further insight into our operating performance. I also want to remind everyone that Q4 last year included an extra week versus this year. To make a more meaningful comparison to last year's performance, financial highlights will be presented on a comparable 12-week basis.

Our reported results include a one-time gain of some \$300 million related to the resolution of the Glenhuron Bank matter. I highlight this fact as we will recover some \$300 million in cash over the coming months.

The strong performance of our fourth quarter built on the momentum we saw in the previous two quarters. We began Q4 with restrictions loosening and customers preparing to celebrate the holidays with family and friends. We ended the quarter with another round of lockdowns.

Across our mix of assets, our stores and our supply chain network rose to the challenge, and our businesses performed very well. On a consolidated basis, revenue for the fourth quarter grew by 2.8 percent to \$12.8 billion, Adjusted EBITDA increased by 6.3 percent to \$1.32 billion, and adjusted earnings per share grew by 35.7 percent to \$1.52. On a two-year basis, we saw average annualized growth in revenue of 4.9 percent, Adjusted EBITDA growth of 9.1 percent, and adjusted earnings per share growth of 30.1 percent. Again, this quarter, our results outperformed our financial framework.

Drug Retail delivered another strong quarter. Absolute sales increased 6.8 percent with same-store sales increased by 7.9 percent in the fourth quarter, lapping a softer quarter of growth of 3.7 percent last year. We saw strong performance across both front store and Rx. Front store same-store

sales were better by 6.1 percent, led by double-digit growth in cosmetics and OTC benefitting from lighter social restrictions throughout most of the quarter. Pharmacy same-store sales grew 10.2 percent, benefitting from the strength of pharmacy services, which grew by over 100 percent in the quarter, as we supported the government COVID vaccine and testing programmes. On a two-year average, Drug same-store sales have grown 5.8 percent, with front store at 4.5 percent and Rx at 7.6 percent.

In Food Retail, same-store sales saw a growth of 1.1 percent, lapping a strong quarter of 8.6 percent last year. Although we saw eat at home trends coming off last year's levels, we continued to experience strong demand. Our market banners continue to outperform and post share gains. Discount began to benefit from the return of price-sensitive customers, gaining momentum towards the end of the quarter. Traffic momentum continued, improving again in Q4, and is showing signs of beginning to normalize to pre-pandemic levels. On a two-year average, Food same-store sales reflected average growth of 4.9 percent.

Performance in the quarter was against a backdrop of rising cost inflation and ongoing supply chain disruptions. Supply chains are facing unprecedented challenges around the world. This is leading to higher inflation in every industry and it continues to be volatile. We are monitoring the supply chain situation very closely. With the largest distribution network in the country, our scale and experience has allowed us to navigate these challenges relatively well. Our teams are doing a great job prioritizing and adapting to these situations as they unfold.

Our shelf price is the tail end of a chain of costs - shipping containers, fuel, farming, ingredients, labour, weather, to name a few. We watch this very carefully and focus on ensuring that our retail prices

are competitive. During the quarter, we saw high rates of input inflation across the board. Our job every day is to ensure that any proposed cost increases are appropriate, keep items on the shelf, and deliver the best value to our customers.

Leading the way with our discount banners, leveraging the price investments that we made last year, and driving the loyalty offers that really matter personally, we work to deliver value. In 2021, our online business generated more than \$3.1 billion in sales, an increase of 14 percent over last year. In Q4, online sales decreased by 8.4 percent, lapping last year's 158 percent growth rate. Digital platform is now deployed and available throughout Canada. Q4 2021 was a quarter with less COVID restrictions than in 2020.

We are pleased with our omnichannel performance as it continues to operate at penetration levels well above pre-COVID rates. Omnichannel's a key pillar of our service offering. We continue to enhance our customers' shopping experience through our digital platform while offsetting its costs through optimizing operational efficiencies, deploying new technology, refining our delivery offering, and seeking out promotional and advertising opportunities.

Retail gross margin in Q4 was 30.9 percent, up 150 basis points compared to last year. We continued to see traction leveraging our unique data to deliver effective food pricing and promotional strategies. Both our Food and Drug Retail businesses benefited from a continued rebound of higher-margin categories consistent with performance from the previous quarter. Pharmacy services were a key contributor to gross margin growth as COVID vaccines and testing peaked during the holiday season.

Comparing to 2019, we have recovered from the challenges of 2020. Gross margin have improved by 80 basis points with similar improvements in both our Food and Drug businesses. Focus on stability of our gross margin while driving our sales performance is a priority. We remain confident regarding our gross margin performance going forward.

Retail SG&A as a percentage of sales was 20.9 percent with the rate higher by 120 basis points compared to last year. The increase was driven by corporate one-time items, lapping austerity measures such as lower store hours in Shoppers, and increased labour cost associated with growth in Rx services. Corporate items included a \$90 million charge related to the optimization of our store network that we discussed on our last call, which was not considered an adjusting item. Also, note that COVID costs came in at \$8 million in the quarter, in line with our expectation. When we exclude our one-time costs, we are pleased with our performance in the quarter. Compared to 2019, our Q4 Retail SG&A rate increased by 20 basis points, driven by higher labour costs to support growth in Rx services and some COVID costs.

Adjusted Retail EBITDA increased by \$60 million or 5.1 percent in the quarter. At PC Financial, revenue was up \$40 million, driven by higher interchange income as we are benefitting from increased spending on PC MasterCard. Adjusted EBITDA at the Bank increased \$18 million year-over-year, primarily driven by favorability in interchange income and lower credit losses, and included a \$27 million gain related to the reversal of prior-year commodity tax remittance. This was partially offset by higher points cost for redemptions, more normal marketing spend compared to last year, and an ECL provision release of \$11 million last year. On a consolidated basis, Adjusted EBITDA margin was 10.4 percent in the quarter, up 40 basis points compared to last year.

In the quarter, IFRS net earnings available to common shareholders was \$744 million, up \$434 million, and fully diluted earnings per share were \$2.20. This includes the \$301 million recovery related to the Glenhuron Bank income tax return.

Retail free cash flow was at \$460 million in the quarter. For the full year, we increased Retail free cash flow by over \$400 million. Our cash flow generation is strong. Our cash balance is high and increasing.

In Q4, we repurchased \$200 million of common shares, finishing the year at \$1.2 billion, representing 15.6 million shares.

Looking ahead to 2022, volatility will remain. We expect inflationary pressures to continue and supply chain to remain challenging. The pandemic will continue to impact sales trends and year-over-year comparison. That said, we are very pleased with the mix and positioning of our businesses and our focus on retail excellence will continue to generate positive operational and financial performance.

So, for Full Year 2022, we expect our Retail business to grow earnings faster than sales, and earnings per share growth in the low double-digits with higher growth in the first half of the year. We plan to invest approximately \$1.4 billion in capital expenditures net of proceeds from property disposals, reflecting incremental store and distribution network investments, and to continue to return capital to shareholders by allocating a significant portion of our free cash flow to share repurchases.

In the fourth quarter, we again demonstrated steady, consistent performance. As we continue our focus on retail excellence and on a few key strategic initiatives, our unique set of assets positions us very well for the future.

I will now turn over the call to Galen.

Galen Weston — Chairman and President, Loblaw Companies Limited

Thank you, Richard, and good morning. I'm pleased with Loblaw's performance in the fourth quarter as we ended the year in a position of strength. Our results were driven by retail excellence with a focus on the fundamentals - top line growth, margin expansion, and cost control. This took place amid complex circumstances as the communities we serve moved through various lockdowns and reopenings, and the country felt the impact of repeated supply chain disruptions including several remarkable weather events.

Our ability to respond to those extraordinary conditions was enabled by scaling up several of our strategic growth areas. Our e-commerce platform stretched beyond the \$3 billion mark as we kept our customers fed and well. We did so while providing uniquely personalized offers to PC Optimum members. Our loyalty programme has become an increasingly effective merchandising tool for driving sales.

The most recent illustration has been our Points Days event, which provided Canadians with exceptional value across our supermarkets, drug stores, digital businesses, and partners such as Esso gas stations, a remarkably powerful campaign that drove results for the entire enterprise.

This is a testament to the level of engagement in the programme which was recognized by IPSOS as one of the country's Top 10 Most Influential Brands, the highest-ranked Canadian brand on the list. It's just one data point which reaffirms that digitally enabled, personalized connections to customers have significant runway as we look ahead.

At the same time, as Richard mentioned, the growth of Pharmacy Services was an important part of how we served patients, and reaffirmed our conviction that the convenient, connected, and local delivery of care will be an increasingly important part of how we will grow. That relentless focus on our core business, paired with scaling up our strategic avenues for growth, builds upon an enduring commitment to the communities that we serve.

That commitment also exists in our efforts to advance both social equity and sustainability. In that spirit, we're proud to announce Loblaw's commitment to achieve net zero carbon emissions by 2040. Having already surpassed our pledge to reduce our corporate footprint by 30 percent in 2030, we are squarely focused on this next challenge. It will see us deploy electric trucks, better lighting, more efficient heating and cooling and other new and innovative measures.

The need for action is as clear as our ambition and reflects the long-term view our Company has held across generations. We've remained focused on serving our customers everyday through the highs and lows of the pandemic and look forward to building a better, more resilient country and business together. As we do so, our purpose - helping Canadians live life well - is the core of how we will create enduring value for shareholders.

I'll now open the call for questions.

Roy MacDonald — Vice President, Investor Relations, Loblaw Companies Limited

Thank you, Galen. Kelsey, if you'd please introduce the Q&A process?

Q & A

Operator

Thank you. Ladies and gentlemen, we'll now begin the question-and-answer session.

Your first question does come from Michael Van Aelst from TD Securities. Please go ahead.

Michael Van Aelst — Analyst, TD Securities

Thank you. I just wanted to start off by asking about the inflation rates that we're seeing right now and hitting highs at least in the last decade or so. How are you seeing customers react or even adjust to these higher prices and both, I guess, within your banners and then within different categories?

Galen Weston — Chairman and President, Loblaw Companies Limited

Yes, thanks, Michael. No question, at 5 percent in the quarter, inflation is significant and there continues to be significant pressure as we look forward, especially over the next couple of months. This is a result, as Richard said, of very real cost pressure all the way through the value chain. So, when it comes to the customer, at the moment we're not seeing a ceiling that's being reached by consumers in terms of prices at retail. However, they are becoming increasingly price-sensitive. There's no question

about that. We see it most notably in the accelerating performance of our discount business, and that's been particularly notable in the last couple of months. Then, of course, the strength of our control brand. You probably would have seen, especially in January, a strong emphasis around our No Name control brand in our stores and we've seen very significant uptake on that front. Probably less significant but still notable has been the increase in engagement in our loyalty programme, where, of course, there's substantial value available to customers who engage in the programme proactively.

In terms of categories, what categories are customers trading in and out of, nothing really notable. It's the usual things. People will trade down from beef into pork or chicken, but that stuff we would expect to continue and not yet at any form of extreme level.

Does that kind of give you a flavour of it?

Michael Van Aelst — Analyst, TD Securities

Yes, it does. Thank you. I guess that inflation being higher in the first part of the year is part of the reason why you have earnings growing in your guidance more in the first half than in the second half?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Yes, Michael, but also inflation started in the second half of last year, so we're going to be cycling that towards the second half. When we cycle that with the performance we also had in the second half, we think it's not going to be as high as it's going to be in our first half.

Michael Van Aelst — Analyst, TD Securities

Okay. And then the other question I had was with respect to Robert Sawyer's focus, because he's been with you now for I think it's about a year almost, roughly, and I know he's been extremely active. I'm wondering after all the work he's done so far, what has he narrowed his focus on to try and improve operations over the next year or two?

Galen Weston — Chairman and President, Loblaw Companies Limited

Yes. I think the general theme, and we use the term retail excellence, is what Robert has been focused on and what he will continue to focus on, and that is, it's the fundamentals. It's relentless focus and attention to detail on retail operations and merchandising. Robert works very, very closely with the divisional presidents and their merchandising and operations teams. Simply put, I think we're tighter and paying much closer attention to some of that stuff than perhaps we have in the past. I hate to use that well-worn maxim that retail is detail, but that is the case and that's what Robert brings and he will continue to bring looking forward.

There are a few places that we've talked about before that he is particularly focused on when it comes to driving incremental performance. Network optimization is certainly one of them. We're spending more money on new stores and renovations in 2022 than we have in the last couple of years, and seeing really strong indications of the contribution that those are going to make. We're also very focused on making sure that we have the best cost in our relationships with our vendors. While that continues to be collaborative, it is another important area of focus for him.

Michael Van Aelst — Analyst, TD Securities

Is there anything other than private label that you could point out in terms of the penetration or profitability that you might be working on?

Galen Weston — Chairman and President, Loblaw Companies Limited

Well, always focused on looking for avenues to improve customer engagement and to improve profitability. Yes, and do we see disproportionate amount of opportunity in control brand, if that's the question? I don't think so, not yet, but it is certainly an area that Robert's spending considerable time.

Richard Dufresne — Chief Financial Officer, Loblaw Companies Limited

Yes, Michael, with this inflation that we're seeing, I think we've been trying to showcase our private brand more in our stores so that our consumers see the value and we're seeing some traction with that.

Michael Van Aelst — Analyst, TD Securities

Okay. Thank you very much.

Operator

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

Irene Nattel — Analyst, RBC Capital Markets

Thanks and good morning. Just following up on the inflation discussion. We just got off the Maple Leaf call and they were talking about price increases that are coming through late March, early April. Can you talk about what you're expecting, and I guess the magnitude of the inflation that you're being faced with and the kinds of discussions you're having with suppliers at this point?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

I guess you saw in our press release, Irene, that the inflation we experienced in the quarter was around 5 percent, and so that's what we're experiencing now. The number and volume of increase is definitely higher than we've seen historically. Right now, our job is to sift through it as efficiently as we can.

Irene Nattel — Analyst, RBC Capital Markets

Understood. Have you seen—you mentioned the growth in discount. Are you seeing it accelerate, the move to private label, and are you also seeing the other typical behaviours, frozen versus fresh and that kind of thing?

Galen Weston — Chairman and President, Loblaw Companies Limited

Irene, it's an interesting dynamic here because we are now kind of in the 5 percent inflationary range. This is usually the place where you start to see meaningful behaviour change, but we're also coming in and out of COVID and, of course, there was a shift away from discount, as you know, that was a result of the COVID dynamic. We're not seeing yet the kinds of behaviour changes that would be typical of this type of inflation rate.

So, it's hard to pin down. It's not as extreme as you might expect it to be, but it's there, and it's manifesting itself most explicitly in the growth of discount. As I said, that has been particularly notable in the last couple of months, six weeks or so, where we've really seen that surge. We also talked about the price sensitivity algorithms that we use with DINA (phon). Those are getting more potent, which is another indication that price sensitivity is more important to customers today than it was this time last year, but the noise here is that COVID shift versus the inflationary pressure are shaping the consumer behaviour, I'd say.

Irene Nattel — Analyst, RBC Capital Markets

That's very helpful. Thank you. If I could just switch gears for a moment to Shoppers, which is a big chunk. I think it's about 40 percent of your EBITDA. Where do you think Shoppers is today in terms of Rx, putting aside the Pharmacy Services, Rx volumes and pre-COVID levels of front of store demand, particularly in those high-margin categories, like cosmetics?

Galen Weston — Chairman and President, Loblaw Companies Limited

Yes. Again, because we've been in and out of lockdowns in quite a volatile way over the last two years, it's hard to say explicitly, but when we're out of lockdown, the Shoppers Drug Mart front store categories surge, and when we go back into lockdown those front store categories come off quite considerably. We were surging in the fourth quarter and we're seeing some headwinds at the very end of the quarter and through this latest phase of the lockdown, and then, yet again, in some of the provinces where we see things opening up again, we see the Shoppers Drug Mart front shop business come right back.

The other place that we see a little bit of volatility, it's maybe more sustained performance, is around our base script volume, which is doctors perhaps not writing the same number of scripts that they would typically. Doctors are not yet back working as GPs at their full capacity. So we expect that also to line up pretty directly or to correlate pretty directly to increased openings.

Irene Nattel — Analyst, RBC Capital Markets

That's great. Thank you.

Operator

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

Mark Petrie — Analyst, CIBC World Markets

Yes, good morning. Just wanted to ask mostly on the Retail gross margin performance. Clearly, all of the work on retail excellence is paying off, but could you just give a sense of the magnitude of the biggest contributors, be it procurement or private label mix? Are you able to quantify or at least roughly the impact of Pharmacy Services in Q4?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Yes. If I start on the Food side, essentially the performance in gross margin on the Food side is just driven by better, efficient merchandising and promotional activities. I think that'd be the bulk of the benefit that we've seen so far. On Rx services, the gross margin is higher than the average Shoppers

business, but the SG&A aspect of it is also higher than Shoppers' SG&A rate. So, net-net, it's accretive to Shoppers' business, but it creates a bit of volatility in both of those figures.

Mark Petrie — Analyst, CIBC World Markets

Okay, helpful. How does Loblaw Media fit into the Retail margin performance today? How important is that to your margin outlook for 2022?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

The Media business is still quite small but growing rapidly. It's a business where we feel is going to have significant strategic advantage and financial advantage going forward to our business. It's definitely going to help in '22, but it's more after that that we're probably going to see the significance of that business. That business from a margin and sales perspective, it's at a significant premium to our Retail business, so to be able to replicate the same dollar margins in that business would require significant dollar on grocery or drug sales.

Mark Petrie — Analyst, CIBC World Markets

Yes, understood. Okay. That sort of dovetails into my last question, which is, in the outlook and in your commentary you sort of highlighted the opportunity for margin expansion this year. I think the longer-term framework typically is more about stable margins. I understand retail excellence work is a driver here and obviously Loblaw Media as well, but do you think there's an opportunity to see margin expansion over the medium term, so call it, three years?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

It's tough to predict what's going to happen to the future. What I can tell you, our focus is and has been stability of gross margin. If we can maintain our gross margin stable, if we can manage our SG&A rate well, we should be able to deliver decent performance to the business year in and year out. That is our daily focus. Not forgetting sales. We need the sales performance to align with that, but that's sort of the metrics we're focused on. I would be remiss to not include market share. To me, those are the four things we're focused on and that's what we focus on on a daily basis.

Mark Petrie — Analyst, CIBC World Markets

Okay, understood. Thank you for the comments. All the best.

Operator

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

Vishal Shreedhar — Analyst, National Bank Financial

Hi. Thanks for taking my questions. Loblaw's continuing to perform amidst all these significant challenges that you're seeing coming at you from a variety of angles. Wondering how Management feels about the in-stock positions in store and is that something that's getting tougher through time or has it stabilized now? If it hasn't stabilized, should we anticipate that in the near term?

Galen Weston — Chairman and President, Loblaw Companies Limited

Yes, we're feeling a lot better about our in-stock position today than we were, say, three or four weeks ago where it was particularly difficult. That's a combination of both the structural challenges related to the supply chain. The ability for us to destuff product, receive product at the ports, and then transport that product across the country, that has been challenged and disrupted over the last number of months, and then that was compounded by some particular weather events that affected our distribution channels in a—I don't know if it's a disproportionate way, but certainly a way that resulted in unsatisfactory conditions in stores.

We're in much better shape now and see ourselves staying in that shape moving forward, but it isn't like it was pre-COVID, and those supply chain challenges are still lurking there and so we would expect to be slightly behind our best standard for a little while longer.

Vishal Shreedhar — Analyst, National Bank Financial

Okay. A different flavour of a question that's already been asked. Looking forward through 2022, Management highlighted a variety of initiatives to deliver continued growth. It commented on strategic buying, leveraging customer loyalty, and promo effectiveness. Solid results throughout 2021, Management's looking for another solid results through 2022, so I was hoping in those buckets if you can help us understand which ones are the major buckets driving that growth.

Richard Dufresne — Chief Financial Officer, Loblaw Companies Limited

I think it's all the buckets. It's a whole. Retail is detail, as Galen mentioned, and so we need to perform on all of these metrics. It's our ability to perform well on all of those that will allow us to

continue to deliver consistent performance. We're very focused on consistency. It's hard to do, but that's our area of focus and that's what we want to be continuing to deliver going forward.

Galen Weston — Chairman and President, Loblaw Companies Limited

Vishal, maybe if I was to pick one where we are feeling particularly optimistic, we're not even feeling it, we're seeing it, is on the use of our data to enhance the decision-making really across the board. I know we've been talking about that and its potential for some time, but we are really beginning to see that impact showing up in our sales results each week. The way to think about that is we built a set of tools, and those tools were sub-optimal during COVID because there was less price sensitivity. There's now more price sensitivity. Those tools are, as a result, much more effective, and now we are scaling up the use of those tools.

In my remarks I touched on the PC Optimum Points Day event as a big picture example of that. Just to kind of repeat the concept. That's a single event that's organized at an enterprise level designed to drive sales at the item level, like a bag of cookies, also at the category level, say, perhaps, across an entire Fresh department, and at the programme level, which would be, call it new businesses or adjacent businesses, whether it's e-commerce, whether it's financial services, or even something like Joe Fresh. We just came off our most recent and probably best-executed event from a total enterprise integration point of view and it drove meaningful top line results in a very efficient manner from an investment perspective.

So, that's happening at the micro level in day-to-day decisions in the merchandising desks and we're learning how to mobilize it at the macro level to move the needle in particular weeks and months quite significantly.

Vishal Shreedhar — Analyst, National Bank Financial

Are you able to measure the benefit delivered from those programmes on gross margin versus base case?

Galen Weston — Chairman and President, Loblaw Companies Limited

Yes.

Vishal Shreedhar — Analyst, National Bank Financial

Okay. Maybe just one more question. Obviously, a lot of media discussions related to some of your discussions—media chatter related to some of your discussions with vendors and the difficult conversations regarding pricing. I'm wondering if Management can provide context on if some of these discussions you're having with vendors is part of a broader way to think about the space allocated to certain sectors and the positioning of private label. Or is that media discussion more of a isolated event with one-on-one discussions with vendors?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Okay. We don't want to comment on the specific discussions about our relationship with our vendors. They are our partners and we really value our relationship with all of them, but as to how we

manage these cost increase requests coming from them, we have a team of experts and what they do is they deconstruct the cost of each SKU into its components, such as the raw ingredients, the packaging, the labour and transport, and look at what's been happening to the cost of all of these components, and using their analysis, we're now well-positioned to assess the requests that are sent our way. Also, we deal with a large number of vendors and this also provides us with a very strong perspective on what's happening on cost increases. That's how we're dealing with this at the moment.

Vishal Shreedhar — Analyst, National Bank Financial

Thank you.

Operator

Thank you. Your next question comes from Kenric Tyghe from ATB Capital Markets. Please go ahead.

Kenric Tyghe — Analyst, ATB Capital Markets

Thank you and good morning. Galen, I heard your comments earlier in the call with respect to Beauty and sort of the ebbs and flows. A follow-up question to that would be, how do you think or do you think that how consumers shop Beauty and how consumers sort of—the preferences will evolve in Beauty on the back of this pandemic? Is there any insight you could share there, just any changes you've seen in the consumers' approach to beauty, beauty spend, and the (inaudible) that would create for your Beauty business?

Galen Weston — Chairman and President, Loblaw Companies Limited

Yes. The consumer behaviour pattern when it comes to shopping pretty much every category is evolving and there's no doubt that there's substantially more beauty sales, for example, online. We just recently introduced a digital tool that allows you to see online what a particular colour cosmetic looks like on your face without having to try it on in the store. I would describe these as evolutionary as opposed to transformational.

Certainly, in the shorter term, call it the next 6 to 12 months, the much bigger forces around consumer behaviour relate very much to COVID and the end of COVID or lockdowns and the end of lockdowns. The point I was trying to make earlier is that it's almost like a light switch. When the market opens up, customers come back to the stores and they purchase beauty items very much the same way and the impact on the sales volume is meaningful.

Kenric Tyghe — Analyst, ATB Capital Markets

Thanks for that, Galen. Then just with respect to the supply position, you commented you're a lot happier with where you were but not back to where you'd like to be. Is the sort of path here likely to be fairly lumpy particularly in the context of the blockade, that there are going to be some puts and takes between here and there with respect to your in-stock position? Certainly, channel check-wise, it appears that, but that could also just be a bit of a false read from a pretty limited sample set. Any further thoughts there?

Galen Weston — Chairman and President, Loblaw Companies Limited

Well, it's been a volatile year in that respect, so I want to be careful not to predict the future with too much confidence. As we look forward, we see most of that volatility now behind us and we're kind of back to more consistent structural constraints as opposed to those one-off disruptions that would result in us seeing big gaps or holes on the shelf in a particular week as we have seen in the last month or two.

But the pressures are still real.

The ability for suppliers to source raw materials remains a bit constrained. There are challenges on the labour front in terms of having people able to work in manufacturing facilities. We touched on this I think in Q3 or maybe even in Q2. One of the consequences of that is that vendors will focus their production capacity on their highest volume SKUs. That results in the smaller SKUs or the alternative flavours not being as available and those are the places where you would expect as a consumer to see perhaps less assortment from a particular brand than you might be used to.

We work very confidently and diligently to source other vendors and bring them into the stores to make sure that our customers have the breadth of assortment that they need. That's the way we're managing the business right now, with the caveat that there might still be future shocks, but those disruptions from the last few months are behind us.

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Yes, and if I might add, from a financial perspective, you've not heard us talk about supply chain being a factor affecting our costs. There's been a slight impact but it's been immaterial.

Kenric Tyghe — Analyst, ATB Capital Markets

Thank you. A quick final one for me and probably a long shot. Any additional colour you could provide on the composition of that \$3.1 billion? We know that typically—we knew what the weighting was pre-COVID in terms of Food Retail versus Drug Retail, but any further insight on that one?

Galen Weston — Chairman and President, Loblaw Companies Limited

No. We won't break it down for you. I'll provide a little bit of colour on what's happening in e-commerce. First and foremost, we're quite comfortable with where that performance sits, and I think as Richard mentioned in his remarks, Q4 was lapping peak e-commerce sales, particularly on the food and grocery side, so we're seeing the consequence of lapping that. We were fully locked down in the fourth quarter last year of 2020 and we were almost fully open in 2021. So that's the largest driver of the discrepancy in the performance.

The one thing I would add just for colour. We continue to see robust strength on the delivery side of our business. If you remember, we launched with enthusiasm our direct home delivery channel in the GTA and in Montreal and a couple of other cities over the last few months. We're very pleased with the traction and performance that we're seeing from that value proposition.

Kenric Tyghe — Analyst, ATB Capital Markets

Thank you. Best of luck. I'll get back in the queue.

Operator

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

Patricia Baker — Analyst, Scotiabank

Yes, good morning everyone. Thank you. Richard, in the outlook you indicated that the CAPEX in F22 would be \$1.4 billion. Can you talk a little bit about where you're spending and what projects you're going to be executing against in 2022?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Yes, it's actually—it's real estate, so you're going to see us spend money in our store network. That's essentially most of the increase.

Patricia Baker — Analyst, Scotiabank

So, renovating stores or...?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Renovating stores, building new stores, like the whole thing.

Patricia Baker — Analyst, Scotiabank

Okay. Are you willing at this point to tell us how many new stores you expect to build in 2022?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Too early, Patricia, sorry.

Patricia Baker — Analyst, Scotiabank

Okay, fair enough. Then just on your very strong and quite nice to see gross margin performance in Retail, up 150 basis points in the quarter, and if we look back to the performance on the gross margin in the third quarter, would it be fair to say that it was more balanced in Q4 relative to Q3, in other words that both Food Retail and Shoppers contributed?

Richard Dufresne — Chief Financial Officer, Loblaw Companies Limited

I'd say it's more or less the same, Patricia. We had strong contribution in both Q3 and Q4 from both businesses.

Patricia Baker — Analyst, Scotiabank

Okay. And then you emphasized that one of the things that you're very much focused on is market share. What can you tell us about 2021 and Q4 with respect to market share?

Galen Weston — Chairman and President, Loblaw Companies Limited

Very happy with our progress. I think I've touched on this, and you can imply market share impact. The Market division, especially since the close of Q4, is facing increasing headwinds as more and more customers start to shift their behaviour towards discount, which is benefitting disproportionately. We feel we're very happy with the way Market is performing relative to its peers and that continues to be the case as we look forward. I'd say really encouraged, especially over the last six or eight weeks, around the accelerating performance of our discount business.

That's the context. Maybe it'll help you think about market share.

Patricia Baker — Analyst, Scotiabank

Yes. No, absolutely. Thank you for that, Galen.

Operator

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

Peter Sklar — Analyst, BMO Capital Markets

Thank you. Richard, question for you. In the guidance, your guidance says the first half of '22 is going to be stronger than the second half and it's because we're at these high levels of inflation and you really don't—in the first half you're coping more moderate levels of inflation but then by the second half you're coping against strong levels. That's basically the argument, but explain to me how this whole inflation argument wraps into it, because yes you're getting more price through on the top line but also you're facing cost pressures. I can't recall when you've ever seen cost pressures you're facing like this, not only cost of goods sales but everything - distribution, labour. It's everything.

So, explain to me how you're wrapping in this inflation argument and how that leads to a stronger first half than the second half.

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

So far, we've been successful in passing through the inflation. If it stays at the levels we're in now, I think we should be able to continue to do it. We have good visibility in our business for the next at least few months. So, we definitely feel more confident about the first half compared to the second. Then after that, it's tough. We're coming out of the pandemic. We saw a glimpse of being out last year but who knows how it is going to be this year so it becomes a little bit more fuzzy for the second half. We do know though that we're going to be cycling this high inflation starting in July, so that's how we built our budget and determined our outlook for 2022.

Peter Sklar — Analyst, BMO Capital Markets

Right. How would you characterize your strategy in Loblaw's conventional and discount banners in terms of price leadership? Do you feel you provide price leadership, or do you feel that other banners provide price leadership and you like to follow along? How would you characterize your strategy in terms of where you want to be in terms of price leadership as we go through this really tough inflationary period?

Galen Weston — Chairman and President, Loblaw Companies Limited

Well, I think, big picture, we want to be the best. We want to be the best market division store and we want to be the best large box superstore and we want to be the best hard discount business. If you're in the hard discount space, you need to have very competitive pricing, and we are, as always, committed to that. It's not just about price though. It's the quality of your fresh proposition, it's the consistency of your store experience, it's your control brand programme, it's the sophistication of your merchandising efforts, both from a promotional perspective and an assortment point of view.

I'd say the way to think about this is, we are watching our price position very, very carefully, we do it every week, but the merchandising teams are seeing opportunities to get more credit for less investment than we were seeing last year. That is what we're trying to optimize for right now and that's what you've seen the teams do over the last nine months. That's driven a big part of the margin expansion and it's precisely those same things that give us the confidence that we can sustain that, at least through the first half of the year.

Peter Sklar — Analyst, BMO Capital Markets

Galen, would you say your merchandising teams are seeing these opportunities? Like, what exactly do you mean? Is this where they're using data and understanding the demand elasticity better, and just seeing gaps where your competitors aren't playing? What do you mean by that?

Galen Weston — Chairman and President, Loblaw Companies Limited

I mean that. I mean both. It's a little bit—I mean, we can go right down into the detail, which we shouldn't do today. The way to think about it is there are opportunities at every element of our go-to-market strategy and the teams have been going through category by category, promotional strategy by promotional strategy, and that's what is contributing to the positive results.

Peter Sklar — Analyst, BMO Capital Markets

Okay.

Richard Dufresne — Chief Financial Officer, Loblaw Companies Limited

We... [Multiple speakers].

Peter Sklar — Analyst, BMO Capital Markets

Sorry, go ahead, Richard.

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

We feel we have a good grip on our gross margin. We feel we have a good grip on our sales performance and we feel we have a good grip on SG&A, and so that's how you run successfully a business like ours. That's the feeling in the business right now and so that's why we have that confidence for the first half.

Peter Sklar — Analyst, BMO Capital Markets

Okay. Just changing topics and my last question, it's on the e-commerce. You'll remember in 2020 when e-commerce exploded and you were just throwing labour at the issue and you disclosed you lost \$200 million. Can you talk a little bit about your profitability for e-commerce in 2021? Can you give us some indication of where that \$200 million loss went to and what the outlook is for 2022?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

So that's a tough one, okay, because it's actually quite volatile, Peter. When we are in lockdowns and penetration rates shoots up, it puts more volume in the system and profitability shoots up. That was actually an interesting data point from our perspective because we see that as we push more volume into the system, we definitely get improvements in efficiency, which translates into profitability. It's

helping us to find ways to become more efficient, but to be able to predict exactly where it's going to be, it's very difficult, because tell me where penetration is going to be three weeks from now and I'll be able to give you a sense.

The business has not yet stabilized. We feel we continue to progress in that business. It's probably going to be more like '23 where hopefully we're back to normal and we have a better sense of where that business will land.

Peter Sklar — Analyst, BMO Capital Markets

What's the read through that? Richard, you would hope the business could break even as you like to measure it financially in 2023. Is that kind of where your hope is?

Galen Weston — Chairman and President, Loblaw Companies Limited

I think it's too early to say that. It depends entirely on the growth rate of penetration, as Richard said, post this kind of COVID period. As long as there is growth, we will invest to maintain the appropriate level of market share and that has an impact on the overall profitability. The message that you should take away from Richard's comment I think is that we have seen a satisfactory economic outcome at certain levels of volume when we've been able to line up the costs with the sales in an efficient way. So we'll continue to work to optimize as the business normalizes.

Peter Sklar — Analyst, BMO Capital Markets

Okay, I get that. Thank you for your comments.

Operator

Thank you. Your last question comes from Chris Li from Desjardins Securities Research. Please go ahead.

Chris Li — Analyst, Desjardins Securities Research

Hi, good morning. Maybe just first question on Digital Retail again. Can you maybe just elaborate a little bit on some of the specific opportunities that you see to optimize operational efficiencies as it relates to delivery and the cost of fulfillment? Thank you.

Galen Weston — Chairman and President, Loblaw Companies Limited

I'm not going to go through the list of initiatives but start with just better picking algorithms as you move people through the store. There is always opportunity to improve that. A better, a more efficient process from the order staging out to people's cars. Then we've actually just opened our first full assortment micro-fulfillment centre. So we've talked before about the importance of improving pick productivity by centralizing assortment in these micro-fulfillment centres, and so you'll see us continue to make investments like that to improve e-commerce (phon).

Chris Li — Analyst, Desjardins Securities Research

Okay, that's helpful. Galen, I think on the last earnings call you mentioned that as part of the retail excellence initiatives, you guys had identified or had raised prices on certain products that

customers weren't really giving you the credit for. Just wondering where are you on that journey? Has it largely been completed?

Galen Weston — Chairman and President, Loblaw Companies Limited

Sorry, Chris, can you just repeat that? You're asking about products that were priced?

Chris Li — Analyst, Desjardins Securities Research

Oh sorry. Yes, no, I think on the last call you mentioned that as part of your retail excellence, you guys were raising prices on certain products that customers were not really giving you the credit for when you had them on promotions. Just wondering if you have finished doing those types of pricing analysis.

Galen Weston — Chairman and President, Loblaw Companies Limited

Yes. Again, I think to be clear, that's optimizing our value portfolio within a category and making sure that we are making investments in the products that customers care about most. That really goes in the bucket that we talked about earlier, which is the detailed approach to merchandising strategies, promotional strategies, increasingly using the data available to us to make smarter decisions. It's an ongoing thing as opposed to we're ever going to finish. Let's say we finish all the categories, which we haven't done yet, but if we finish all the categories as soon as we're done we're going to start at the front of the line again and do all the categories again.

So, think about it not as an initiative with a finite delivery date, but just an ongoing way of doing business that makes sure we're optimizing our category structures all the time.

Chris Li — Analyst, Desjardins Securities Research

Okay, that's helpful. Maybe just a quick one on the PC Optimum programme. It's already the largest loyalty programme in Canada, I think with 18 million active members. I guess my question is, has that number grown or is there room for that membership base to grow or is there real opportunity really just trying to increase engagement with your existing members?

Galen Weston — Chairman and President, Loblaw Companies Limited

The biggest opportunity by far is increasing the level of engagement within that 18-million-person list. We are constantly bringing new people into the programme. We have attrition, but it's taking our highly engaged base and increasing that week over week, month over month. The last six months have been pretty encouraging on that front.

One thing I didn't talk about when I mentioned the PC Points Days event, although it wasn't intended to do this, it had a secondary consequence which was driving up overall engagement, so the number of people downloading the app, the number of people checking their offers in any given week. So it had a pretty synergistic effect on that front as well.

Chris Li — Analyst, Desjardins Securities Research

Perfect. Maybe just a last quick one for Richard. The COVID expense run rate of \$8 million in the quarter, is that a good run rate to pencil in for the year?

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Yes. For the moment, yes, and we'll update you every quarter on that one, Chris.

Chris Li — Analyst, Desjardins Securities Research

Perfect. Okay. Thanks and best of luck.

Richard Dufresne – Chief Financial Officer, Loblaw Companies Limited

Thank you.

Operator

Thank you. There are no further questions at this time. You may please proceed.

Roy MacDonald — Vice President, Investor Relations, Loblaw Companies Limited

Great. Thanks very much for your time, everybody. If you have any follow-up questions just give me a shout or drop me a line and circle May 4 on your calendar when we will be releasing our Q1 results. Have a great day.

Operator

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