## Management's Discussion and Analysis


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The following Management's Discussion and Analysis ("MD&A") for Loblaw Companies Limited and its subsidiaries (collectively, the "Company" or "Loblaw") should be read in conjunction with the annual audited consolidated financial statements and the accompanying notes on pages 55 to 117 of this Annual Report – Financial Review ("Annual Report").

The Company's annual audited consolidated financial statements and accompanying notes for the year ended January 3, 2015 have been prepared in accordance with International Financial Reporting Standards ("IFRS" or "GAAP") and include the accounts of the Company and other entities that the Company controls and are reported in Canadian dollars, except where otherwise noted.

The information in this MD&A is current to February 25, 2015, unless otherwise noted. A glossary of terms used throughout this Annual Report can be found on page 119.

Unless otherwise indicated, all comparisons of results for the fourth quarter of 2014 (13 weeks ended January 3, 2015) are against results for the fourth quarter of 2013 (12 weeks ended December 28, 2013) and all comparisons of results for the full year of 2014 (53 weeks ended January 3, 2015) are against the results for the full year of 2013 (52 weeks ended December 28, 2013).

## 1. Forward-Looking Statements

This Annual Report, including this MD&A, for the Company contains forward-looking statements about the Company's objectives, plans, goals, aspirations, strategies, financial condition, results of operations, cash flows, performance, prospects and opportunities. Specific forward-looking statements in this Annual Report include, but are not limited to, statements with respect to the Company's anticipated future results, events and plans, synergies and other benefits associated with the acquisition of Shoppers Drug Mart Corporation ("Shoppers Drug Mart"), future liquidity and debt reduction targets, planned capital investments, and status and impact of information technology ("IT") systems implementation. These specific forward-looking statements are contained throughout this Annual Report including, without limitation, in Section 3 "Strategic Framework", Section 9.2 "Liquidity and Capital Structure" and Section 19 "Outlook" of this MD&A. Forward-looking statements are typically identified by words such as "expect", "anticipate", "believe", "foresee", "could", "estimate", "goal", "intend", "plan", "seek", "strive", "will", "may", "on track" and "should" and similar expressions, as they relate to the Company and its management.

Forward-looking statements reflect the Company's current estimates, beliefs and assumptions, which are based on management's perception of historical trends, current conditions and expected future developments, as well as other factors it believes are appropriate in the circumstances. The Company's expectation of operating and financial performance in 2015 is based on certain assumptions including assumptions about anticipated cost savings, operating efficiencies and continued growth from current initiatives. The Company's estimates, beliefs and assumptions are inherently subject to significant business, economic, competitive and other uncertainties and contingencies regarding future events and as such, are subject to change. The Company can give no assurance that such estimates, beliefs and assumptions will prove to be correct.

Numerous risks and uncertainties could cause the Company's actual results to differ materially from those expressed, implied or projected in the forward-looking statements, including those described in Section 15 "Enterprise Risks and Risk Management" of this MD&A and the Company's Annual Information Form (for the year ended January 3, 2015). Such risks and uncertainties include:

- failure to realize the anticipated strategic benefits or operational, competitive and cost synergies following the acquisition of Shoppers Drug Mart;
- failure to reduce indebtedness associated with the acquisition of Shoppers Drug Mart to bring leverage ratios to a level consistent with investment grade ratings;
- failure to realize benefits from investments in the Company's IT systems, including the Company's IT systems implementation, or unanticipated results from these initiatives;
- failure to realize anticipated results, including revenue growth, anticipated cost savings or operating efficiencies from the Company's major initiatives, including those from restructuring;
- the inability of the Company's IT infrastructure to support the requirements of the Company's business;
- changes in the Company's estimate of inventory cost as a result of its IT system upgrade;
- changes to the regulation of generic prescription drug prices and the reduction of reimbursements under public drug benefit plans and the elimination or reduction of professional allowances paid by drug manufacturers;
- failure to achieve desired results in labour negotiations, including the terms of future collective bargaining agreements, which could lead to work stoppages;
- heightened competition, whether from current competitors or new entrants to the marketplace;
- changes in economic conditions, including the rate of inflation or deflation, changes in interest and currency exchange rates and derivative and commodity prices;

- changes in the Company's income, capital, commodity, property and other tax and regulatory liabilities, including changes in tax laws, regulations or future assessments;
- the inability of the Company to manage inventory to minimize the impact of obsolete or excess inventory and to control shrink;
- the risk that the Company would experience a financial loss if its counterparties fail to meet their obligations in accordance with the terms and conditions of their contracts with the Company; and
- the inability of the Company to collect on and fund its credit card receivables.

**This is not an exhaustive list of the factors that may affect the Company's forward-looking statements. Other risks and uncertainties not presently known to the Company or that the Company presently believes are not material could also cause actual results or events to differ materially from those expressed in its forward-looking statements. Additional risks and uncertainties are discussed in the Company's materials filed with the Canadian securities regulatory authorities from time to time, including, without limitation, the section entitled "Risks" in the Company's Annual Information Form (for the year ended January 3, 2015).** Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect the Company's expectations only as of the date of this MD&A. Except as required by law, the Company does not undertake to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## 2. Overview

Loblaw Companies Limited includes retail businesses, a bank and a real estate company. The Company has three operating segments: Retail, Financial Services and Choice Properties Real Estate Investment Trust ("Choice Properties"). The Retail segment consists primarily of a discount supermarket business, a full-service supermarket business, an emerging and wholesale business and Shoppers Drug Mart. The Company's Financial Services segment provides retail banking, credit card services, auto, home, travel and pet insurance and wireless mobile products and services. The Company also holds an 82.9% effective interest in Choice Properties, which owns, leases and manages income-producing commercial properties.

## 3. Strategic Framework

The Company's strategic framework is anchored by its vision to help Canadians "*Live Life Well*" and its commitment to produce industry leading financial results through operational excellence. At the core of this framework is our focus on the customer – by providing the best in food experience and the best in health and beauty.

Achieving a "best in food" experience is driven by our desire to lead in fresh selection, drive sustainable and competitive pricing and provide customized assortments across our banners. Achieving "best in health and beauty" is driven by our pharmacies putting customers first, our desire to provide high quality health and wellness products, a diverse and differentiated beauty offering and convenient locations and hours of operations to meet individuals' wellness needs.

The Company's operational excellence goals include driving efficiencies and realizing synergies from its business acquisitions, particularly the acquisition of Shoppers Drug Mart. We are focused on continued growth from President's Choice Financial Services, Choice Properties, product innovation, our emerging businesses and loyalty program initiatives.

## 4. Key Financial Performance Indicators

The Company has identified key financial performance indicators to measure the progress of short and long term objectives. With the completion of the acquisition of Shoppers Drug Mart, the Company's 2014 results include the consolidation of Shoppers Drug Mart and the associated acquisition-related accounting adjustments. Certain key financial performance indicators are set out below:

| As at or for the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | | **2014**<br>**(53 weeks)** | | 2013[4]<br>(52 weeks) |
|---|---|---|---|---|
| **Consolidated:** | | | | |
| Revenue growth | | **31.6%** | | 2.4% |
| EBITDA[2] | **$** | **2,134** | $ | 2,145 |
| Adjusted EBITDA[2] | | **3,236** | | 2,106 |
| Adjusted EBITDA margin[2] | | **7.6%** | | 6.5% |
| Operating income | **$** | **662** | $ | 1,321 |
| Adjusted operating income[2] | | **2,181** | | 1,282 |
| Adjusted operating margin[2] | | **5.1%** | | 4.0% |
| Net earnings | **$** | **53** | $ | 627 |
| Adjusted net earnings[2] | | **1,224** | | 696 |
| Basic net earnings per common share ($) | | **0.14** | | 2.23 |
| Adjusted basic net earnings per common share[2] ($) | | **3.22** | | 2.48 |
| Cash and cash equivalents, short term investments and security deposits | | **1,027** | | 4,251 |
| Cash flows from operating activities | | **2,569** | | 1,491 |
| Adjusted debt[2] to adjusted EBITDA[2] | | **3.1x** | | 3.0x |
| Free cash flow[2] | **$** | **977** | $ | 244 |
| Adjusted debt[2] | | **9,995** | | 6,288 |
| **Retail Segment:** | | | | |
| Same-store sales[1], [6] growth | | **2.0%** | | 1.1% |
| Gross profit | **$** | **9,734** | $ | 6,961 |
| Adjusted gross profit[2] | | **10,722** | | 6,961 |
| Adjusted gross profit %[2] | | **25.7%** | | 22.0% |
| Adjusted operating margin[2] | | **4.8%** | | 3.6% |
| Adjusted EBITDA margin[2] | | **7.3%** | | 6.2% |
| **Financial Services Segment[7]:** | | | | |
| Earnings before income taxes | **$** | **111** | $ | 93 |
| Annualized yield on average quarterly gross credit card receivables | | **13.7%** | | 13.6% |
| Annualized credit loss rate on average quarterly gross credit card receivables | | **4.4%** | | 4.2% |
| **Choice Properties Segment[5]:** | | | | |
| Adjusted funds from operations[2] | **$** | **285** | $ | 131 |

During 2014, the Company introduced two new financial measures to the key financial performance indicators: Retail segment adjusted gross profit[2] and Retail segment adjusted gross profit percentage[2], which are both non-GAAP financial measures. Management uses these and other non-GAAP financial measures to exclude the impact of certain expenses and income that must be recognized under GAAP when analyzing consolidated and segment underlying operating performance, as the excluded items are not necessarily reflective of the Company's underlying operating performance and make comparisons between periods difficult. From time to time, the Company may exclude additional items if it believes doing so would result in a more effective analysis of underlying operating performance. The exclusion of certain items does not imply that they are non-recurring. See Section 20 "Non-GAAP Financial Measures" for more information on the Company's non-GAAP financial measures.

## 5. Overall Financial Performance

### 5.1 Significant Accomplishments in 2014

**Acquisition of Shoppers Drug Mart** On March 28, 2014, the Company acquired all of the outstanding shares of Shoppers Drug Mart for total consideration of $12,273 million, comprised of approximately $6,600 million of cash and the issuance of approximately 119.5 million common shares of the Company. The cash portion of the acquisition was partially funded by the issuance of $5,100 million of debt.

During 2014, the Company realized approximately $101 million of net synergies generated primarily from improved cost of goods sold and from purchasing efficiencies in goods not for resale. Loblaw continues to expect to achieve annualized synergies of $300 million in the third full year following the close of the acquisition of Shoppers Drug Mart (net of related costs).

**Deleveraging** On closing of the acquisition of Shoppers Drug Mart, adjusted debt(2) was $11,060 million. The Company made significant progress in meeting its debt reduction target by decreasing adjusted debt(2) by $1,065 million since the closing of the acquisition of Shoppers Drug Mart resulting in an outstanding adjusted debt(2) balance of $9,995 million as at January 3, 2015. The reduction in adjusted debt(2) since closing included the repayment of a $350 million medium term note ("MTN") and a repayment of the unsecured term loan facility (net of the replacement of all tranches of inter-corporate debt of Choice Properties initially held by Loblaw and sold to unrelated parties).

**Information Technology and Other Systems Implementations** As of the end of 2014, the Company completed the conversion of substantially all of its corporate grocery locations and associated distribution centres to the new IT systems.

### 5.2 Consolidated Results of Operations

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014<br>(53 weeks)** | 2013(4)<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Revenue | **$ 42,611** | $ 32,371 | $ 10,240 | 31.6 % |
| *Revenue excluding Shoppers Drug Mart* | ***33,561*** | *32,371* | *1,190* | *3.7 %* |
| EBITDA(2) | **$ 2,134** | $ 2,145 | $ (11) | (0.5)% |
| Adjusted EBITDA(2) | **3,236** | 2,106 | 1,130 | 53.7 % |
| Adjusted EBITDA margin(2) | **7.6%** | 6.5% | | |
| *Adjusted EBITDA(2) excluding Shoppers Drug Mart* | ***$ 2,248*** | *$ 2,106* | *$ 142* | *6.7 %* |
| *Adjusted EBITDA margin(2) excluding Shoppers Drug Mart* | ***6.7%*** | *6.5%* | | |
| Operating income | **$ 662** | $ 1,321 | $ (659) | (49.9)% |
| Adjusted operating income(2) | **2,181** | 1,282 | 899 | 70.1 % |
| Adjusted operating margin(2) | **5.1%** | 4.0% | | |
| *Adjusted operating income(2) excluding Shoppers Drug Mart* | ***$ 1,397*** | *$ 1,282* | *$ 115* | *9.0 %* |
| *Adjusted operating income margin(2) excluding Shoppers Drug Mart* | ***4.2%*** | *4.0%* | | |
| Net interest expense and other financing charges | **$ 584** | $ 468 | $ 116 | 24.8 % |
| Adjusted net interest expense and other financing charges(2) | **529** | 354 | 175 | 49.4 % |
| Net earnings | **53** | 627 | (574) | (91.5)% |
| Adjusted net earnings(2) | **1,224** | 696 | 528 | 75.9 % |
| Basic net earnings per common share ($) | **0.14** | 2.23 | (2.09) | (93.7)% |
| Adjusted basic net earnings per common share(2) ($) | **3.22** | 2.48 | 0.74 | 29.8 % |

With the completion of the acquisition of Shoppers Drug Mart in 2014, the Company's results include the consolidation of Shoppers Drug Mart from the date of acquisition. The Shoppers Drug Mart assets were recognized in the Company's financial results at their fair value, including:

- a fair value increase to Shoppers Drug Mart's inventory on the date of acquisition of $798 million, which was fully recognized in cost of merchandise inventories sold with a resulting negative impact on gross profit; and
- a $6,050 million increase for the acquisition of definite life intangible assets, which is being amortized over their estimated useful lives. In 2014, $417 million of related amortization was recognized in operating income. Annual amortization of approximately $550 million associated with these intangibles will be recognized over the next ten years and decreasing thereafter.

The Company also recognized acquisition-related costs and a net divestitures loss of $72 million (2013 – $6 million) in selling, general and administrative expenses ("SG&A") and $15 million (2013 – $25 million) in net interest expenses and other financing charges related to the acquisition of Shoppers Drug Mart and the divestitures required by the Competition Bureau.

With the upgrade of its IT infrastructure, the Company completed the conversion of substantially all of its corporate grocery locations to a perpetual inventory management system in 2014. As a result, the Company recognized a $190 million decrease in the value of inventory in gross profit. The implementation of a perpetual inventory system, combined with visibility to integrated costing information provided by the new IT systems enables the Company to estimate the cost of inventory using a more precise system-generated average cost.

In 2014, the Company restructured its fee arrangements with the franchisees of certain franchise banners. These revised arrangements are expected to result in an annual reduction of Retail segment sales of approximately $150 million and a corresponding decrease in SG&A. As a result of this restructuring, the Company re-evaluated the recoverable amount of franchise-related financial instruments and recorded a reduction in previously recorded impairment of $40 million.

In 2014, the Company recorded $46 million (2013 – $35 million) in restructuring and reorganization costs primarily associated with the reduction of corporate and store-support positions, the departure of certain executives and the realignment of certain of the Company's central office functions.

The Company's 2014 financial results also included a charge of $37 million (2013 – $25 million), related to the transition of certain grocery stores to more cost effective and efficient operating terms under collective agreements.

**Revenue** Revenue of $42,611 million in 2014 increased by $10,240 million compared to 2013, primarily due to Shoppers Drug Mart and the impact of the 53rd week in 2014. Revenue in the 53rd week of 2014 was $789 million ($574 million excluding Shoppers Drug Mart). Excluding the impact of Shoppers Drug Mart, consolidated revenue increased by $1,190 million, or 3.7%. Excluding the impact of Shoppers Drug Mart and the 53rd week of 2014, consolidated revenue increased by $616 million, or 1.9%.

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014**<br>**(53 weeks)** | 2013[4]<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| EBITDA[2] | **$ 2,134** | $ 2,145 | $ (11) | (0.5)% |
| Adjustments to EBITDA[2] | **1,102** | (39) | | |
| Adjusted EBITDA[2] | **$ 3,236** | $ 2,106 | $ 1,130 | 53.7 % |
| Operating income | **$ 662** | $ 1,321 | $ (659) | (49.9)% |
| Adjustments to EBITDA[2] | **1,102** | (39) | | |
| Amortization of intangible assets acquired with Shoppers Drug Mart | **417** | | | |
| Adjusted operating income[2] | **$ 2,181** | $ 1,282 | $ 899 | 70.1 % |

**EBITDA[2]** EBITDA[2] of $2,134 million in 2014 decreased by $11 million compared to 2013. The decrease in EBITDA[2] was negatively impacted by adjustments of $1,102 million including the full recognition of the fair value increment on the acquired Shoppers Drug Mart inventory sold ($798 million), the charge related to inventory measurement and other conversion differences associated with the implementation of a perpetual inventory system ($190 million), increased costs related to the acquisition of Shoppers Drug Mart and a net divestitures loss ($66 million), year-over-year unfavourable fixed asset and other related impairments ($48 million), a gain related to defined benefit plan amendments recorded in 2013 ($51 million), increased restructuring and reorganization costs ($11 million) and certain other items ($17 million). These increases were partially offset by restructuring of franchise fees ($40 million).

After excluding these adjustments, adjusted EBITDA[2] of $3,236 million increased by $1,130 million compared to 2013. The increase included $988 million of adjusted EBITDA[2] contributed by Shoppers Drug Mart, with the remainder of the increase of $142 million primarily driven by the Retail segment. The increase was positively impacted by net synergies of $101 million and the 53rd week in 2014 of $71 million. Adjusted EBITDA margin[2] was 7.6% compared to 6.5% in 2013. Excluding the impact of Shoppers Drug Mart, adjusted EBITDA[2] increased by $142 million, or 6.7%, compared to 2013 and adjusted EBITDA margin[2] was 6.7%, compared to 6.5% in 2013.

**Operating Income** Operating income of $662 million in 2014 decreased by $659 million compared to 2013, primarily driven by the acquisition-related accounting adjustments of Shoppers Drug Mart. Operating income was negatively impacted by the net adjustments related to EBITDA[2] noted above of $1,102 million and the amortization of intangible assets of $417 million related to the acquisition of Shoppers Drug Mart.

After excluding these impacts to operating income, adjusted operating income[2] of $2,181 million increased by $899 million compared to 2013, including $784 million of adjusted operating income[2] contributed by Shoppers Drug Mart. Adjusted operating margin[2] was 5.1% compared to 4.0% in 2013. Excluding the impact of Shoppers Drug Mart, adjusted operating income[2] increased by $115 million and was positively impacted by the increase described in adjusted EBITDA[2] noted above of $142 million, partially offset by an increase in depreciation and amortization[2] of $27 million.

**Net Interest Expense and Other Financing Charges** Net interest expense and other financing charges of $584 million in 2014 increased by $116 million compared to 2013, including non-recurring charges incurred in 2013 related to Choice Properties initial public offering ("IPO") transaction costs and early debt settlement costs, and certain other adjustments as set out in Section 20 "Non-GAAP Financial Measures".

After excluding these impacts to net interest expense and other financing charges, adjusted net interest expense and other financing charges[2] of $529 million increased by $175 million, primarily driven by higher interest on long term debt, primarily as a result of debt incurred to finance the acquisition of Shoppers Drug Mart and distributions paid by Choice Properties on its Units, partially offset by a decrease in net interest on the post-employment and other long term employee benefits.

**Income Taxes** Income tax expense for 2014 was $25 million and the effective tax rate was 32.1%. Income tax expense for 2013 was $226 million and the effective tax rate was 26.5%. The increase in the effective tax rate compared to 2013 was primarily attributable to a decrease in certain non-taxable amounts. The adjusted income tax expense[2] for 2014 was $428 million and the adjusted income tax rate[2] was 25.9%. The adjusted income tax expense[2] for 2013 was $232 million and the adjusted income tax rate[2] was 25.0%. The increase in the adjusted income tax rate[2] was primarily attributable to a decrease in certain non-taxable amounts.

In 2012, the Company received indication from the Canada Revenue Agency (the "CRA") that the CRA intends to proceed with reassessments of the tax treatment of the Company's wholly owned subsidiary, Glenhuron Bank Limited ("Glenhuron"). The CRA's position is that certain income earned by Glenhuron in Barbados in respect of the 2000 to 2010 taxation years should be treated, and taxed, as income in Canada.

Based on the proposal letter from the CRA, if the CRA and the relevant provincial tax authorities were to prevail in all of these reassessments, which the Company believes would be unlikely, the estimated total tax and interest for the 2000 to 2010 taxation years would be approximately $440 million, which would increase as interest accrues. However, the Company is in discussions with the CRA about the amount of taxes in dispute. The Company believes it is likely that the CRA and the relevant provincial tax authorities will issue reassessments for 2011 to 2013 on the same or similar basis. No amount for any reassessments has been provided for in the Company's consolidated financial statements.

Subsequent to the end of 2014, the Company received a letter from the CRA stating that the CRA will be proceeding with the reassessments. The Company expects to receive reassessments from the CRA and the relevant provincial tax authorities sometime in the coming months. The Company strongly disagrees with the CRA's position and intends to vigorously defend its position including appealing the reassessments as and when they are received. The Company will make cash payments or provide other forms of security on a portion of the taxes in dispute. If the Company is successful in defending its position, in whole or in part, some or all of the cash payments or security would be returned to the Company.

**Net Earnings** Net earnings of $53 million in 2014 decreased by $574 million compared to 2013, primarily driven by the decrease in operating income and the increase in net interest expense and other financing charges, partially offset by the decrease in income tax expense, described above. Adjusted net earnings[2] of $1,224 million increased by $528 million compared to 2013, primarily driven by the increase in adjusted operating income[2], primarily as a result of Shoppers Drug Mart, partially offset by the increase in adjusted net interest expense and other financing charges[2] and the increase in adjusted income tax expense[2], described above.

**Basic Net Earnings Per Common Share** Basic net earnings per common share were $0.14 compared to $2.23 in 2013. Basic net earnings per common share included the negative impact of the full recognition of the Shoppers Drug Mart acquisition-related fair value increment on inventory sold ($1.55 per share), the amortization of intangible assets acquired with Shoppers Drug Mart ($0.80 per share), a charge related to inventory measurement and other conversion differences associated with the implementation of a perpetual inventory system ($0.37 per share), costs and a net divestitures loss associated with the acquisition of Shoppers Drug Mart ($0.19 per share) and restructuring costs ($0.09 per share), accelerated amortization of deferred financing costs ($0.04 per share), fair value adjustment on Trust Unit Liability ($0.04 per share), fixed asset and other related impairments, net of recoveries ($0.04 per share) and certain other adjustments ($0.04 per share) and the positive impact of restructuring of franchise fees ($0.08 per share).

Adjusted basic net earnings per common share[2] were $3.22 compared to $2.48 in 2013, primarily due to the increase in adjusted net earnings[2] as described above, partially offset by the dilutive effect of the 119.5 million common shares issued as part of the total consideration for the acquisition of Shoppers Drug Mart.

### 5.3 Selected Financial Information

The selected information presented below has been derived from and should be read in conjunction with the annual consolidated financial statements of the Company dated January 3, 2015, December 28, 2013 and December 29, 2012. The analysis of the data contained in the table focuses on the trends and significant events or items affecting the financial condition and results of the Company's operations over the latest three year periods.

| For the years ended January 3, 2015 and December 28, 2013 and December 29, 2012<br>(millions of Canadian dollars except where otherwise indicated) | | **2014**<br>**(53 weeks)** | | 2013[4]<br>(52 weeks) | | 2012[3]<br>(52 weeks) |
|---|---|---|---|---|---|---|
| Revenue | **$** | **42,611** | $ | 32,371 | $ | 31,604 |
| *Revenue excluding Shoppers Drug Mart* | | **33,561** | | 32,371 | | 31,604 |
| EBITDA[2] | **$** | **2,134** | $ | 2,145 | $ | 1,972 |
| Adjusted EBITDA[2] | | **3,236** | | 2,106 | | 2,041 |
| *Adjusted EBITDA[2] excluding Shoppers Drug Mart* | | **2,248** | | 2,106 | | 2,041 |
| Operating income | **$** | **662** | $ | 1,321 | $ | 1,195 |
| Adjusted operating income[2] | | **2,181** | | 1,282 | | 1,264 |
| *Adjusted operating income[2] excluding Shoppers Drug Mart* | | **1,397** | | 1,282 | | 1,264 |
| Adjusted net interest expense and other financing charges[2] | **$** | **529** | $ | 354 | $ | 351 |
| Adjusted income tax rate[2] | | **25.9%** | | 25.0% | | 25.0% |
| Net earnings | **$** | **53** | $ | 627 | $ | 634 |
| Adjusted net earnings[2] | | **1,224** | | 696 | | 685 |
| Basic net earnings per common share ($) | **$** | **0.14** | $ | 2.23 | $ | 2.25 |
| Diluted net earnings per common share ($) | | **0.14** | | 2.21 | | 2.23 |
| Adjusted basic net earnings per common share[2] ($) | | **3.22** | | 2.48 | | 2.43 |
| Dividends declared per common share ($) | **$** | **0.975** | $ | 0.940 | $ | 0.850 |
| Dividends declared per Second Preferred Share, Series A ($) | | **1.49** | | 1.49 | | 1.49 |

**Revenue** Revenue of $42,611 million increased by $10,240 million compared to 2013, primarily due to Shoppers Drug Mart and the impact of the 53rd week in 2014. Revenue in the 53rd week of 2014 was $789 million. Excluding the impact of Shoppers Drug Mart and the 53rd week of 2014, consolidated revenue increased by $616 million, or 1.9%. Retail same-store[6] sales growth, on a comparable week basis, was 2.0% (2013 – 1.1%) and excluding gas bar, was 2.1% (2013 – 1.0%).

Revenue in 2013 of $32,371 million increased by $767 million compared to 2012, primarily due to the increase in the Retail segment. Retail same-store[6] sales growth was 1.1% (2012 – decline of 0.2%) and excluding gas bar was 1.0% (2012 – decline of 0.2%).

The Company's Retail segment sales have continued to grow under the pressure of an intensely competitive retail market and uncertain economic environment over the last three years.

**EBITDA[2]** EBITDA[2] of $2,134 million in 2014 decreased by $11 million compared to 2013, primarily driven by a decrease in the Retail segment EBITDA[2] due to the acquisition-related accounting adjustments from the acquisition of Shoppers Drug Mart, partially offset by increases in the Financial Services and Choice Properties segments. The 53rd week contributed $71 million to EBITDA[2].

EBITDA[2] in 2013 of $2,145 million increased by $173 million compared to 2012, primarily driven by increases in each of the Company's operating segments.

Over the past three years, the Company's consolidated EBITDA[2] has been impacted by a number of items which the Company does not consider to be indicative of operational performance. These items have been adjusted in the presentation of adjusted EBITDA[2] as set out in Section 20 "Non-GAAP Financial Measures".

**Operating Income** Operating income in 2014 of $662 million decreased by $659 million compared to 2013, primarily due to a decrease in the Retail segment operating income. The decrease in the Retail segment is primarily driven by the items as set out in Section 20 "Non-GAAP Financial Measures" and also impacted by the amortization of intangible assets related to the acquisition of Shoppers Drug Mart.

Operating income in 2013 of $1,321 million increased by $126 million compared to 2012, primarily driven by increases in each of the Company's operating segments.

Over the past three years, the Company's consolidated operating income has been impacted by a number of items which the Company does not consider to be indicative of operational performance. These items have been adjusted in the presentation of adjusted operating income[2] as set out in Section 20 "Non-GAAP Financial Measures".

**Net Earnings and Basic Net Earnings per Common Share** In 2014, the decreases in net earnings and basic net earnings per common share were primarily due to the decrease in operating income and the increase in net interest expense and other financing charges, partially offset by the decrease in income tax expense. Net interest and other financing charges increased due to increased debt as a result of the acquisition of Shoppers Drug Mart. The decrease in basic net earnings per common share was also impacted by the dilutive effect of the 119.5 million common shares issued as part of the total consideration for the acquisition of Shoppers Drug Mart.

In 2013, the decreases in net earnings and basic net earnings per common share were negatively impacted by an increase in net interest expense and other financing charges, driven by higher interest on long term debt, primarily as a result of debt incurred to finance the acquisition of Shoppers Drug Mart and distributions paid by Choice Properties on its Units, and by a higher effective income tax rate, partially offset by higher operating income.

Over the past three years, the Company's adjusted net earnings[2] and adjusted net earnings per common share[2] have been impacted by a number of items which the Company does not consider to be indicative of operational performance. These items have been normalized in the presentation of adjusted net earnings[2] and adjusted net earnings per common share[2] as set out in Section 20 "Non-GAAP Financial Measures".

**Total Assets and Long Term Financial Liabilities**

| (millions of Canadian dollars) | **As at January 3, 2015** | As at December 28, 2013 | As at December 29, 2012 |
|---|---|---|---|
| Total Assets | **$ 33,684** | $ 20,741 | $ 17,961 |
| Long Term Debt | **$ 11,462** | $ 7,680 | $ 5,669 |
| Capital Securities | **—** | 224 | 223 |
| Trust Unit Liability | **722** | 688 | — |
| Long term financial liabilities | **$ 12,184** | $ 8,592 | $ 5,892 |

In 2014, total assets of $33,684 million and long term financial liabilities of $12,184 million increased by 62.4% and 41.8%, respectively, compared to 2013. These increases were primarily driven by the consolidation of Shoppers Drug Mart balances, the issuance of debt to finance the acquisition of Shoppers Drug Mart, partially offset by debt repayments. In 2014, capital securities became due within one year and were presented in current liabilities.

In 2013, total assets of $20,741 million and long term financial liabilities of $8,592 million increased by 15.5% and 45.8%, respectively, compared to 2012. These increases were primarily driven by the Choice Properties IPO, the completed offering of senior unsecured debentures and the financing transactions in preparation for the Shoppers Drug Mart acquisition. Excluding these impacts, the Company's total assets and long term financial liabilities increased marginally over 2012.

## 6. Reportable Operating Segments Results of Operations

### 6.1 Retail Segment

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | 2014<br>(53 weeks) | 2013[4]<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Sales | **$ 41,731** | $ 31,600 | $ 10,131 | 32.1 % |
| Gross profit | **9,734** | 6,961 | 2,773 | 39.8 % |
| Adjusted gross profit[2] | **10,722** | 6,961 | 3,761 | 54.0 % |
| EBITDA[2] | **1,950** | 1,989 | (39) | (2.0)% |
| Adjusted EBITDA[2] | **3,038** | 1,947 | 1,091 | 56.0 % |
| Operating income | **497** | 1,180 | (683) | (57.9)% |
| Adjusted operating income[2] | **2,002** | 1,138 | 864 | 75.9 % |

| For the years ended January 3, 2015 and December 28, 2013 | 2014<br>(53 weeks) | 2013[4]<br>(52 weeks) |
|---|---|---|
| Same-store sales[1], [6] growth | **2.0%** | 1.1% |
| Adjusted gross profit %[2] | **25.7%** | 22.0% |
| Adjusted EBITDA margin[2] | **7.3%** | 6.2% |
| Adjusted operating margin[2] | **4.8%** | 3.6% |

***Sales***

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | 2014<br>(53 weeks) | 2013[4]<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Retail segment sales | **$ 41,731** | $ 31,600 | $ 10,131 | 32.1% |
| Shoppers Drug Mart | **9,050** | | | |
| Excluding Shoppers Drug Mart | **$ 32,681** | $ 31,600 | $ 1,081 | 3.4% |

- Retail segment sales of $41,731 million in 2014 increased by $10,131 million compared to 2013, primarily due to Shoppers Drug Mart and the impact of the 53rd week in 2014. Retail segment sales in the 53rd week of 2014 were $789 million ($574 million excluding Shoppers Drug Mart). Excluding the impact of Shoppers Drug Mart and the 53rd week of 2014, Retail segment sales increased by $507 million, or 1.6%, due to the following factors:
  - Same-store sales[1, 6] growth, for core grocery and on a comparable week basis, was 2.0% (2013 – 1.1%) and excluding gas bar, was 2.1% (2013 – 1.0%);
  - On a comparable week basis:
    - Sales growth in food was moderate;
    - Sales in drugstore were flat;
    - Sales growth in gas bar was modest;
    - Sales in general merchandise, excluding apparel, were flat; and
    - Sales in retail apparel were modest, while U.S. wholesale apparel sales declined significantly;
  - The Company's average annual internal food price index was slightly higher than (2013 – lower than) the average annual national food price inflation of 2.5% (2013 – 1.1%) as measured by "The Consumer Price Index for Food Purchased from Stores" ("CPI"). CPI does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores; and
  - 22 corporate and franchise stores were opened and 12 corporate and franchise stores were closed in the last 12 months, with an additional two franchise grocery stores divested as a result of a Consent Agreement with the Competition Bureau related to the acquisition of Shoppers Drug Mart, resulting in flat square footage growth.

- Since the acquisition date, Shoppers Drug Mart opened 17 new drug stores and closed 24 drug stores, including 13 drug stores divested in accordance with the Consent Agreement with the Competition Bureau related to the acquisition of Shoppers Drug Mart. As a result, net square footage increased by 0.1 million square feet, or 0.6%.

***Gross Profit***

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014**<br>**(53 weeks)** | 2013[4]<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Retail gross profit | **$ 9,734** | $ 6,961 | $ 2,773 | 39.8% |
| Adjustments[2] | **988** | — | | |
| Adjusted Retail gross profit[2] | **$ 10,722** | $ 6,961 | $ 3,761 | 54.0% |
| Adjusted gross profit %[2] | **25.7%** | 22.0% | | |
| Shoppers Drug Mart | **$ 3,543** | | | |
| Excluding Shoppers Drug Mart | **$ 7,179** | $ 6,961 | $ 218 | 3.1% |
| Adjusted gross profit %[2] | **22.0%** | 22.0% | | |

- In 2014, gross profit of $9,734 million increased by $2,773 million compared to 2013, primarily due to Shoppers Drug Mart and was negatively impacted by adjustments[2] of $988 million including the full recognition of the fair value increment on the acquired Shoppers Drug Mart inventory sold and the charge related to inventory measurement and other conversion differences associated with the implementation of a perpetual inventory system.

  After excluding these adjustments[2], adjusted gross profit[2] of $10,722 million increased by $3,761 million, including $3,543 million of adjusted gross profit[2] contributed by Shoppers Drug Mart. Adjusted gross profit percentage[2] was 25.7% compared to 22.0% in 2013.

  Excluding Shoppers Drug Mart, adjusted gross profit percentage[2] was 22.0%, flat compared to 2013. While flat, adjusted gross profit percentage[2] was positively impacted by synergies related to the acquisition and reductions in transportation costs, but were negatively impacted by increased shrink. Excluding Shoppers Drug Mart, adjusted gross profit[2] increased by $218 million, or 3.1%, compared to 2013, driven by higher sales, including the impact of the 53rd week of 2014.

***EBITDA[2]***

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014**<br>**(53 weeks)** | 2013[4]<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| EBITDA[2] | **$ 1,950** | $ 1,989 | $ (39) | (2.0)% |
| Adjustments[2] | **1,088** | (42) | | |
| Adjusted Retail EBITDA[2] | **$ 3,038** | $ 1,947 | $ 1,091 | 56.0 % |
| Adjusted EBITDA margin[2] | **7.3%** | 6.2% | | |
| Shoppers Drug Mart | **$ 988** | | | |
| Excluding Shoppers Drug Mart | **$ 2,050** | $ 1,947 | $ 103 | 5.3 % |
| Adjusted EBITDA margin[2] | **6.3%** | 6.2% | | |

- EBITDA[2] of $1,950 million in 2014 decreased by $39 million compared to 2013. EBITDA[2] was negatively impacted by adjustments of $1,088 million as set out in Section 20 "Non-GAAP Financial Measures". The significant adjustments during 2014 included the Shoppers Drug Mart acquisition-related costs of the full recognition of the fair value increment on the acquired Shoppers Drug Mart inventory sold and the charge related to inventory measurement and other conversion differences associated with the implementation of a perpetual inventory system.

  After excluding these adjustments[2], adjusted EBITDA[2] of $3,038 million increased by $1,091 million compared to 2013, including $988 million of adjusted EBITDA[2] contributed by Shoppers Drug Mart.

Excluding the impact of Shoppers Drug Mart, adjusted EBITDA[2] of $2,050 million increased by $103 million, driven by the increase in adjusted gross profit[2] of $218 million, as described above, partially offset by the increase in SG&A of $115 million. The increase in SG&A was driven by the additional week in 2014 and a $12 million year-over-year increase in charges related to the transition of certain grocery stores to more cost effective and efficient operating terms under collective agreements. Excluding these impacts, SG&A decreased. This decrease was primarily driven by supply chain efficiencies and changes in the fair value of the Company's franchise investments, partially offset by investments in the Company's emerging business, higher foreign exchange losses, synergy related costs and higher investments in the Company's franchise business.

- Adjusted EBITDA margin[2] for 2014 was 7.3%, compared to 6.2% in 2013, primarily driven by Shoppers Drug Mart. Excluding the impact of Shoppers Drug Mart, adjusted EBITDA margin[2] was 6.3% compared to 6.2% in 2013.

***Operating Income***

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014<br>(53 weeks)** | 2013[4]<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Retail operating income | **$ 497** | $ 1,180 | $ (683) | (57.9)% |
| Adjustments[2] | **1,505** | (42) | | |
| Adjusted Retail operating income[2] | **$ 2,002** | $ 1,138 | $ 864 | 75.9 % |
| Adjusted operating margin[2] | **4.8%** | 3.6% | | |
| Shoppers Drug Mart | **$ 784** | | | |
| Excluding Shoppers Drug Mart | **$ 1,218** | $ 1,138 | $ 80 | 7.0 % |
| Adjusted operating margin[2] | **3.7%** | 3.6% | | |

- Operating income of $497 million in 2014 decreased by $683 million compared to 2013, primarily driven by the acquisition-related accounting adjustments of Shoppers Drug Mart. Operating income was negatively impacted by the net adjustments related to EBITDA[2] as noted above of $1,088 million and the amortization of intangible assets related to the acquisition of Shoppers Drug Mart of $417 million.

  After excluding the adjustments to operating income set out in Section 20 "Non-GAAP Financial Measures", adjusted operating income[2] of $2,002 million increased by $864 million compared to 2013, including $784 million of adjusted operating income[2] contributed by Shoppers Drug Mart. Excluding the impact of Shoppers Drug Mart, adjusted operating income[2] increased by $80 million or 7.0%, driven by the increase in adjusted EBITDA[2] described above, partially offset by the increase in retail depreciation and amortization[2] of $23 million.

- Adjusted operating margin[2] for 2014 was 4.8%, compared to 3.6% in 2013, primarily driven by the inclusion of Shoppers Drug Mart. Excluding the impact of Shoppers Drug Mart, adjusted operating margin[2] was 3.7% compared to 3.6% in 2013.

**6.2 Financial Services Segment[7]**

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | 2014<br>(53 weeks) | 2013<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Revenue | **$ 810** | $ 739 | $ 71 | 9.6% |
| Operating income | **164** | 142 | 22 | 15.5% |
| Earnings before income taxes | **111** | 93 | 18 | 19.4% |

| (millions of Canadian dollars except where otherwise indicated) | As at<br>January 3, 2015 | As at<br>December 28, 2013 | $ Change | % Change |
|---|---|---|---|---|
| Average quarterly net credit card receivables | **$ 2,535** | $ 2,345 | $ 190 | 8.1% |
| Credit card receivables | **2,630** | 2,538 | 92 | 3.6% |
| Allowance for credit card receivables | **54** | 47 | 7 | 14.9% |
| Annualized yield on average quarterly gross credit card receivables | **13.7%** | 13.6% | | |
| Annualized credit loss rate on average quarterly gross credit card receivables | **4.4%** | 4.2% | | |

- Revenue for 2014 of $810 million increased by $71 million, or 9.6%, compared to 2013. This increase was primarily driven by higher interest, interchange and other service fee related income as a result of a growth in the credit card receivables portfolio.
- Operating income of $164 million and earnings before income taxes of $111 million in 2014 increased by $22 million and $18 million, respectively, compared to 2013. These increases were mainly attributable to the higher revenue described above, partially offset by higher operating costs as a result of an increase in the active customer base, higher credit losses from increased credit card receivable balances and higher costs associated with the Financial Services loyalty program.
- As at January 3, 2015, credit card receivables were $2,630 million, an increase of $92 million compared to December 28, 2013. This increase was primarily driven by a growth in the active customer base as a result of continued investments in customer acquisitions and marketing initiatives. As at January 3, 2015, the allowance for credit card receivables was $54 million, an increase of $7 million compared to December 28, 2013, primarily due to the growth in the credit card receivables portfolio.
- Subsequent to the end of 2014:
    - The Company, through President's Choice Bank ("PC Bank"), extended the maturity date for certain Other Independent Securitization Trust agreements from the second quarter of 2016 to the second quarter of 2017, with all other terms and conditions remaining substantially the same; and
    - PC Bank entered into USD foreign exchange forward agreements, which mature by December 2015. The notional amounts of the contracts total USD $27 million.

### 6.3 Choice Properties Segment[5]

| For the periods ended January 3, 2015 and December 28, 2013 (millions of Canadian dollars except where otherwise indicated) | 2014 (53 weeks) | 2013[i] (52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Revenue | **$ 683** | $ 319 | $ 364 | 114.1% |
| Operating income | **568** | 370 | 198 | 53.5% |
| Adjusted operating income[2] | **582** | 373 | 209 | 56.0% |
| Net interest expense and other financing charges | **369** | 303 | 66 | 21.8% |
| Adjusted funds from operations[2] | **285** | 131 | 154 | 117.6% |

(i) Based on operations beginning July 5, 2013.

- Revenue for 2014 of $683 million increased by $364 million, or 114.1%, compared to 2013, and included $613 million (2013 – $287 million) primarily related to intersegment revenue from Loblaw retail locations. The increase was primarily driven by the inclusion of a full year of operations in 2014 compared to a partial year in 2013.
- Operating income of $568 million and adjusted operating income[2] of $582 million in 2014 increased by $198 million and $209 million, respectively, compared to 2013. These increases were mainly attributable to a full year of operations in 2014, partially offset by a $62 million year-over-year unfavourable fair value adjustment on investment properties. The fair value adjustment on investment properties is eliminated on consolidation.
- Adjusted funds from operations[2] of $285 million in 2014 increased by $154 million compared to 2013. The increase was mainly attributable to a full year of operations and acquisitions of properties from Loblaw.
- During 2014, the Company sold 36 investment properties to Choice Properties for an aggregate purchase price of approximately $410 million, which was settled through the issuance of 21,957,351 Class B Limited Partnership units, $179 million in cash and the assumption of a $4 million mortgage by Choice Properties. In addition, Choice Properties acquired a 40% interest in a limited partnership, which acquired land from the Company, intended for development into a mixed-used property, for approximately $6 million.
- Choice Properties also acquired in 2014, from a third party, an industrial property in Mississauga, Ontario, for approximately $16 million, funded by cash. This property is fully leased to a related party.
- In 2014, Choice Properties acquired a 70% interest in a limited partnership, which holds land intended for future retail development, for approximately $18 million.
- Subsequent to the end of 2014:
  - The Company sold a warehouse to Choice Properties for approximately $81 million. The warehouse is fully occupied by the Company as the single tenant with a 20-year initial lease term with six five-year renewal options;
  - The Company sold a parcel of land to Choice Properties for approximately $12 million. Consideration for the acquisition included 265,665 Class B Limited Partnership units, $7 million in cash and the assumption of a $2 million obligation. The Class B Limited Partnership units issued to the Company as partial consideration for this transaction did not impact the Company's effective ownership percentage; and
  - Choice Properties issued $250 million aggregate principal amount of Series E senior unsecured debentures bearing interest at a rate of 2.30% per annum and maturing in 2020. The net proceeds from the issuance were used by Choice Properties to repay existing indebtedness and for general business purposes.
- As of January 3, 2015, the Company's ownership interest in Choice Properties was 82.9%.

## 7. Acquisition of Shoppers Drug Mart Corporation

On March 28, 2014, the Company acquired all of the outstanding shares of Shoppers Drug Mart for total consideration of $12,273 million, comprised of approximately $6,600 million of cash and the issuance of approximately 119.5 million common shares of the Company.

The cash portion of the acquisition of Shoppers Drug Mart was financed as follows:

- $3,500 million was obtained through an unsecured term loan facility bearing interest at a rate equal to the Bankers' Acceptance rate plus 1.75% and maturing March 28, 2019 (the facility was re-priced to Bankers' Acceptance rate plus 1.45% on July 23, 2014);
- $1,600 million of proceeds from the issuance of unsecured notes in 2013;
- $500 million was received in consideration of the issuance of 10.5 million common shares to George Weston Limited ("Weston"); and
- approximately $1,000 million was used from cash on hand.

Based on a preliminary assessment, the Company recognized the following amounts of net tangible assets, goodwill and intangible assets in 2014:

| (millions of Canadian dollars except where otherwise indicated) | | | Estimated Useful Life |
|---|---|---|---|
| **Fair Value of Net Tangible Assets Acquired** | **$** | **548** | |
| **Goodwill** | | **2,285** | |
| Prescription files | | 5,005 | 11 years |
| Brands | | 3,390 | indefinite |
| Optimum loyalty program | | 490 | 18 years |
| Other | | 555 | 5 to 10 years |
| **Total Intangible Assets** | | **9,440** | |
| **Total Net Assets Acquired** | **$** | **12,273** | |

As at January 3, 2015, the Company has not yet finalized the above purchase price allocation. In the fourth quarter of 2014, the Company revised its fair value estimate of intangible assets and updated the purchase price equation. The result was to decrease intangible assets by $35 million to $9,440 million, decrease deferred income tax liabilities by $9 million to $2,252 million and increase goodwill by $26 million to $2,285 million. The Company has one year from the date of acquisition to finalize the fair value of net tangible assets, goodwill and intangible assets and any further changes to the amounts presented above will be reflected in the first half of 2015.

Pursuant to a Consent Agreement reached with the Competition Bureau in 2014, the Company was required to divest 16 Shoppers Drug Mart stores, two of the Company's franchise grocery stores and nine in-store pharmacies.

During 2014, two franchise grocery stores and 13 Shoppers Drug Mart stores were sold and nine in-store pharmacies were licensed to unrelated parties, which resulted in a net divestitures loss of $12 million. The final three Shoppers Drug Mart stores were approved for sale by the Competition Bureau and were sold subsequent to the end of 2014 for estimated proceeds of $9 million.

The Company has incurred costs of $75 million (2013 – $31 million) related to the acquisition of Shoppers Drug Mart, of which $60 million (2013 – $6 million) was recorded in SG&A and $15 million (2013 – $25 million) was recorded in net interest expense and other financing charges.

Upon closing of the acquisition, all amounts owing on Shoppers Drug Mart's revolving bank credit facility were repaid and the facility was cancelled. In addition, upon closing, the Company guaranteed the outstanding principal amount of Shoppers Drug Mart MTNs of $500 million, along with accrued interest. The Company has also provided guarantees to various Canadian banks in support of the financing obtained by Shoppers Drug Mart's licensees ("Associates"). An Associate is a pharmacist-owner of a corporation that is licensed to operate a retail drug store at a specific location using Shoppers Drug Mart's trademarks.

## 8. Other Business Matters

**Inventory Valuation** Prior to the second quarter of 2014, the Company valued its merchandise inventories at the lower of cost and net realizable value and used the retail method to measure the cost of the majority of its retail store inventories. The implementation of a perpetual inventory system, combined with visibility to integrated costing information provided by the new IT systems, enables the Company to estimate the cost of inventory using a more precise system-generated average cost.

As of the end of 2014, the Company completed the conversion of substantially all of its corporate grocery locations and associated distribution centres to the new IT systems. As a result of the conversion, the Company recognized a $190 million charge to cost of merchandise inventories sold and a corresponding reduction in inventory, representing the estimate of the difference between the measurement of the cost of corporate grocery store inventory using a system generated weighted average cost compared to the retail inventory method and other conversion differences associated with the implementation of a perpetual inventory system.

## 9. Liquidity and Capital Resources

### 9.1 Cash Flows

***Major Cash Flow Components***

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014**<br>**(53 weeks)** | 2013<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Cash flows from (used in): | | | | |
| Operating activities | **$ 2,569** | $ 1,491 | $ 1,078 | 72.3 % |
| Investing activities | **(5,684)** | (1,839) | (3,845) | (209.1)% |
| Financing activities | **1,845** | 1,521 | 324 | 21.3 % |

**Cash Flows from Operating Activities** Cash flows from operating activities were $2,569 million compared to $1,491 million in 2013. The increase was primarily driven by higher cash earnings, primarily driven by the acquisition of Shoppers Drug Mart and a lower increase in credit card receivables, partially offset by a higher change in non-cash working capital and the settlement of cross currency swaps in 2013. The change in non-cash working capital was due to year-over-year increases in inventory and prepaid expenses, partially offset by a lower year-over-year increase in accounts receivable.

**Cash Flows used in Investing Activities** Cash flows used in investing activities were $5,684 million compared to $1,839 million in 2013. The increase in cash flows used in investing activities was primarily due to the acquisition of Shoppers Drug Mart.

Fixed asset purchases in 2014 were $996 million (2013 – $865 million). Approximately 22% (2013 – 14%) of this investment was for new store developments, expansions and land, approximately 45% (2013 – 45%) was for store conversions and renovations, and approximately 33% (2013 – 41%) was for infrastructure investments. Intangible asset additions in 2014 were $90 million (2013 – $12 million) and primarily related to the acquisition and development of software and the acquisition of prescription files.

During 2014, 22 corporate and franchise stores were opened and 12 corporate and franchise stores were closed, with an additional two franchise grocery stores divested as a result of a Consent Agreement with the Competition Bureau related to the acquisition of Shoppers Drug Mart, resulting in flat square footage growth. Since the acquisition date, Shoppers Drug Mart opened 17 new drug stores and closed 24 drug stores, including 13 drug stores divested in accordance with the Consent Agreement with the Competition Bureau related to the acquisition of Shoppers Drug Mart. As a result, Shoppers Drug Mart's net square footage increased by 0.1 million square feet, or 0.6%.

The Company expects to invest approximately $1,200 million in capital investments in 2015. Approximately 22% of these funds are expected to be dedicated to investing in IT and supply chain projects, 57% will be spent on retail operations, 14% on Choice Properties' development projects and 7% on other infrastructure projects.

***Capital Investments and Store Activity***

| As at or for the years ended January 3, 2015 and December 28, 2013 | 2014 (53 weeks) | 2013 (52 weeks) | % Change |
|---|---|---|---|
| Capital investments (millions of Canadian dollars) | **$ 1,086** | $ 877 | 23.8 % |
| Corporate square footage (in millions) | **36.8** | 37.2 | (1.1)% |
| Franchise square footage (in millions) | **15.5** | 14.7 | 5.4 % |
| Associate-owned drug store square footage (in millions) | **17.7** | — | 100.0 % |
| Total retail square footage (in millions) | **70.0** | 51.9 | 34.9 % |
| Number of corporate stores[(i)] | **615** | 570 | 7.9 % |
| Number of franchise stores | **527** | 496 | 6.3 % |
| Number of Associate-owned drug stores | **1,302** | — | 100.0 % |
| Total number of stores | **2,444** | 1,066 | 129.3 % |
| Percentage of corporate real estate owned | **72.0%** | 72.0% | |
| Percentage of franchise real estate owned | **45.0%** | 45.0% | |
| Percentage of Associate-owned drug store real estate owned | **1.0%** | —% | |
| Average store size (square feet) | | | |
| Corporate | **59,800** | 65,300 | (8.4)% |
| Franchise | **29,400** | 29,600 | (0.7)% |
| Associate-owned drug store | **13,600** | — | 100.0 % |

(i) 2014 figure includes 68 Shoppers Drug Mart corporate stores.

**Cash Flows from Financing Activities** During 2014, cash flows from financing activities were $1,845 million compared to cash flows from financing activities of $1,521 million in 2013. In 2014, cash flows used in financing activities were primarily driven by net issuance of long term debt and proceeds from the issuance of common shares, both primarily used to fund the acquisition of Shoppers Drug Mart. These cash inflows were partially offset by interest and dividend payments, which include one quarter of Shoppers Drug Mart dividends that were declared prior to closing of the acquisition and paid during the second quarter of 2014. Cash flows from financing activities in 2013 were primarily driven by net issuance of long term debt and the issuance of Choice Properties' Trust Units ("Units"), partially offset by repayment of short term debt, as well as interest and dividend payments.

In 2014, net issuances of long term debt included:

- Drawings on the unsecured term loan facility of $3,500 million and repayments of $2,271 million for a net outstanding amount of $1,229 million;
- The issuance and sale to unrelated parties of $1,500 million of replacement notes related to the Choice Properties Transferor Notes;
- The issuance of $450 million aggregate principal amount of senior unsecured debentures by Choice Properties;
- The net issuance of $201 million of Guaranteed Investment Certificates ("GICs");
- The repayment of the Company's $100 million, 6.0% MTN upon maturity;
- The repayment of the Company's $350 million, 4.85% MTN upon maturity;
- The repayment of the outstanding $478 million balance of the Shoppers Drug Mart revolving bank credit facility; and
- Drawings on the $500 million senior unsecured committed credit facility ("Choice Properties' Credit Facility") of $122 million.

In 2013, net issuances of long term debt included:

- The issuance of $1,600 million aggregate principal amount of senior unsecured notes issued to partially fund the acquisition of the outstanding common shares of Shoppers Drug Mart;
- Choice Properties' public offering of $600 million aggregate principal amount of Debentures;
- The issuance of $400 million of senior and subordinated term notes by the Independent Securitization Trust, partially offset by the repayment of its $250 million of senior and subordinated term notes;
- The net issuance of $125 million of GICs;
- The repayment of the Company's remaining USD $300 million U.S. Private Placement ("USPP") note; and
- The repayment of the Company's $200 million, 5.40% MTN upon maturity.

**Free Cash Flow(2)**

| For the years ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014<br>(53 weeks)** | 2013(4)<br>(52 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Free cash flow(2) | **$ 977** | $ 244 | $ 733 | 300.4% |

For 2014, free cash flow(2) was $977 million compared to $244 million in 2013. The increase in free cash flow(2) for 2014 was primarily due to higher cash flows from operating activities, partially offset by an increase in capital investments as well as higher interest payments.

**9.2 Liquidity and Capital Structure**

The Company expects that cash and cash equivalents, short term investments, future operating cash flows and the amounts available to be drawn against its committed credit facilities will enable the Company to finance its capital investments program and fund its ongoing business requirements, including working capital, pension plan funding requirements, financial obligations and debt reduction commitments over the next 12 months.

**Adjusted Debt(2)** On closing of the acquisition of Shoppers Drug Mart, adjusted debt(2) was $11,060 million. The Company made significant progress in meeting its debt reduction target by decreasing adjusted debt(2) by $1,065 million since the closing of the acquisition of Shoppers Drug Mart resulting in an outstanding adjusted debt(2) balance of $9,995 million as at January 3, 2015. The reduction in adjusted debt(2) since closing included the repayment of a $350 million MTN and a repayment of the unsecured term loan facility (net of the replacement of all tranches of inter-corporate debt of Choice Properties initially held by Loblaw and sold to unrelated parties).

Under the terms of the unsecured term loan facility, the proceeds from the store divestitures required pursuant to the Consent Agreement must be used to repay the facility. Of the total amount repaid under the facility in 2014, $57 million related to these proceeds.

**Adjusted Debt(2) to Adjusted EBITDA(2)**

| | **As at<br>January 3, 2015** | As at<br>December 28, 2013(4) |
|---|---|---|
| Adjusted debt(2) to adjusted EBITDA(2) | **3.1x** | 3.0x |

The adjusted debt(2) to adjusted EBITDA(2) ratio increased at the end of 2014 compared to the end of 2013 as a result of the $3,500 million unsecured term loan facility used to partially fund the cash portion of the Shoppers Drug Mart acquisition, and the assumption of Shoppers Drug Mart outstanding debt, partially offset by the increase in adjusted EBITDA(2) due to the inclusion of Shoppers Drug Mart adjusted EBITDA(2) and the debt reduction progress since the acquisition. The Company will continue to target leverage ratios consistent with those of investment grade ratings.

**Unsecured Term Loan Facility** In connection with the financing of the acquisition of Shoppers Drug Mart, $3,500 million was obtained through an unsecured term loan facility bearing interest at a rate equal to the Bankers' Acceptance rate plus 1.75% maturing March 28, 2019. Loblaw used the proceeds from the sale of $1,500 million of Transferor Notes to third parties, mentioned below, to partially repay the $3,500 million unsecured term loan facility. The overall consolidated impact was neutral to adjusted debt(2). However, this repayment combined with the $771 million in unsecured term loan facility repayments during the year reduced the term loan facility balance to approximately $1,229 million as at January 3, 2015.

In 2014, the Company reached an agreement to re-price the interest rate on its unsecured term loan facility, obtained to finance the acquisition of Shoppers Drug Mart, to reduce the rate from Bankers' Acceptance rate plus 1.75% to Bankers' Acceptance rate plus 1.45%.

**Committed Credit Facility** In 2014, effective on the closing of the acquisition of Shoppers Drug Mart, the Company's $800 million committed credit facility ("Credit Facility") was increased to $1,000 million and the term was extended to December 31, 2018, with all other terms and conditions remaining substantially the same. The Credit Facility contains certain financial covenants with which the Company was in compliance throughout the year and as at the end of 2014. As at January 3, 2015 and December 28, 2013, there were no amounts drawn under the Credit Facility.

**PC Bank Securities Portfolio** In 2014, the Office of the Superintendent of Financial Institutions ("OFSI") released the final Guideline on Liquidity Adequacy Requirements ("LARs"). The LARs guideline establishes standards based on the Basel III framework, including a Liquidity Coverage Ratio ("LCR") standard effective January 1, 2015 and a Net Stable Funding Ratio standard effective January 1, 2018. The LCR standard specifies the level of liquid securities that PC Bank is required to maintain to meet its financial liabilities.

**Choice Properties** Choice Properties expects to obtain its long term financing, for the acquisition of accretive properties, primarily through the issuance of equity and unsecured debentures.

In 2014, Choice Properties Limited Partnership entered into a Master Trust Indenture agreement with Computershare Trust Company of Canada to create supplemental indentures in order to facilitate the replacement of all tranches of Transferor Notes held by Loblaw, with Series 5 to Series 10 notes containing the same principal amounts, interest rates and maturity dates. These replacement notes bear fixed interest rates between 3.00% and 3.60% and mature during 2016 through 2022. The remaining terms and conditions were substantially similar to the original notes. Loblaw subsequently sold the replacement notes to unrelated parties and received net proceeds of $1,500 million.

In 2014, Choice Properties issued $250 million principal amount of Series C senior unsecured debentures with a 7-year term and a coupon rate of 3.50% per annum and $200 million principal amount of Series D senior unsecured debentures with a 10-year term and a coupon rate of 4.29% per annum, under its Short Form Base Shelf Prospectus. The majority of the proceeds were used to repay $440 million of Transferor Notes held by Loblaw.

Subsequent to the end of the year, Choice Properties issued $250 million aggregate principal amount of Series E senior unsecured debentures bearing interest at a rate of 2.30% per annum and maturing in 2020. The net proceeds from the issuance were used by Choice Properties to repay existing indebtedness and for general business purposes.

In 2013, Choice Properties entered into an agreement for the Choice Properties Credit Facility, provided by a syndicate of lenders. In 2014, Choice Properties extended the maturity date of the Choice Properties Credit Facility to July 5, 2019. The facility contains certain financial covenants with which Choice Properties was in compliance throughout the year and as at the end of 2014. As at January 3, 2015, Choice Properties had drawn $122 million (2013 – nil) under the Choice Properties Credit Facility.

**Prospectus** Subsequent to the end of 2014, the Company received approval from its Board of Directors ("Board") to file a Short Form Base Shelf Prospectus which allows for the issuance of up to $1,500 million of unsecured debentures and/or preference shares subject to the availability of funding in capital markets.

### 9.3 Credit Ratings

The Company guaranteed the outstanding MTNs of Shoppers Drug Mart (see Section 7, "Acquisition of Shoppers Drug Mart" of this MD&A). As a result, Standard & Poor's changed its credit rating of the outstanding Shoppers Drug Mart MTNs to BBB with "Stable" outlook and DBRS changed its rating to BBB with a "Stable" trend, in each case consistent with the credit ratings of the Company. In the fourth quarter of 2014, Dominion Bond Rating Service reaffirmed Loblaw's credit ratings and trends.

The following table sets out the current credit ratings of the Company:

| | Dominion Bond Rating Service | | Standard & Poor's | |
|---|---|---|---|---|
| Credit Ratings (Canadian Standards) | Credit Rating | Trend | Credit Rating | Outlook |
| Issuer rating | BBB | Stable | BBB | Stable |
| Medium term notes | BBB | Stable | BBB | n/a |
| Other notes and debentures | BBB | Stable | BBB | n/a |
| Preferred shares | Pfd-3 | Stable | P-3 (high) | n/a |

The following table sets out the current credit ratings of Choice Properties:

| | Dominion Bond Rating Service | | Standard & Poor's | |
|---|---|---|---|---|
| Credit Ratings (Canadian Standards) | Credit Rating | Trend | Credit Rating | Outlook |
| Issuer rating | BBB | Stable | BBB | Stable |
| Senior unsecured debentures | BBB | Stable | BBB | n/a |

**9.4 Other Sources of Funding**

**Independent Securitization Trusts** The Company, through PC Bank, participates in various securitization programs that provide the primary source of funds for the operation of its credit card business. PC Bank sells and repurchases credit card receivables with independent securitization trusts, including *Eagle Credit Card Trust®* ("*Eagle*") and Other Independent Securitization Trusts, from time to time, depending on PC Bank's financing requirements. As at January 3, 2015, the amount of credit card receivables securitized to *Eagle* was $750 million (December 28, 2013 – $750 million) and $605 million (December 28, 2013 – $605 million) were securitized to Other Independent Securitization Trusts.

Letters of credit for the benefit of independent securitization trusts with respect to the securitization programs of PC Bank have been issued by major financial institutions. These standby letters of credit can be drawn upon in the event of a major decline in the income flow from or in the value of the securitized credit card receivables. The Company has agreed to reimburse the issuing banks for any amount drawn on the standby letters of credit.

As at January 3, 2015, the aggregate gross potential liability under these arrangements for the Other Independent Securitization Trusts was $61 million (December 28, 2013 – $54 million), which represented 10% (2013 – 9%) of the securitized credit card receivables amount. As at January 3, 2015, the aggregate gross potential liability under these arrangements for *Eagle* was $68 million (December 28, 2013 – nil), which represented 9% (2013 – nil) of the *Eagle* notes outstanding.

In 2014, PC Bank extended the maturity date for one of its Other Independent Securitization Trust agreements from the third quarter of 2015 to the third quarter of 2016, with all other terms and conditions remaining substantially the same. In addition, PC Bank extended the maturity date for two of its Other Independent Securitization Trust agreements from the second quarter of 2015 to the second quarter of 2016, with all other terms and conditions remaining substantially the same. Subsequent to the end of the year, PC Bank extended the maturity date for certain Other Independent Securitization Trust agreements from the second quarter of 2016 to the second quarter of 2017, with all other terms and conditions remaining substantially the same.

The undrawn commitments on facilities available from the Other Independent Securitization Trusts as at January 3, 2015 were $120 million (December 28, 2013 – $120 million).

**Independent Funding Trusts** The Company has a revolving committed credit facility that is the source of funding to the independent funding trusts. As at January 3, 2015, the independent funding trusts had drawn $498 million (December 28, 2013 – $475 million).

In 2014, the Company renewed the revolving committed credit facility and extended the maturity date to May 6, 2017, with terms and conditions remaining substantially the same.

The Company provides credit enhancement in the form of a standby letter of credit for the benefit of the independent funding trusts representing not less than 10% of the principal amount of the loans outstanding. As at January 3, 2015, the Company had provided a letter of credit in the amount of $50 million (December 28, 2013 – $48 million). This credit enhancement allows the independent funding trusts to provide financing to the Company's independent franchisees. As well, each independent franchisee provides security to the independent funding trusts for its obligations by way of a general security agreement. In the event that an independent franchisee defaults on its loan and the Company has not, within a specified time period, assumed the loan, or the default is not otherwise remedied, the independent funding trusts would assign the loan to the Company and draw upon this standby letter of credit. This standby letter of credit has never been drawn upon. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit.

**Guaranteed Investment Certificates** The following table summarizes PC Bank's GICs activity, before commissions, for the years ended 2014 and 2013:

| (millions of Canadian dollars) | 2014 | 2013 |
|---|---|---|
| Balance, beginning of year | $ 430 | $ 303 |
| GICs issued | 261 | 167 |
| GICs matured | (57) | (40) |
| Balance, end of year | $ 634 | $ 430 |

As at January 3, 2015, $29 million in GICs were recorded as long term debt due within one year (December 28, 2013 – $52 million).

**Associate Guarantees** The Company has arranged for its Shoppers Drug Mart Associates to obtain financing to facilitate their inventory purchases and fund their working capital requirements by providing guarantees to various Canadian chartered banks that support Associate loans. As at January 3, 2015, the Company's maximum obligation in respect of such guarantees was $570 million with an aggregate amount of $476 million in available lines of credit allocated to the Associates by the various banks. As at January 3, 2015, Associates had drawn an aggregate amount of $162 million against these available lines of credit. Any amounts drawn by the Associates are included in bank indebtedness on the Company's consolidated balance sheet. As recourse in the event that any payments are made under the guarantees, the Company holds a first-ranking security interest on all assets of Associates, subject to certain prior-ranking statutory claims.

### 9.5 Share Capital

**Outstanding Share Capital and Capital Securities** The following table details the outstanding common shares and preferred shares as at January 3, 2015:

| | Authorized | Outstanding |
|---|---|---|
| Common Shares | Unlimited | 412,480,891 |
| First Preferred Shares | 1,000,000 | nil |
| Second Preferred Shares, Series A[(i)] | 12,000,000 | 9,000,000 |

(i) The Second Preferred Shares, Series A are presented as capital securities on the consolidated balance sheet.

**Common Shares (authorized – unlimited)** Common shares issued are fully paid and have no par value. The activity in the common shares issued and outstanding during 2014 and 2013 were as follows:

| (number of common shares) | 2014 | 2013 |
|---|---|---|
| Issued and outstanding, beginning of year | 282,311,573 | 281,680,157 |
| Issued for settlement of stock options | 3,536,489 | 2,131,416 |
| Issued for acquisition of Shoppers Drug Mart[(i)] | 119,471,382 | — |
| Issued to controlling shareholder[(i)] | 10,515,247 | — |
| Purchased for cancellation | (3,353,800) | (1,500,000) |
| Issued and outstanding, end of year | 412,480,891 | 282,311,573 |
| Shares held in trust, beginning of year | (1,067,323) | — |
| Purchased for future settlement of RSUs and PSUs | — | (1,103,500) |
| Released for settlement of RSUs and PSUs | 512,277 | 36,177 |
| Shares held in trust, end of year | (555,046) | (1,067,323) |
| Issued and outstanding, net of shares held in trust, end of year | 411,925,845 | 281,244,250 |
| Weighted average outstanding, net of shares held in trust | 380,540,877 | 281,123,452 |

(i) See Section 7 "Acquisition of Shoppers Drug Mart Corporation".

**Dividends** The declaration and payment of dividends on the Company's common shares and the amount thereof are at the discretion of the Board, which takes into account the Company's financial results, capital requirements, available cash flow, future prospects of the Company's business and other factors considered relevant from time to time. Over time, it is the Company's intention to increase the amount of the dividend while retaining appropriate free cash flow to reduce debt and finance future growth.

The following table summarizes the Company's cash dividends declared for 2014 and 2013:

| | | **2014[i] (53 weeks)** | | 2013 (52 weeks) |
|---|---|---|---|---|
| Dividends declared per share ($): | | | | |
| Common share | **$** | **0.975** | $ | 0.940 |
| Second Preferred Share, Series A[ii] | **$** | **1.49** | $ | 1.49 |

(i) The fourth quarter dividends of $0.245 per share declared on common shares were paid on December 30, 2014. The fourth quarter dividends of $0.37 per share declared on Second Preferred Shares, Series A were paid on January 31, 2015.
(ii) Dividends on Second Preferred Share, Series A are presented in net interest and other financing charges on the consolidated statements of earnings.

Subsequent to the end of the year, the Board declared a quarterly dividend of $0.245 per common share, payable April 1, 2015, and declared a quarterly dividend of $0.37 per Second Preferred Share, Series A, payable April 30, 2015. At the time such dividends are declared, the Company identifies on its website, loblaw.ca, the designation of eligible and ineligible dividends in accordance with the administrative position of the CRA.

**Normal Course Issuer Bid** The activity under the Company's Normal Course Issuer Bid ("NCIB") is summarized as follows:

| (millions of Canadian dollars except where otherwise indicated) | | **2014 (53 weeks)** | | 2013 (52 weeks) |
|---|---|---|---|---|
| Shares repurchased under the NCIB for cancellation (number of shares) | | **3,353,800** | | 1,500,000 |
| Cash consideration paid | **$** | **178** | $ | 73 |
| Premium charged to Retained Earnings | | **115** | | 64 |
| Reduction in common shares | | **63** | | 9 |
| Shares repurchased under the NCIB and held in trusts (number of shares) | | **—** | | 1,103,500 |
| Cash consideration paid | **$** | **—** | $ | 46 |
| Premium charged to Retained Earnings | | **—** | | 40 |
| Reduction in common shares | | **—** | | 6 |

In 2014, the Company renewed its NCIB to purchase on the Toronto Stock Exchange ("TSX") or to enter into equity derivatives to purchase up to 20,636,596 of the Company's common shares, representing approximately 5% of the common shares outstanding after taking into account shares issued in connection with the acquisition of Shoppers Drug Mart. In accordance with the rules and by-laws of the TSX, the Company may purchase its common shares from time to time at the then market price of such shares.

### 9.6 Contractual Obligations

The following illustrates certain of the Company's significant contractual obligations and discusses other obligations as at January 3, 2015:

***Summary of Contractual Obligations***

| | Payments due by year | | | | | | |
|---|---|---|---|---|---|---|---|
| (millions of Canadian dollars) | 2015 | 2016 | 2017 | 2018 | 2019 | Thereafter | Total |
| Long term debt (including interest payments[i]) | $ 911 | $ 1,445 | $ 1,278 | $ 1,767 | $ 2,920 | $ 8,263 | $ 16,584 |
| Operating leases[ii] | 674 | 654 | 620 | 573 | 529 | 2,818 | 5,868 |
| Contracts for purchases of investment projects[iii] | 191 | 1 | — | — | — | — | 192 |
| Purchase obligations[iv] | 124 | 68 | 36 | 23 | 1 | 5 | 257 |
| Total contractual obligations | $ 1,900 | $ 2,168 | $ 1,934 | $ 2,363 | $ 3,450 | $ 11,086 | $ 22,901 |

(i) Fixed interest payments are based on the maturing face values and annual interest for each instrument, including GICs, long term independent securitization trusts and an independent funding trust, as well as annual payment obligations for Consolidated Structured Entities, mortgages and finance lease obligations. Variables interest payments are based on the forward rates as of January 3, 2015.

(ii) Represents the minimum or base rents payable. Amounts are not offset by any expected sub-lease income.

(iii) These obligations include agreements for the purchase of real property and capital commitments for construction, expansion and renovation of buildings. These agreements may contain conditions that may or may not be satisfied. If the conditions are not satisfied, it is possible the Company will no longer have the obligation to proceed with the underlying transactions.

(iv) Include contractual obligations to purchase goods or services of a material amount where the contract prescribes fixed or minimum volumes to be purchased or payments to be made within a fixed period of time for a set or variable price. These are only estimates of anticipated financial commitments under these arrangements and the amount of actual payments will vary. These purchase obligations do not include purchase orders issued or agreements made in the ordinary course of business which are solely for goods which are meant for resale, nor do they include any contracts which may be terminated on relatively short notice or with relatively insignificant cost or liability to the Company.

At year end, the Company had additional long term liabilities which included post-employment and other long term employee benefit plan liabilities, deferred vendor allowances, deferred income tax liabilities, Trust Unit Liability and provisions, including insurance liabilities. These long term liabilities have not been included above as the timing and amount of future payments are uncertain.

### 10. Financial Derivative Instruments

The following describes the financial derivative instruments that were terminated in 2013:

**Cross Currency Swaps** In 2013, Glenhuron unwound its cross currency swaps and received a net cash settlement of $76 million, representing the cumulative fair value gain on the swaps. The swaps were offset by the effect of translation gains and losses relating to USD cash and cash equivalents, short term investments and security deposits.

In 2013, the Company settled its USD $300 million USPP cross currency swaps in conjunction with the settlement of the underlying USD $300 million USPP debt.

The following table summarizes the 2013 impact to operating income resulting from changes in the fair value of the cross currency swaps and the underlying exposures:

| (millions of Canadian dollars) | Glenhuron Cross Currency Swaps December 28, 2013 (52 weeks) | USPP Cross Currency Swaps December 28, 2013 (52 weeks) |
|---|---|---|
| Fair value loss (gain) related to swaps[i] | $ 37 | $ (11) |
| Translation (gain) loss related to the underlying exposures | (33) | 14 |
| | | |

(i) The impact to USPP cross currency swaps excludes the $7 million gain on derecognized derivative instruments, before income taxes, reclassified from accumulated other comprehensive income.

**Interest Rate Swaps** During 2013, the Company settled its notional $150 million in interest rate swaps and recognized a $5 million fair value gain in operating income related to these swaps.

**Trust Unit Liability** As at January 3, 2015, the fair value of the Trust Unit Liability of $722 million (December 28, 2013 – $688 million) was recorded on the consolidated balance sheet. In 2014, the Company recorded a fair value loss of $17 million (2013 – $27 million), in net interest expense and other financing charges related to Choice Properties' Units.

## 11. Off-Balance Sheet Arrangements

In the normal course of business, the Company enters into off-balance sheet arrangements including:

**Letters of Credit** Standby and documentary letters of credit are used in connection with certain obligations mainly related to real estate transactions, benefit programs, purchase orders and performance guarantees, securitization of PC Bank's credit card receivables and third party financing made available to the Company's independent franchisees. The aggregate gross potential liability related to the Company's letters of credit is approximately $586 million (December 28, 2013 – $470 million).

As at January 3, 2015, the Company had agreements to cash collateralize certain of these letters of credit up to an amount of $141 million (December 28, 2013 – $136 million), of which $7 million (December 28, 2013 – $102 million) was deposited with major financial institutions and classified as security deposits.

**Guarantees** In addition to the letters of credit mentioned above, the Company has entered into various guarantee arrangements including obligations to indemnify third parties in connection with leases, business dispositions and other transactions in the normal course of business, some of which are discussed in section 9 "Liquidity and Capital Resources."

In addition, the Company has provided a guarantee on behalf of PC Bank to MasterCard® International Incorporated ("MasterCard®") for accepting PC Bank as a card member and licensee of MasterCard®. As at January 3, 2015, the guarantee on behalf of PC Bank to MasterCard® was USD $170 million (December 28, 2013 – USD $170 million).

## 12. Quarterly Results of Operations

### 12.1 Results by Quarter

Under an accounting convention common in the retail industry, the Company follows a 52-week reporting cycle which periodically necessitates a fiscal year of 53 weeks. Fiscal year 2014 is 53 weeks and fiscal year 2013 is 52 weeks. When a fiscal year such as 2014 contains 53 weeks, the fourth quarter is 13 weeks in duration. The 52-week reporting cycle is divided into four quarters of 12 weeks each except for the third quarter, which is 16 weeks in duration.

The following is a summary of selected consolidated financial information derived from the Company's unaudited interim period condensed consolidated financial statements for each of the eight most recently completed quarters:

**Summary of Consolidated Quarterly Results**

| | | | | | 2014 | | | | | 2013[4] |
|---|---|---|---|---|---|---|---|---|---|---|
| (millions of Canadian dollars except where otherwise indicated) | First Quarter (12 weeks) | Second Quarter (12 weeks) | Third Quarter (16 weeks) | Fourth Quarter (13 weeks) | Total (audited) (53 weeks) | First Quarter (12 weeks) | Second Quarter (12 weeks) | Third Quarter (16 weeks) | Fourth Quarter (12 weeks) | Total (audited) (52 weeks) |
| Revenue | $ 7,292 | $ 10,307 | $ 13,599 | $ 11,413 | $ 42,611 | $ 7,202 | $ 7,520 | $ 10,009 | $ 7,640 | $ 32,371 |
| Net earnings (loss) | $ 120 | $ (456) | $ 142 | $ 247 | $ 53 | $ 186 | $ 177 | $ 150 | $ 114 | $ 627 |
| Net earnings (loss) per common share: | | | | | | | | | | |
| Basic ($) | $ 0.43 | $ (1.13) | $ 0.34 | $ 0.60 | $ 0.14 | $ 0.66 | $ 0.63 | $ 0.53 | $ 0.41 | $ 2.23 |
| Diluted ($) | $ 0.42 | $ (1.13) | $ 0.34 | $ 0.59 | $ 0.14 | $ 0.65 | $ 0.62 | $ 0.53 | $ 0.40 | $ 2.21 |
| Average national food price inflation (as measured by CPI) | 1.2% | 2.5% | 2.8% | 3.5% | 2.5% | 1.4% | 1.5% | 0.9% | 0.9% | 1.1% |
| Retail same-store sales[(1), (6)] growth | 0.9% | 1.8% | 2.6% | 2.4% | 2.0% | 2.8% | 1.1% | 0.4% | 0.6% | 1.1% |

CPI does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores.

Over the past eight quarters, net retail square footage increased by 0.4 million square feet to 51.9 million square feet, excluding Shoppers Drug Mart.

Fluctuations in quarterly net earnings reflect the underlying operations of the Company and are impacted by seasonality, which is greatest in the fourth quarter and least in the first quarter, the timing of holidays and were impacted by the items set out in Section 20 "Non-GAAP Financial Measures" of the MD&A as well as the following significant items:

- Transition of certain stores to more cost effective and efficient operating terms under collective agreements; and
- Equity-based compensation, net of equity forwards.

**12.2 Fourth Quarter Results**

The following is a summary of selected consolidated unaudited financial information for the fourth quarter of 2014:

| For the periods ended January 3, 2015 and December 28, 2013 | | **2014** | | 2013[4] | | | |
|---|---|---|---|---|---|---|---|
| (millions of Canadian dollars except where otherwise indicated) | | **(13 weeks)** | | (12 weeks) | | $ Change | % Change |
| Revenue | **$** | **11,413** | $ | 7,640 | $ | 3,773 | 49.4 % |
| *Revenue excluding Shoppers Drug Mart* | | ***8,359*** | | *7,640* | | *719* | *9.4 %* |
| EBITDA[2] | **$** | **900** | $ | 492 | $ | 408 | 82.9 % |
| Adjusted EBITDA[2] | | **950** | | 489 | | 461 | 94.3 % |
| Adjusted EBITDA margin[2] | | **8.3%** | | 6.4% | | | |
| *Adjusted EBITDA[2] excluding Shoppers Drug Mart* | ***$*** | ***598*** | *$* | *489* | *$* | *109* | *22.3 %* |
| *Adjusted EBITDA margin[2] excluding Shoppers Drug Mart* | | ***7.2%*** | | *6.4%* | | | |
| Operating income | **$** | **507** | $ | 296 | $ | 211 | 71.3 % |
| Adjusted operating income[2] | | **681** | | 293 | | 388 | 132.4 % |
| Adjusted operating margin[2] | | **6.0%** | | 3.8% | | | |
| *Adjusted operating income[2] excluding Shoppers Drug Mart* | ***$*** | ***391*** | *$* | *293* | *$* | *98* | *33.4 %* |
| *Adjusted operating margin[2] excluding Shoppers Drug Mart* | | ***4.7%*** | | *3.8%* | | | |
| Net interest expense and other financing charges | **$** | **169** | $ | 141 | $ | 28 | 19.9 % |
| Adjusted net interest expense and other financing charges[2] | | **144** | | 92 | | 52 | 56.5 % |
| Net earnings | | **247** | | 114 | | 133 | 116.7 % |
| Adjusted net earnings[2] | | **396** | | 161 | | 235 | 146.0 % |
| Basic net earnings per common share ($) | **$** | **0.60** | $ | 0.41 | $ | 0.19 | 46.3 % |
| Adjusted basic net earnings per common share[2] ($) | | **0.96** | | 0.57 | | 0.39 | 68.4 % |
| Cash flows from (used in): | | | | | | | |
| Operating activities | $ | 952 | $ | 738 | $ | 214 | 29.0 % |
| Investing activities | | (363) | | 471 | | (834) | (177.1)% |
| Financing activities | | (575) | | (387) | | (188) | (48.6)% |
| Dividends declared per common share ($) | $ | 0.245 | $ | 0.240 | $ | 0.005 | 2.1 % |
| Dividends declared on Second Preferred Share, Series A ($) | | 0.37 | | 0.37 | | — | — % |

**Revenue** Revenue of $11,413 million in the fourth quarter of 2014 increased by $3,773 million compared to the fourth quarter of 2013, primarily due to Shoppers Drug Mart and the impact of the 13th week of the fourth quarter of 2014. Revenue in the 13th week of the fourth quarter of 2014 was $789 million ($574 million excluding Shoppers Drug Mart). Excluding the impact of Shoppers Drug Mart, consolidated revenue increased by $719 million, or 9.4%. Excluding the impact of Shoppers Drug Mart and the 13th week of the fourth quarter of 2014, consolidated revenue increased by $145 million, or 1.9%.

**EBITDA[2]** EBITDA[2] of $900 million in the fourth quarter of 2014 increased by $408 million compared to the fourth quarter of 2013, primarily driven by Shoppers Drug Mart. The increase in EBITDA[2] was positively impacted by adjustments of $50 million including restructuring of franchise fees ($40 million) and restructuring costs incurred in 2013 ($32 million), that were not incurred in 2014. The increases were partially offset by the net loss on divestitures related to the acquisition of Shoppers Drug Mart ($7 million), the recognition of the fair value increment on the acquired Shoppers Drug Mart inventory sold ($69 million), increased fixed asset and other related impairments ($43 million), the fair value adjustment on fuel and foreign currency contracts ($4 million) and the fair value adjustment on Shoppers Drug Mart's equity-based compensation liability ($2 million).

After excluding these adjustments, adjusted EBITDA[2] of $950 million increased by $461 million compared to the fourth quarter of 2013. The increase included $352 million of adjusted EBITDA[2] contributed by Shoppers Drug Mart, with the remainder of the increase of $109 million primarily driven by the Retail segment. The increase was positively impacted by net synergies of $49 million and the 13th week of the fourth quarter of 2014 of $71 million. Adjusted EBITDA margin[2] was 8.3% for the fourth quarter of 2014 compared to 6.4% in the same quarter in 2013. Excluding the impact of Shoppers Drug Mart, adjusted EBITDA[2] increased by $109 million, or 22.3%, compared to the fourth quarter of 2013 and adjusted EBITDA margin[2] was 7.2% compared to 6.4% in the same quarter in 2013.

**Synergies** During the fourth quarter of 2014, the Company realized approximately $49 million of net synergies associated with the acquisition of Shoppers Drug Mart, primarily in cost of goods sold.

**Operating Income** Operating income of $507 million in the fourth quarter of 2014 increased by $211 million compared to the fourth quarter of 2013, primarily driven by Shoppers Drug Mart. Operating income was negatively impacted by the net adjustments related to EBITDA[2] noted above of $50 million and by the amortization of intangible assets of $124 million related to the acquisition of Shoppers Drug Mart.

After excluding these impacts to operating income, adjusted operating income[2] of $681 million increased by $388 million compared to the fourth quarter of 2013, including $290 million of adjusted operating income[2] contributed by Shoppers Drug Mart. Adjusted operating margin[2] was 6.0% compared to 3.8% in the fourth quarter of 2013. Excluding the impact of Shoppers Drug Mart, adjusted operating income[2] increased by $98 million and was positively impacted by the increase in adjusted EBITDA[2] noted above of $109 million, partially offset by an increase in depreciation and amortization[2] of $11 million.

**Net Interest Expense and Other Financing Charges** Net interest expense and other financing charges of $169 million in the fourth quarter of 2014 increased by $28 million compared to the fourth quarter of 2013, including a lower fair value adjustment related to the Trust Unit Liability for the change in the fair value of Choice Properties' Units held by unitholders other than the Company, Shoppers Drug Mart acquisition-related costs incurred in the fourth quarter of 2013 and certain other adjustments as set out in Section 20 "Non-GAAP Financial Measures".

After excluding these impacts to net interest expense and other financing charges, adjusted net interest expense and other financing charges[2] of $144 million increased by $52 million, primarily driven by higher interest on long term debt, primarily as a result of debt incurred to finance the acquisition of Shoppers Drug Mart.

**Income Taxes** Income tax expense for the fourth quarter of 2014 was $91 million and the effective tax rate was 26.9%. Income tax expense for the fourth quarter of 2013 was $41 million and the effective tax rate was 26.5%. The marginal increase in the effective tax rate was primarily attributable to an increase in certain non-deductible amounts. The adjusted income tax expense[2] for the fourth quarter was $141 million and the adjusted income tax rate[2] was 26.3%. The adjusted income tax expense[2] for the fourth quarter of 2013 was $40 million and the adjusted income tax rate[2] was 19.9%, which reflects an increase in certain non-taxable amounts.

**Net Earnings** Net earnings of $247 million in the fourth quarter of 2014 increased by $133 million compared to the fourth quarter of 2013, primarily driven by the increase in operating income, partially offset by the increase in net interest expense and other financing charges and by the increase in the income tax expense, described above.

Adjusted net earnings[2] of $396 million increased by $235 million compared to the fourth quarter of 2013, primarily driven by the increase in adjusted operating income[2], primarily as a result of Shoppers Drug Mart, partially offset by the increase in adjusted net interest expense and other financing charges[2] and the increase in the adjusted income tax expense[2], described above.

**Basic Net Earnings Per Common Share** Basic net earnings per common share were $0.60 compared to $0.41 in the fourth quarter of 2013. Basic net earnings per common share included the negative impacts of amortization of intangible assets ($0.22 per share), the recognition of a portion of the Shoppers Drug Mart acquisition-related fair value adjustments for inventory sold ($0.12 per share), the divestiture of certain stores related to the acquisition of Shoppers Drug Mart ($0.02 per share), certain other adjustments ($0.07 per share), partially offset by restructuring of franchise fees ($0.07 per share).

Adjusted basic net earnings per common share[2] were $0.96 in the fourth quarter of 2014 compared to $0.57 in the fourth quarter of 2013. This increase was primarily due to the increase in adjusted net earnings[2] as described above, partially offset by the dilutive effect of the 119.5 million common shares issued as partial consideration for the acquisition of Shoppers Drug Mart.

**Capital Investments** In the fourth quarter of 2014, the Company invested $400 million (2013 – $304 million) in fixed asset purchases and intangible asset additions.

**Free Cash Flow[2]** For the fourth quarter of 2014, free cash flow[2] was $439 million compared to $336 million in the fourth quarter of 2013. The increase in free cash flow[2] in the fourth quarter of 2014 was primarily due to higher cash flows from operating activities, partially offset by an increase in capital investments as well as higher interest payments.

**Adjusted Debt[2]** On closing of the acquisition of Shoppers Drug Mart, adjusted debt[2] was $11,060 million. The Company made significant progress in meeting its debt reduction target by decreasing adjusted debt[2] by $421 million in the fourth quarter of 2014 and by $1,065 million since the closing of the acquisition of Shoppers Drug Mart resulting in an outstanding adjusted debt[2] balance of $9,995 million as at January 3, 2015. The reduction in adjusted debt[2] since closing included the repayment of a $350 million MTN and a repayment of the unsecured term loan facility (net of the replacement of all tranches of inter-corporate debt of Choice Properties initially held by Loblaw and sold to unrelated parties).

**Cash Flows from Operating Activities** Cash flows from operating activities for the fourth quarter of 2014 were $952 million compared to $738 million in 2013. The increase was primarily driven by higher cash earnings, primarily driven by the acquisition of Shoppers Drug Mart, partially offset by a higher change in non-cash working capital and the settlement of cross currency swaps in the fourth quarter of 2013. The change in non-cash working capital was due to a quarter over quarter lower increase in accounts payable and decrease in prepaid expenses, partially offset by a decrease in inventory.

**Cash Flows (used in) from Investing Activities** Cash flows used in investing activities for the fourth quarter of 2014 were $363 million compared to cash flows from investing activities of $471 million in 2013. The decrease in cash flows from investing activities was primarily due to a reduction in short term investments and the release of funds from security deposits in the fourth quarter of 2013 for the repayment of *Eagle* notes.

**Cash Flows used in Financing Activities** Cash flows used in financing activities for the fourth quarter of 2014 were $575 million compared to $387 million in 2013. In the fourth quarter of 2014, cash flows used in financing activities were primarily driven by net repayment of long term debt, change in bank indebtedness acquired with the Shoppers Drug Mart acquisition, as well as interest and dividend payments. In the same period in 2013, cash flows used in financing activities were primarily due to the repayment of short term debt and interest payments.

**Retail Segment Fourth Quarter Results of Operations**

| For the periods ended January 3, 2015 and December 28, 2013 (millions of Canadian dollars except where otherwise indicated) | 2014 (13 weeks) | 2013[4] (12 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Sales | $ 11,164 | $ 7,419 | $ 3,745 | 50.5% |
| Gross profit | 2,925 | 1,625 | 1,300 | 80.0% |
| Adjusted gross profit[2] | 2,994 | 1,625 | 1,369 | 84.2% |
| EBITDA[2] | 847 | 443 | 404 | 91.2% |
| Adjusted EBITDA[2] | 897 | 440 | 457 | 103.9% |
| Operating income | 459 | 252 | 207 | 82.1% |
| Adjusted operating income[2] | 633 | 249 | 384 | 154.2% |

| For the periods ended January 3, 2015 and December 28, 2013 | 2014 (13 weeks) | 2013[4] (12 weeks) |
|---|---|---|
| Same-store sales[1], [6] growth | 2.4% | 0.6% |
| Adjusted gross profit %[2] | 26.8% | 21.9% |
| Adjusted EBITDA margin[2] | 8.0% | 5.9% |
| Adjusted operating margin[2] | 5.7% | 3.4% |

For a discussion of Shoppers Drug Mart results, please see Addendum A on page 29 of the Company's fourth quarter of 2014 News Release.

***Sales***

| For the periods ended January 3, 2015 and December 28, 2013 (millions of Canadian dollars except where otherwise indicated) | | 2014 (13 weeks) | | 2013[4] (12 weeks) | | $ Change | % Change |
|---|---|---|---|---|---|---|---|
| Retail segment sales | **$** | **11,164** | $ | 7,419 | $ | 3,745 | 50.5% |
| Shoppers Drug Mart | | **3,054** | | | | | |
| Excluding Shoppers Drug Mart | **$** | **8,110** | $ | 7,419 | $ | 691 | 9.3% |

- Retail segment sales of $11,164 million in the fourth quarter of 2014 increased by $3,745 million compared to the fourth quarter of 2013, primarily due to Shoppers Drug Mart and the impact of the 13th week of the fourth quarter of 2014. Retail segment sales in the 13th week of the fourth quarter of 2014 were $789 million ($574 million excluding Shoppers Drug Mart). Excluding the impact of Shoppers Drug Mart and the 13th week of the fourth quarter of 2014, Retail segment sales increased by $117 million, or 1.6%, due to the following factors:
  - Same-store sales[1, 6] growth, for core grocery, was 3.3% for the quarter, excluding gas bar (0.5%) and the negative impact of a change in distribution model by a tobacco supplier (0.4%). On a comparable basis, same-store sales[1, 6] growth was 2.4% (2013 – 0.6%);
  - On a comparable week basis:
    - Sales growth in food was strong, primarily driven by inflation;
    - Sales in drugstore were flat, with increases in health and beauty, offset by declines in pharmacy;
    - Sales in gas bar declined, primarily driven by a decline in gas prices;
    - Sales in general merchandise, excluding apparel, were flat; and
    - Sales in retail apparel were flat, while U.S. wholesale apparel sales declined significantly;
  - The Company's average quarterly internal food price index was slightly higher than (2013 – lower than) the average quarterly national food price inflation of 3.5% (2013 – 0.9%) as measured by CPI. CPI does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores; and
  - 22 corporate and franchise stores were opened and 12 corporate and franchise stores were closed in the last 12 months, with an additional two franchise grocery stores divested as a result of a Consent Agreement with the Competition Bureau related to the acquisition of Shoppers Drug Mart, resulting in flat square footage growth.
- Since the acquisition date, Shoppers Drug Mart opened 17 new drug stores and closed 24 drug stores, including 13 drug stores divested in accordance with the Consent Agreement with the Competition Bureau related to the acquisition of Shoppers Drug Mart. As a result, net square footage increased by 0.1 million square feet, or 0.6%.

***Gross Profit***

| For the periods ended January 3, 2015 and December 28, 2013 (millions of Canadian dollars except where otherwise indicated) | | 2014 (13 weeks) | | 2013[4] (12 weeks) | | $ Change | % Change |
|---|---|---|---|---|---|---|---|
| Retail gross profit | **$** | **2,925** | $ | 1,625 | $ | 1,300 | 80.0% |
| Adjustments[2] | | **69** | | — | | | |
| Adjusted Retail gross profit[2] | **$** | **2,994** | $ | 1,625 | $ | 1,369 | 84.2% |
| Adjusted gross profit %[2] | | **26.8%** | | 21.9% | | | |
| Shoppers Drug Mart | **$** | **1,221** | | | | | |
| Excluding Shoppers Drug Mart | **$** | **1,773** | $ | 1,625 | $ | 148 | 9.1% |
| Adjusted gross profit %[2] | | **21.9%** | | 21.9% | | | |

- In the fourth quarter of 2014, gross profit of $2,925 million increased by $1,300 million compared to 2013, primarily due to Shoppers Drug Mart and was negatively impacted by the recognition of the fair value increment on the acquired Shoppers Drug Mart inventory sold ($69 million).

  After excluding this adjustment[2], adjusted gross profit[2] of $2,994 million increased by $1,369 million, including $1,221 million of adjusted gross profit[2] contributed by Shoppers Drug Mart. Adjusted gross profit percentage[2] was 26.8% compared to 21.9% in the fourth quarter of 2013.
- Excluding Shoppers Drug Mart, adjusted gross profit percentage[2] was 21.9%, flat compared to 2013. While flat, adjusted gross profit percentage[2] was positively impacted by synergies related to the acquisition and reductions in transportation costs, but negatively impacted by increased shrink. Excluding Shoppers Drug Mart, adjusted gross profit[2] increased by $148 million, or 9.1%, compared to 2013, driven by higher sales, including the impact of the 13th week in the fourth quarter of 2014.

***EBITDA[2]***

| For the periods ended January 3, 2015 and December 28, 2013 (millions of Canadian dollars except where otherwise indicated) | 2014 (13 weeks) | 2013[4] (12 weeks) | $ Change | % Change |
|---|---|---|---|---|
| EBITDA[2] | $ 847 | $ 443 | $ 404 | 91.2% |
| Adjustments[2] | 50 | (3) | | |
| Adjusted Retail EBITDA[2] | $ 897 | $ 440 | $ 457 | 103.9% |
| Adjusted EBITDA margin[2] | 8.0% | 5.9% | | |
| Shoppers Drug Mart | $ 352 | | | |
| Excluding Shoppers Drug Mart | $ 545 | $ 440 | $ 105 | 23.9% |
| Adjusted EBITDA margin[2] | 6.7% | 5.9% | | |

- EBITDA[2] of $847 million in the fourth quarter of 2014 increased by $404 million compared to the fourth quarter of 2013, primarily driven by Shoppers Drug Mart. EBITDA[2] was negatively impacted by adjustments of $50 million as set out in Section 20 "Non-GAAP Financial Measures". The significant adjustments during the fourth quarter of 2014 included restructuring of franchise fees, the recognition of the fair value increment on the acquired Shoppers Drug Mart inventory sold and net divestitures loss related to the acquisition of Shoppers Drug Mart.

  After excluding these adjustments[2], adjusted EBITDA[2] of $897 million increased by $457 million compared to the fourth quarter of 2013, including $352 million of adjusted EBITDA[2] contributed by Shoppers Drug Mart.

  Excluding the impact of Shoppers Drug Mart, adjusted EBITDA[2] of $545 million increased by $105 million, driven by the increase in adjusted gross profit[2] of $148 million, as described above, partially offset by the increase in SG&A of $43 million. The increase in SG&A was driven by the 13th week in the fourth quarter of 2014. Excluding the 13th week of the fourth quarter of 2014, SG&A decreased. This decrease was primarily driven by supply chain efficiencies, changes in the fair value of the Company's franchise investments and lower administrative and other operating costs, partially offset by higher foreign exchange losses, higher investments in the Company's franchise business and synergy related costs.
- For the fourth quarter of 2014, adjusted EBITDA margin[2] was 8.0% compared to 5.9% in 2013, primarily driven by Shoppers Drug Mart. Excluding the impact of Shoppers Drug Mart, adjusted EBITDA margin[2] was 6.7% compared to 5.9% in 2013.

***Operating Income***

| For the periods ended January 3, 2015 and December 28, 2013 (millions of Canadian dollars except where otherwise indicated) | 2014 (13 weeks) | 2013[4] (12 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Retail operating income | $ 459 | $ 252 | $ 207 | 82.1% |
| Adjustments[2] | 174 | (3) | | |
| Adjusted Retail operating income[2] | $ 633 | $ 249 | $ 384 | 154.2% |
| Adjusted operating margin[2] | 5.7% | 3.4% | | |
| Shoppers Drug Mart | $ 290 | | | |
| Excluding Shoppers Drug Mart | $ 343 | $ 249 | $ 94 | 37.8% |
| Adjusted operating margin[2] | 4.2% | 3.4% | | |

- Operating income of $459 million in the fourth quarter of 2014 increased by $207 million compared to the fourth quarter of 2013, primarily driven by the acquisition-related accounting adjustments of Shoppers Drug Mart. Operating income was negatively impacted by the amortization of intangible assets related to the acquisition of $124 million and the net adjustments related to EBITDA[2] of $50 million, as noted above.

  After excluding the adjustments to operating income set out in Section 20 "Non-GAAP Financial Measures", adjusted operating income[2] of $633 million increased by $384 million compared to the fourth quarter of 2013, including $290 million of adjusted operating income[2] contributed by Shoppers Drug Mart. Excluding the impact of Shoppers Drug Mart, adjusted operating income[2] increased by $94 million, or 37.8%, driven by the increase in adjusted EBITDA[2] described above, partially offset by the increase in retail depreciation and amortization[2] of $11 million.
- For the fourth quarter of 2014, adjusted operating margin[2] was 5.7%compared to 3.4% in 2013, primarily driven by the inclusion of Shoppers Drug Mart. Excluding the impact of Shoppers Drug Mart, adjusted operating margin[2] was 4.2% compared to 3.4% in 2013.

### Financial Services Segment Fourth Quarter Results of Operations[7]

| For the periods ended January 3, 2015 and December 28, 2013<br>(millions of Canadian dollars except where otherwise indicated) | **2014**<br>**(13 weeks)** | 2013<br>(12 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Revenue | **$ 231** | $ 204 | $ 27 | 13.2% |
| Operating income | **49** | 43 | 6 | 14.0% |
| Earnings before income taxes | **35** | 29 | 6 | 20.7% |

| (millions of Canadian dollars except where otherwise indicated) | **As at**<br>**January 3, 2015** | As at<br>December 28, 2013 | $ Change | % Change |
|---|---|---|---|---|
| Average quarterly net credit card receivables | **$ 2,535** | $ 2,345 | $ 190 | 8.1% |
| Credit card receivables | **2,630** | 2,538 | 92 | 3.6% |
| Allowance for credit card receivables | **54** | 47 | 7 | 14.9% |
| Annualized yield on average quarterly gross credit card receivables | **13.7%** | 13.6% | | |
| Annualized credit loss rate on average quarterly gross credit card receivables | **4.4%** | 4.2% | | |

- Revenue for the fourth quarter of 2014 of $231 million increased by $27 million, or 13.2%,compared to the fourth quarter of 2013. This increase was primarily driven by higher interest and interchange income as a result of growth in the credit card receivables portfolio.
- Operating income of $49 million increased by $6 million and earnings before income taxes of $35 million in the fourth quarter of 2014 increased by $6 million, respectively, compared to the fourth quarter of 2013. These increases were primarily driven by higher revenue described above, partially offset by higher costs associated with the Financial Services loyalty program, higher credit losses from increased credit card receivable balances and higher operating costs as a result of an increase in the active customer base.
- As at January 3, 2015, credit card receivables were $2,630 million, an increase of $92 million compared to December 28, 2013. This increase was primarily driven by a growth in the active customer base as a result of continued investments in customer acquisitions and marketing initiatives. As at January 3, 2015, the allowance for credit card receivables was $54 million, an increase of $7 million compared to December 28, 2013, primarily due to the growth in the credit card receivables portfolio.
- Subsequent to the end of 2014:
    - The Company, through PC Bank, extended the maturity date for certain Other Independent Securitization Trust agreements from the second quarter of 2016 to the second quarter of 2017, with all other terms and conditions remaining substantially the same; and
    - PC Bank entered into USD foreign exchange forward agreements, which mature by December 2015. The notional amounts of the contracts total USD $27 million.

**Choice Properties Segment Fourth Quarter Results of Operations(5)**

| For the periods ended January 3, 2015 and December 28, 2013 (millions of Canadian dollars) | 2014 (13 weeks) | 2013(4) (12 weeks) | $ Change | % Change |
|---|---|---|---|---|
| Revenue | $ 175 | $ 165 | $ 10 | 6.1 % |
| Operating income | 223 | 186 | 37 | 19.9 % |
| Adjusted operating income(2) | 223 | 186 | 37 | 19.9 % |
| Net interest expense and other financing charges | 137 | 193 | (56) | (29.0)% |
| Adjusted funds from operations(2) | 74 | 65 | 9 | 13.8 % |

- Revenue for the fourth quarter of 2014 of $175 million increased by 10 million, or 6.1%,compared to 2013, and included $157 million (2013 – $148 million) generated from tenants within the Retail segment. The increase was primarily driven by revenue from properties acquired since the IPO.
- Operating income and adjusted operating income(2) of $223 million in the fourth quarter of 2014 increased by $37 million compared to the fourth quarter of 2013 and included a $29 million year-over-year favourable fair value adjustment on investment properties. The fair value adjustment on investment properties is eliminated on consolidation.
- Adjusted funds from operations(2) of $74 million in the fourth quarter of 2014 increased by $9 million compared to the fourth quarter of 2013. The increase was mainly attributable to an increase in net property income and the decrease in sustaining property and leasing capital expenditures, normalized, partially offset by increased general and administrative expenses and interest and other financing charges.
- In the fourth quarter of 2014:
    - The Company sold 16 properties to Choice Properties for an aggregate price of approximately $210 million. Consideration for the properties included 10,698,143 Class B Limited Partnership units, $98 million in cash and the assumption of a $4 million mortgage by Choice Properties. In addition, Choice Properties acquired a 40% interest in a limited partnership, which acquired land from the Company, intended for development into a mixed-used property, for approximately $6 million; and
    - Choice Properties acquired a 70% interest in a limited partnership, which holds land intended for future retail development, for approximately $18 million.
- Subsequent to the end of 2014:
    - The Company sold a warehouse to Choice Properties for approximately $81 million. The warehouse is fully occupied by the Company as the single tenant with a 20-year initial lease term with six five-year renewal options;
    - The Company sold a parcel of land to Choice Properties for approximately $12 million. Consideration for the acquisition included 265,665 Class B Limited Partnership units, $7 million in cash and the assumption of a $2 million obligation. The Class B Limited Partnership units issued to the Company as partial consideration for this transaction did not impact the Company's effective ownership percentage; and
    - Choice Properties issued $250 million aggregate principal amount of Series E senior unsecured debentures bearing interest at a rate of 2.30% per annum and maturing in 2020. The net proceeds from the issuance were used by Choice Properties to repay existing indebtedness and for general business purposes.
- As of January 3, 2015, the Company's ownership interest in Choice Properties was 82.9%.

## 13. Disclosure Controls and Procedures

Management is responsible for establishing and maintaining a system of disclosure controls and procedures to provide reasonable assurance that all material information relating to the Company and its subsidiaries is gathered and reported to senior management on a timely basis so that appropriate decisions can be made regarding public disclosure.

As required by National Instrument 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings), the President, as the Chief Executive Officer ("CEO"), and the Chief Financial Officer ("CFO") have caused the effectiveness of the disclosure controls and procedures to be evaluated. Based on that evaluation, they have concluded that the design and operation of the system of disclosure controls and procedures were effective as at January 3, 2015.

## 14. Internal Control over Financial Reporting

Management is also responsible for establishing and maintaining adequate internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial reports for external purposes in accordance with IFRS.

As required by National Instrument 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings), the President, as CEO, and the CFO have caused the effectiveness of the internal controls over financial reporting to be evaluated using the framework established in 'Internal Control – Integrated Framework (COSO Framework)' published by The Committee of Sponsoring Organizations of the Treadway Commission (COSO), 2013. Based on that evaluation, they have concluded that the design and operation of the Company's internal controls over financial reporting were effective as at January 3, 2015.

In designing such controls, it should be recognized that due to inherent limitations, any controls, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and may not prevent or detect misstatements. Projections of any evaluations of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Additionally, management is required to use judgment in evaluating controls and procedures.

**Changes in Internal Control over Financial Reporting** There were no changes in the Company's internal controls over financial reporting in the fourth quarter of 2014 that materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting, except as noted below:

In accordance with the provisions of National Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings, management, including the CEO and CFO, have limited the scope of their design of the Company's disclosure controls and procedures and internal control over financial reporting to exclude controls, policies and procedures of Shoppers Drug Mart. Loblaw acquired the net assets of Shoppers Drug Mart and its subsidiaries on March 28, 2014.

Shoppers Drug Mart's contribution to the Company's consolidated financial statements for the year ended January 3, 2015 was approximately 20 percent of consolidated revenues and approximately 35 percent of consolidated adjusted operating income. Additionally, Shoppers Drug Mart's current assets and current liabilities were approximately 30 percent and 25 percent of consolidated current assets and liabilities, respectively, and its long term assets and long term liabilities were approximately 55 percent and 20 percent of consolidated long term assets and long term liabilities, respectively.

The scope limitation is primarily based on the time required to assess Shoppers Drug Mart's disclosure controls and procedures (DC&P) and internal controls over financial reporting in a manner consistent with the Company's other operations. The assessment on the design effectiveness of DC&P and internal controls over financial reporting is on track for completion by the second quarter of 2015 and the assessment of operating effectiveness will be completed by fourth quarter of 2015.

Further details related to the acquisition of Shoppers Drug Mart are disclosed in Section 7 "Acquisition of Shoppers Drug Mart Corporation" of this MD&A and in the notes to the Company's annual audited consolidated financial statements for the fiscal year ended January 3, 2015.

## 15. Enterprise Risks and Risk Management

The Company is committed to maintaining a framework that ensures risk management is an integral part of its activities. To ensure the continued growth and success of the Company, risks are identified and managed through an Enterprise Risk Management ("ERM") program. The Board has approved an ERM policy and oversees the ERM program through approval of the Company's risks and risk prioritization. The ERM program assists all areas of the business in managing appropriate levels of risk tolerance by bringing a systematic approach, methodology and tools for evaluating, measuring and monitoring key risks. The results of the ERM program and other business planning processes are used to identify emerging risks to the Company, prioritize risk management activities and develop a risk-based internal audit plan.

Risks are not eliminated through the ERM program. Risks are identified and managed within understood risk tolerances. The ERM program is designed to:

- promote a culture of awareness of risk management and compliance within the Company;
- facilitate corporate governance by providing a consolidated view of risks across the Company and insight into the methodologies for identification, assessment, measurement and monitoring of the risks;
- assist in developing consistent risk management methodologies and tools across the organization; and
- enable the Company to focus on its key risks in the business planning process and reduce harm to financial performance through responsible risk management.

Risk identification and assessments are important elements of the Company's ERM framework. An annual ERM assessment is completed to assist in the update and identification of internal and external risks, which may be both strategic and operational in nature. Key risks affecting the Company are prioritized under five categories: financial, operational, regulatory, human capital and reputational risks. The annual ERM assessment is carried out through interviews, surveys and facilitated workshops with management and the Board. Risks are assessed and evaluated based on the Company's vulnerability to the risk and the potential impact that the underlying risks would have on the Company's ability to execute its strategies and achieve its objectives. Risk owners are assigned relevant risks and key risk indicators are developed. Management provides a semi-annual update to a committee of the Board on the status of the key risks based on significant changes from the prior update, anticipated impacts in future quarters and significant changes in key risk indicators. In addition, the long term risk level is assessed to monitor potential long term risk impacts, which may assist in risk mitigation planning activities. Accountability for oversight of the management of each risk is allocated by the Board either to the full Board or to a committee of the Board.

Operating and financial risks which are reasonably likely to affect the Company's future performance are discussed below. Any of these risks has the potential to negatively affect the Company and its financial performance. The Company has risk management strategies, including insurance programs, controls and contractual arrangements. However, there can be no assurance that the associated risks will be mitigated or will not materialize or that events or circumstances will not occur that could adversely affect the Company's financial condition or performance. The risks included below should be read in conjunction with the risks included in the Company's AIF (for the year ended January 3, 2015).

### 15.1 Operating Risks and Risk Management

The following is a summary of the Company's key operating risks which are discussed in detail below:

| | |
|---|---|
| Acquisition of Shoppers Drug Mart Corporation | Competitive Environment |
| IT Systems Implementations | Regulatory and Tax |
| Pharmacy Industry Regulations | Legal Proceedings |
| Inventory Management | Vendor Management and Third Party Service Providers |
| Information Integrity and Reliability | Franchisee Independence and Relationships |
| Availability, Access and Security of Information Technology | Associate-owned Drug Store Network and Relationships with Associates |
| Product Safety and Public Health | Alternative Arrangements for Sourcing Generic Drug Products |
| Labour Relations | Multi-Employer Pension Plans |

### Discussion of Operating Risks and Risk Management Strategies

**Acquisition of Shoppers Drug Mart Corporation** On March 28, 2014, the Company acquired all of the outstanding shares of Shoppers Drug Mart. The realization of the anticipated strategic benefits associated with this acquisition will depend on several factors and will require significant effort on the part of management of the Company. Failure to realize the anticipated strategic benefits or operational, competitive and cost synergies associated with this acquisition could adversely affect the reputation, operations or financial performance of the Company.

**IT Systems Implementations** The Company continues to undertake a major upgrade of its IT infrastructure. Completing the IT systems deployment will require continued focus and investment. Failure to successfully migrate from legacy systems to the new IT systems or a significant disruption in the Company's current IT systems during the implementation of the new systems could result in a lack of accurate data to enable management to effectively manage day-to-day operations of the business or achieve its operational objectives, causing significant disruptions to the business and potential financial losses. Failure to successfully adopt the new IT systems or to implement appropriate processes to support them could result in inefficiencies and duplication in processes, which could in turn adversely affect the reputation, operations and financial performance of the Company. Failure to realize the anticipated strategic benefits including revenue growth, anticipated cost savings or operating efficiencies associated with the new IT systems could adversely affect the reputation, operations or financial performance of the Company.

**Pharmacy Industry Regulation** With the acquisition of Shoppers Drug Mart, the Company is reliant on prescription drug sales for a more significant portion of its sales and profits. Prescription drugs and their sales are subject to numerous federal, provincial, territorial and local laws and regulations. Changes to these laws and regulations, or non-compliance with these laws and regulations, could adversely affect the reputation, operations or financial performance of the Company.

Federal and provincial laws and regulations that establish public drug plans typically regulate prescription drug coverage, patient eligibility, pharmacy reimbursement, drug product eligibility and drug pricing and may also regulate manufacturer allowance funding that is provided to or received by pharmacy or pharmacy suppliers. With respect to pharmacy reimbursement, such laws and regulations typically regulate the allowable drug cost of a prescription drug product, the permitted mark-up on a prescription drug product and the professional or dispensing fees that may be charged on prescription drug sales to patients eligible under the public drug plan. With respect to drug product eligibility, such laws and regulations typically regulate the requirements for listing the manufacturer's products as a benefit or partial benefit under the applicable governmental drug plan, drug pricing and, in the case of generic prescription drug products, the requirements for designating the product as interchangeable with a branded prescription drug product. In addition, other federal, provincial, territorial and local laws and regulations govern the approval, packaging, labeling, sale, marketing, advertising, handling, storage, distribution, dispensing and disposal of prescription drugs.

Sales of prescription drugs, pharmacy reimbursement and drug prices may be affected by changes to the health care industry, including legislative or other changes that impact patient eligibility, drug product eligibility, the allowable cost of a prescription drug product, the mark-up permitted on a prescription drug product, the amount of professional or dispensing fees paid by third-party payers or the provision or receipt of manufacturer allowances by pharmacy and pharmacy suppliers.

The majority of prescription drug sales are reimbursed or paid by third-party payers, such as governments, insurers or employers. These third-party payers have pursued and continue to pursue measures to manage the costs of their drug plans. Each provincial jurisdiction has implemented legislative and/or other measures directed towards managing pharmacy service costs and controlling increasing drug costs incurred by public drug plans and private payers which impact pharmacy reimbursement levels and the availability of manufacturer allowances. Legislative measures to control drug costs include lowering of generic drug pricing, restricting or prohibiting the provision of manufacturer allowances and placing limitations on private label prescription drug products. Other measures that have been implemented by certain government payers include restricting the number of interchangeable prescription drug products which are eligible for reimbursement under provincial drug plans. Additionally, the Council of the Federation, an institution created by the provincial Premiers in 2003 to collaborate on intergovernmental relations, continues its work regarding cost reduction initiatives for pharmaceutical products and services.

Legislation in certain provincial jurisdictions establish listing requirements that ensure that the selling price for a prescription drug product will not be higher than any selling price established by the manufacturer for the same prescription drug product under other provincial drug insurance programs. In some provinces, elements of the laws and regulations that impact pharmacy reimbursement and manufacturer allowances for sales to the public drug plans are extended by legislation to sales in the private sector. Also, private third-party payers (such as corporate employers and their insurers) are looking or may look to benefit from any measures implemented by government payers to reduce prescription drug costs for public plans by attempting to extend these measures to prescription drug plans they own or manage. Accordingly, changes to pharmacy reimbursement and manufacturer allowances for a public drug plan could also impact pharmacy reimbursement and manufacturer allowances for private sector sales. In addition, private third-party payers could reduce pharmacy reimbursement for prescription drugs provided to their members or could elect to reimburse members only for products included on closed formularies or available from preferred providers.

Ongoing changes impacting pharmacy reimbursement programs, prescription drug pricing and manufacturer allowance funding, legislative or otherwise, are expected to continue to put downward pressure on prescription drug sales. These changes may have a material adverse impact on the Company's business, sales and profitability. In addition, the Company could incur significant costs in the course of complying with any changes in the regulatory regime affecting prescription drugs. Non-compliance with any such existing or proposed laws or regulations, particularly those that provide for the licensing and conduct of wholesalers, the licensing and conduct of pharmacists, the regulation and ownership of pharmacies, the advertising of pharmacies and prescription services, the provision of information concerning prescription drug products, the pricing of prescription drugs and restrictions on manufacturer allowance funding, could result in audits, civil or regulatory proceedings, fines, penalties, injunctions, recalls or seizures, any of which could adversely affect the reputation, operations and financial performance of the Company.

**Inventory Management** The Company is subject to risks associated with managing its inventory. Failure to successfully manage such risks could result in shortages of inventory, or excess or obsolete inventory which cannot be sold profitably or increases in levels of inventory shrink. Any of these outcomes could negatively affect the financial results of the Company. The Company is continuing to convert its grocery stores to a new IT system, and in doing so is gaining increased visibility to integrated costing and sales information at store level. With this increased visibility, the Company will have more precise information to better identify and assess risks relating to inventory, however this will not eliminate such risks.

**Information Integrity and Reliability** Management depends on relevant and reliable information for decision making purposes, including key performance indicators and financial reporting. A lack of relevant and reliable information necessary to manage the business could preclude the Company from optimizing its overall performance. Any significant loss of data or failure to maintain reliable data could adversely affect the reputation, operations or financial performance of the Company.

**Availability, Access and Security of Information Technology** The Company is reliant on the continuous and uninterrupted operations of its IT systems. Point of sale availability, 24/7 user access and security of all IT systems, including distribution of prescription drugs and reimbursement by third-party payors, are critical elements to the operations of the Company. Protection against cyber security incidents and cloud security, and security of all of the Company's IT systems are critical to the operations of the Company. Any IT failure pertaining to availability, access or system security could result in disruption for the customer and could adversely affect the reputation, operations or financial performance of the Company.

**Product Safety and Public Health** The Company is subject to risks associated with product safety and defects, including the Company's control brand products. The Company could be adversely affected in the event of a significant outbreak of food-borne illness or other public health concerns related to food, health and wellness, including pharmaceuticals, or general merchandise products. The occurrence of such events or incidents could result in harm to customers, negative publicity or damage to the Company's brands and could lead to unforeseen liabilities from legal claims or otherwise. Failure to trace or locate any contaminated or defective products could affect the Company's ability to be effective in a recall situation. Any of these events, as well as the failure to maintain the cleanliness and health standards at store level, could adversely affect the reputation, operations or financial performance of the Company.

**Labour Relations** The Company's workforce is comprised of both unionized and non-unionized colleagues. With respect to those colleagues that are covered by collective agreements, there can be no assurance as to the outcome of any labour negotiations or the timing of their completion. Failure to renegotiate collective agreements could result in strikes, work stoppages or business interruptions, and if any of these events were to occur, they could adversely affect the reputation, operations or financial performance of the Company. If non-unionized colleagues become unionized, the terms of the resulting collective agreements would have implications for the affected operations and those implications could be material.

**Competitive Environment** The retail industry in Canada is highly competitive. If the Company is ineffective in responding to consumer trends or in executing its strategic plans, its financial performance could be adversely affected.

The Company's competitors include supermarket and retail drug store operators, as well as mass merchandisers, warehouse clubs, on-line retailers, mail order prescription drug distributors, limited assortment stores, discount stores, convenience stores and specialty stores. Many of these competitors now offer a selection of food, drug store and general merchandise. Others remain focused on supermarket-type merchandise. The Company is subject to competitive pressures from new entrants into the marketplace and from the expansion or renovation of existing competitors, particularly those expanding into the grocery market. The Company's inability to effectively predict market activity or compete effectively with its current or future competitors could result in, among other things, reduced market share and lower pricing in response to its competitors' pricing activities. Failure by the Company to sustain its competitive position could adversely affect the financial performance of the Company.

**Regulatory and Tax** Changes to any of the laws, rules, regulations or policies (collectively, "laws") applicable to the Company's business, including laws affecting all types of taxes, and laws affecting the production, processing, preparation, distribution, packaging and labelling of products, could have an adverse impact on the financial or operational performance of the Company. In the course of complying with such changes, the Company could incur significant costs. Changing laws or interpretations of such laws or enhanced enforcement of existing laws could restrict the Company's operations or profitability and thereby threaten the Company's competitive position and ability to efficiently conduct business. Failure by the Company to comply with applicable laws and orders could subject the Company to civil or regulatory actions, investigations or proceedings, including fines, assessments, injunctions, recalls or seizures, which in turn could adversely affect the reputation, operations or financial performance of the Company.

The Company is subject to tax audits from various government and regulatory agencies on an ongoing basis. As a result, from time to time, taxing authorities may disagree with the positions and conclusions taken by the Company in its tax filings or legislation could be amended or interpretations of current legislation could change, any of which events could lead to reassessments. These reassessments could have a material impact on the Company.

In 2012, the Company received indication from the CRA that the CRA intends to proceed with reassessments of the tax treatment of the Company's wholly owned subsidiary, Glenhuron. The CRA's position is that certain income earned by Glenhuron in Barbados in respect of the 2000 to 2010 taxation years should be treated, and taxed, as income in Canada.

Based on the proposal letter from the CRA, if the CRA and the relevant provincial tax authorities were to prevail in all of these reassessments, which the Company believes would be unlikely, the estimated total tax and interest for the 2000 to 2010 taxation years would be approximately $440 million, which would increase as interest accrues. However, the Company is in discussions with the CRA about the amount of taxes in dispute. The Company believes it is likely that the CRA and the relevant provincial tax authorities will issue reassessments for 2011 to 2013 on the same or similar basis. No amount for any reassessments has been provided for in the Company's consolidated financial statements.

Subsequent to the end of 2014, the Company received a letter from the CRA stating that the CRA will be proceeding with the reassessments. The Company expects to receive reassessments from the CRA and the relevant provincial tax authorities sometime in the coming months. The Company strongly disagrees with the CRA's position and intends to vigorously defend its position including appealing the reassessments as and when they are received. The Company will make cash payments or provide other forms of security on a portion of the taxes in dispute. If the Company is successful in defending its position, in whole or in part, some or all of the cash payments or security would be returned to the Company. If the CRA were to ultimately prevail with respect to the proposed reassessment or if the CRA were to successfully pursue other reassessments, the outcome could have a negative material impact on the Company's reputation, results of operations and financial position of the Company in the year(s) of resolution.

As part of the review undertaken by the Competition Bureau of the acquisition by the Company of Shoppers Drug Mart, it expressed concerns about practices that the Company has in place with certain suppliers. In connection with this review, the Competition Bureau issued requests for documents from 12 suppliers of the Company. The Company has and will continue to cooperate with the Competition Bureau in its review of these practices. At this stage of the review, it is not possible to predict when the review will be completed or the outcome of such review. If the Competition Bureau is not satisfied that the Company's practices satisfy the Competition Bureau's objectives of maintaining competitive markets, then the Competition Bureau may pursue remedies that could have a negative material impact on the Company's reputation, results of operations and financial position of the Company.

PC Bank operates in a highly regulated environment and a failure by it to comply, understand, acknowledge and effectively respond to applicable regulators could result in monetary penalties, regulatory intervention and reputational damage.

Choice Properties is currently classified as a "unit trust" and a "mutual fund trust" under the *Income Tax Act*. It also qualifies for the Real Estate Investment Trust Exception under the *Income Tax Act* and as such is not subject to specified investment flow-through rules. If Choice Properties ceases to qualify for these and other classifications and exceptions, the taxation of Choice Properties and unitholders, including Loblaw, could be materially adversely different in certain respects, which in turn could materially adversely affect the trading price of the Units.

**Legal Proceedings** As part of its normal course of operations, the Company is involved in and potentially subject to a variety of legal claims and proceedings. With the acquisition of Shoppers Drug Mart, the Company is the subject of a class action brought by two licensed Associate-owners. The claim seeks damages in the amount of $500 million based on alleged breaches of the Associate Agreement with Shoppers Drug Mart. At this stage of the proceeding any potential liability and the quantum of any loss cannot be determined. Since litigation is inherently uncertain, the outcome of this class action, and all other litigation proceedings and claims remains uncertain. However, based on information currently available, these matters, individually and in the aggregate, are not expected to have a material impact on the Company. In the event that management's assessment of materiality of current claims and proceedings proves inaccurate or litigation that is material arises in the future, there may be a material adverse effect on the Company's operations, revenues or financial performance.

**Vendor Management and Third Party Service Providers** The Company relies on vendors, including offshore vendors in both mature and developing markets, to provide the Company with goods and services. Offshore sourcing increases certain risks to the Company, including risks associated with food safety and general merchandise product defects, non-compliance with ethical and safe business practices and inadequate supply of products. The Company has no direct influence over how vendors are managed. Negative events affecting vendors or inefficient, ineffective or incomplete vendor management strategies, policies and/or procedures could adversely impact the Company's reputation and impair the Company's ability to meet customer needs or control costs and quality, which could adversely affect the reputation, operations and financial performance of the Company.

The Company also uses third party suppliers, carriers, logistic service providers and operators of warehouses and distribution facilities, including for product development, design and sourcing of the Company's control brand apparel products. Ineffective selection, contract terms or relationship management could impact the Company's ability to source control brand products, to have products available for customers, to market to customers or to operate efficiently and effectively. Disruption in services from third party suppliers could interrupt the delivery of merchandise to stores, thereby adversely affecting the operations or financial performance of the Company.

*President's Choice Financial* banking services are provided by a major Canadian chartered bank. PC Bank uses third party service providers to process credit card transactions, operate call centres and operationalize certain risk management strategies for the *President's Choice Financial* MasterCard®. A significant disruption in the services provided by the chartered bank or by third party service providers would adversely affect the financial performance of PC Bank and the Company.

The Company relies on third parties for investment management, custody and other services for its cash equivalents, short term investments, security deposits and pension assets. Any disruption in the services provided by these suppliers could adversely affect the return on these assets or liquidity of the Company.

**Franchisee Independence and Relationships** A substantial portion of the Company's revenues and earnings comes from amounts paid by franchisees of its grocery store operations. Franchisees are independent businesses and, as a result, their operations may be negatively affected by factors beyond the Company's control, which in turn could negatively affect the Company's reputation, operations and financial performance. Revenues and earnings could also be negatively affected, and the Company's reputation could be harmed, if a significant number of franchisees were to experience operational failures, health and safety exposures or were unable to pay the Company for products, rent or fees. The Company's franchise system is also subject to franchise legislation enacted by a number of provinces. Any new legislation or failure to comply with existing legislation could negatively affect operations and could add administrative costs and burdens, any of which could affect the Company's relationship with its franchisees. Relationships with franchisees could pose significant risks if they are disrupted, which could negatively affect the reputation, operations and financial performance of the Company. Supply chain or system changes by the Company could cause or be perceived to cause disruptions to franchise operations and could result in negative effects on franchisee financial performance. Reputational damage or adverse consequences for the Company, including litigation and disruption to revenue from franchise stores could result.

**Associate-owned Drug Store Network and Relationships with Associates** The success of the Company and the reputation of its brands are closely tied to the performance of the Shoppers Drug Mart Associate-owned drug stores. Accordingly, the Company relies on Associates to successfully operate, manage and execute retail programs and strategies at their respective drug store locations. Associates are independent business operators and the success of the operations and financial performance of their respective drug stores may be beyond the Company's control. In addition, Associates operate in the same regulatory framework as described above under "Franchisee Independence and Relationships". Disruptions to the Company's relationships with Shoppers Drug Mart Associate-owned drug stores or changes in legislation could negatively affect revenue from Associates, which in turn, could adversely affect the reputation, operations or financial performance of the Company.

**Alternative Arrangements for Sourcing Generic Drug Products** As the utilization rate of generic prescription drugs increases, the Company is pursuing alternative sourcing and procurement models for generic prescription drug products. As part of this alternative sourcing and procurement initiative, the Company has entered into contracts for the fabrication of private label generic prescription drug products. These alternative sourcing and procurement models contain certain additional risks beyond those associated with the Company's conventional procurement strategy. The most significant of these additional risks are product liability and intellectual property infringement. Product liability claims may arise in the event that the use of the Company's products cause, or are alleged to have caused, any injury to consumers. Intellectual property infringement claims may arise in the event that the Company's products infringe or violate, or are alleged to infringe or violate, the patents or other intellectual property rights of any third parties, including the brand manufacturer. Both product liability and intellectual property infringement claims could be costly to defend and could result in significant liabilities and monetary damages. Failure to successfully implement these alternative sourcing and procurement models could adversely affect the reputation, operations or financial performance of the Company.

In addition, the market for generic prescription drug products and eligibility for reimbursement from governmental and other third-party payers will depend on the extent to which the products are designated as interchangeable with the branded products and are included as a benefit on the public drug plans in Canada. These interchangeability designations and benefit listings are highly regulated and will be dependent on the products and the procurement model meeting the regulatory requirements. If the demand for generic products is negatively affected by fewer designations, it could adversely affect the reputation, operations or financial performance of the Company.

**Multi-Employer Pension Plans** In addition to the Company-sponsored pension plans, the Company participates in various multi-employer pension plans, providing pension benefits to union employees pursuant to provisions of collective bargaining agreements. Approximately 27% (2013 – 39%) of employees of the Company, and of its franchisees and Associates, participate in these plans. These plans are administered by independent boards of trustees generally consisting of an equal number of union and employer representatives. In some circumstances, the Company has a representative on the board of trustees of these plans. The Company's responsibility to make contributions to these plans is limited by the amounts established pursuant to its collective agreements; however, poor performance of these plans could have an adverse impact on the Company's employees and former employees who are members of these plans or could result in changes to the terms and conditions of participation in these plans, which in turn could adversely affect the financial performance of the Company.

The Company, together with its franchisees, is the largest participating employer in the Canadian Commercial Workers Industry Pension Plan ("CCWIPP"), with approximately 52,000 (2013 – 53,000) employees as members. In 2014, the Company contributed approximately $54 million (2013 – $54 million) to CCWIPP. The recent actuarial reports filed for CCWIPP indicate that the Plan is underfunded with the accrued benefit obligations exceeding the value of CCWIPP assets. Any benefit reductions would negatively affect the retirement benefits of the Company's employees, which in turn could negatively affect their morale and productivity and, in turn, could adversely affect the reputation of the Company.

### 15.2 Financial Risks and Risk Management

The Company is exposed to a number of financial risks, including those associated with financial instruments, which have the potential to affect its operating and financial performance. The Company uses over-the-counter derivative instruments to offset certain of these risks. Policies and guidelines prohibit the use of any derivative instrument for trading or speculative purposes. The fair value of derivative instruments is subject to changing market conditions which could adversely affect the financial performance of the Company.

The following is a list of the Company's financial risks which are discussed in detail below:

| | |
|---|---|
| Level of Indebtedness | Foreign Currency Exchange Rates |
| Liquidity | Interest Rates |
| Choice Properties' Capital Availability | Credit |
| Commodity Prices | Choice Properties Unit Price |

### Discussion of Financial Risks

**Level of Indebtedness** To fund the cash portion of the acquisition of Shoppers Drug Mart, the Company utilized excess cash and significantly increased its indebtedness. Although the Company has made progress in reducing its indebtedness subsequent to the acquisition of Shoppers Drug Mart, there can be no assurance that the Company will generate sufficient free cash flow to significantly further reduce indebtedness and maintain adequate cash reserves. A failure to achieve these objectives could adversely affect the Company's credit ratings and its cost of funding.

If the Company, PC Bank or Choice Properties' financial performance and condition deteriorate or downgrades in the Company's or Choice Properties' current credit ratings occur, their ability to obtain funding from external sources could be restricted, which could adversely affect the financial performance of the Company.

**Liquidity** Liquidity risk is the risk that the Company is unable to generate or obtain sufficient cash or its equivalents in a cost effective manner to fund its obligations as they come due. The Company is exposed to liquidity risk through, among other areas, PC Bank and its credit card business, which requires a reliable source of funding for its credit card business. PC Bank relies on its securitization programs and the acceptance of GIC deposits to fund the receivables of its credit cards. The Company would experience liquidity risks if it fails to maintain appropriate levels of cash and short term investments, it is unable to access sources of funding or it fails to appropriately diversify sources of funding. If any of these events were to occur, they would adversely affect the financial performance of the Company.

Liquidity risk is mitigated by maintaining appropriate levels of cash and cash equivalents and short term investments, actively monitoring market conditions, and by diversifying sources of funding, including the Company's committed credit facility, and maintaining a well-diversified maturity profile of debt and capital obligations.

**Choice Properties' Capital Availability** The real estate industry is highly capital intensive. Choice Properties requires access to capital to maintain its properties, refinance its indebtedness as well as to fund its growth strategy and certain capital expenditures from time to time. Although Choice Properties expects to have access to its credit facility, there can be no assurance that it will otherwise have sufficient capital or access to capital on acceptable terms for future property acquisitions, refinancing indebtedness, financing or refinancing properties, funding operating expenses or for other purposes. Further, in certain circumstances, Choice Properties may not be able to borrow funds due to certain limitations. Failure by Choice Properties to access required capital could have a material adverse effect on the Company's ability to pay its financial or other obligations. An inability to access capital could also impact Choice Properties' ability to make distributions which could have a material adverse effect on the trading price of Units which would adversely affect the financial performance of the Company.

**Commodity Prices** The Company is exposed to increases in the prices of commodities in operating its stores and distribution networks, as well as to the indirect effect of changing commodity prices on the price of consumer products. Rising commodity prices could adversely affect the financial performance of the Company and the impact could be material. To manage a portion of this exposure, the Company uses purchase commitments for a portion of its need for certain consumer products that are commodities based. The Company enters into exchange traded futures contracts and forward contracts to minimize cost volatility related to energy.

**Foreign Currency Exchange Rates** The Company is exposed to foreign currency exchange rate variability, primarily on its USD denominated based purchases in trade payables and other liabilities. A depreciating Canadian dollar relative to the USD will have a negative impact on year-over-year changes in reported operating income and net earnings, while an appreciating Canadian dollar relative to the USD will have the opposite impact.

**Interest Rates** The Company is exposed to interest rate risk from fluctuations in interest rates on its floating rate debt and financial instruments, net of cash and cash equivalents, short term investments and security deposits. An increase in interest rates could adversely affect the financial performance of the Company. The Company manages interest rate risk by monitoring the respective mix of fixed and floating rate debt, net of cash and cash equivalents, short term investments and security deposits, and by taking action as necessary to maintain an appropriate balance considering current market conditions.

**Credit** The Company is exposed to credit risk resulting from the possibility that counterparties could default on their financial obligations to the Company. Exposure to credit risk relates to derivative instruments, cash and cash equivalents, short term investments, security deposits, PC Bank's credit card receivables, franchise loans receivable, pension assets held in the Company's defined benefit plans and accounts receivable, including amounts due from independent franchisees, government, prescription sales and third-party drug plans, independent accounts and amounts owed from vendors. Failure to manage credit risk could adversely affect the financial performance of the Company.

The risk related to derivative instruments, cash and cash equivalents, short term investments and security deposits is reduced by policies and guidelines that require that the Company enters into transactions only with counterparties or issuers that have a minimum long term "A-" credit rating from a recognized credit rating agency and place minimum and maximum limits for exposures to specific counterparties and instruments.

Choice Properties mitigates the risk of credit loss relating to rent receivables by evaluating the creditworthiness of new tenants, obtaining security deposits wherever permitted by legislation, ensuring its tenant mix is diversified and by limiting its exposure to any one tenant except Loblaw. Choice Properties establishes an allowance for doubtful accounts that represents the estimated losses with respect to rents receivable. The allowance is determined on a tenant-by-tenant basis based on the specific factors related to the tenant.

PC Bank manages its credit card receivable risk by employing stringent credit scoring techniques, actively monitoring the credit card portfolio and reviewing techniques and technology that can improve the effectiveness of the collection process. In addition, these receivables are dispersed among a large, diversified group of credit card customers.

Franchise loans receivable and accounts receivable, including amounts due from independent franchisees, governments, prescription sales covered by third-party drug plans, independent accounts and amounts owed from vendors, are actively monitored on an ongoing basis and settled on a frequent basis in accordance with the terms specified in the applicable agreements.

**Choice Properties Unit Price** The Company is exposed to market price risk as a result of Choice Properties' Units that are held by unitholders other than the Company. These Units are presented as a liability on the Company's consolidated balance sheets as they are redeemable for cash at the option of the holder. The liability is recorded at fair value at each reporting period based on the market price of Units. The change in the fair value of the liability negatively impacts net earnings when the Unit price increases and positively impacts net earnings when the Unit price declines.

## 16. Related Party Transactions

The Company's controlling shareholder is Weston, which owns, directly and indirectly, 187,815,136 of the Company's common shares, representing approximately 46% of the Company's outstanding common shares. Mr. W. Galen Weston controls Weston, directly and indirectly through private companies which he controls, including Wittington Investments, Limited ("Wittington") who owns a total of 80,746,099 of Weston's common shares, representing approximately 63% of Weston's outstanding common shares. Mr. Weston also beneficially owns 5,096,189 of the Company's common shares, representing approximately 1% of the Company's outstanding common shares. The Company's policy is to conduct all transactions and settle all balances with related parties on market terms and conditions.

Transactions with Related Parties

| | Transaction Value | |
|---|---|---|
| (millions of Canadian dollars) | **2014 (53 weeks)** | 2013 (52 weeks) |
| **Included in Cost of Merchandise Inventories Sold** | | |
| Inventory purchases from a subsidiary of Weston | **$ 615** | $ 601 |
| Inventory purchases from a related party(i) | **24** | 22 |
| **Operating Income** | | |
| Cost sharing agreements with Parent(ii) | **$ 20** | $ 9 |
| Net administrative services provided by Parent(iii) | **18** | 13 |
| Choice Properties distributions to Parent(iv) | **14** | 6 |
| Lease of office space from a subsidiary of Wittington | **3** | 3 |

(i) Associated British Foods plc is a related party by virtue of Mr. W. Galen Weston being a director of such entity's parent company. Total balance outstanding owing to Associated British Foods plc as at January 3, 2015 was $3 million (December 28, 2013 – $4 million).

(ii) Weston and the Company have each entered into certain contracts with third parties for administrative and corporate services, including telecommunication services and IT related matters on behalf of itself and the related party. Through cost sharing agreements that have been established between the Company and Weston concerning these costs, the Company has agreed to be responsible to Weston for the Company's proportionate share of the total costs incurred.

(iii) The Company and Weston have entered into an agreement whereby certain administrative services are provided by one party to the other. The services to be provided under this agreement include those related to commodity management, pension and benefits, tax, medical, travel, information system, risk management, treasury and legal. Payments are made quarterly based on the actual costs of providing these services. Where services are provided on a joint basis for the benefit of the Company and Weston together, each party pays the appropriate proportion of the costs. Fees paid under this agreement are reviewed each year by the Audit Committee.

(iv) Weston is a unitholder of Choice Properties and is entitled to receive distributions declared by the trust. Unitholders who elect to participate in the Choice Properties Distribution Reinvestment Plan ("DRIP") receive a further distribution, payable in Units, equal in value to 3% of each cash distribution. In 2014, Choice Properties issued 1,306,847 Units (2013 – 107,810 Units) to Weston under its DRIP at a weighted average price of $10.30 (2013 – $10.05) per Unit.

The net balances due to Weston are comprised as follows:

| (millions of Canadian dollars) | **As at January 3, 2015** | As at December 28, 2013 |
|---|---|---|
| Trade payables and other liabilities | **$ 7** | $ 27 |

**Joint Venture** In 2014, a joint venture, formed between Choice Properties and Wittington, completed the acquisition of property from Loblaw. The joint venture intends to develop the acquired site into a mixed-used property, anchored by a Loblaw food store. As at January 3, 2015, the joint venture did not have any operating activity. Choice Properties uses the equity method of accounting to record its 40% interest in the joint venture, which is included in other assets.

**Post-Employment Benefit Plans** The Company sponsors a number of post-employment plans, which are related parties. Contributions made by the Company to these plans are disclosed in the notes to the consolidated financial statements.

**Income Tax Matters** From time to time, the Company, Weston and its affiliates may enter into agreements to make elections that are permitted or required under applicable income tax legislation with respect to affiliated corporations. In 2014, these elections and accompanying agreements did not have a material impact on the Company.

**Key Management Personnel** The Company's key management personnel are comprised of the Board and certain members of the executive team of the Company, as well as both the Board and certain members of the executive team of Weston and Wittington to the extent that they have the authority and responsibility for planning, directing and controlling the day-to-day activities of the Company.

**Compensation of Key Management Personnel** Annual compensation of key management personnel that is directly attributable to the Company was as follows:

| (millions of Canadian dollars) | **2014 (53 weeks)** | 2013 (52 weeks) |
|---|---|---|
| Salaries, director fees and other short term employee benefits | **$ 9** | $ 8 |
| Equity-based compensation | **3** | 6 |
| Total compensation | **$ 12** | $ 14 |

## 17. Critical Accounting Estimates and Judgments

The preparation of the consolidated financial statements requires management to make estimates and judgments in applying the Company's accounting policies that affect the reported amounts and disclosures made in the consolidated financial statements and accompanying notes.

Within the context of this Annual Report, a judgment is a decision made by management in respect of the application of an accounting policy, a recognized or unrecognized financial statement amount and/or note disclosure, following an analysis of relevant information that may include estimates and assumptions. Estimates and assumptions are used mainly in determining the measurement of balances recognized or disclosed in the consolidated financial statements and are based on a set of underlying data that may include management's historical experience, knowledge of current events and conditions and other factors that are believed to be reasonable under the circumstances. Management continually evaluates the estimates and judgments it uses.

The following are the accounting policies subject to judgments and key sources of estimation uncertainty that the Company believes could have the most significant impact on the amounts recognized in the consolidated financial statements.

### 17.1 Consolidation

***Judgments Made in Relation to Accounting Policies Applied*** The Company uses judgment in determining the entities that it controls and therefore consolidates. The Company controls an entity when the Company has the existing rights that give it the current ability to direct the activities that significantly affect the entities' returns. The Company consolidates all of its wholly owned subsidiaries. Judgment is applied in determining whether the Company controls the entities in which it does not have ownership rights or does not have full ownership rights. Most often, judgment involves reviewing contractual rights to determine if rights are participating (giving power over the entity) or protective rights (protecting the Company's interest without giving it power).

### 17.2 Inventories

***Key Sources of Estimation*** Inventories are carried at the lower of cost and net realizable value which requires the Company to utilize estimates related to fluctuations in shrink, future retail prices, the impact of vendor rebates on cost, seasonality and costs necessary to sell the inventory.

### 17.3 Impairment of Non-Financial Assets (Goodwill, Intangible Assets, Fixed Assets and Investment Properties)

***Judgments Made in Relation to Accounting Policies Applied*** Management is required to use judgment in determining the grouping of assets to identify their cash generating units ("CGUs") for the purposes of testing fixed assets for impairment. Judgment is further required to determine appropriate groupings of CGUs, for the level at which goodwill and intangible assets are tested for impairment. The Company has determined that each location is a separate CGU for purposes of fixed asset impairment testing. For the purpose of goodwill and indefinite life intangible impairment testing, CGUs are grouped at the lowest level at which goodwill and intangibles are monitored for internal management purposes. In addition, judgment is used to determine whether a triggering event has occurred requiring an impairment test to be completed.

***Key Sources of Estimation*** In determining the recoverable amount of a CGU or a group of CGUs, various estimates are employed. The Company determines fair value less costs to sell using such estimates as market rental rates for comparable properties, recoverable operating costs for leases with tenants, non-recoverable operating costs, discount rates, capitalization rates and terminal capitalization rates. The Company determines value in use by using estimates including projected future sales, earnings and capital investment consistent with strategic plans presented to the Board. Discount rates are consistent with external industry information reflecting the risk associated with the specific cash flows.

**17.4 Franchise Loans Receivable and Certain Other Financial Assets**

***Judgments Made in Relation to Accounting Policies Applied*** Management reviews franchise loans receivable, trade receivables and certain other assets relating to the Company's franchise business at each balance sheet date utilizing judgment to determine whether a triggering event has occurred requiring an impairment test to be completed.

***Key Sources of Estimation*** Management determines the initial fair value of its franchise loans and certain other financial assets using discounted cash flow models. The process of determining these fair values requires management to make estimates of a long term nature regarding discount rates, projected revenues, and margins, as applicable, derived from past experience, actual operating results, budgets and the Company's five year forecast.

**17.5 Loyalty Programs**

***Key Sources of Estimation*** The Company defers revenue equal to the fair value of the award points earned by loyalty program members at the time of award. The Company determines fair value using such estimates as breakage (the amount of points that will never be redeemed) and the estimated retail value per point on redemption. The trends in breakage are reviewed on an ongoing basis and the estimated retail value per point is adjusted based on expected future activity.

**17.6 Income and Other Taxes**

***Judgments Made in Relation to Accounting Policies Applied*** The calculation of current and deferred income taxes requires management to make certain judgments regarding the tax rules in jurisdictions where the Company performs activities. Application of judgments is required regarding the classification of transactions and in assessing probable outcomes of claimed deductions including expectations about future operating results, the timing and reversal of temporary differences and possible audits of income tax and other tax filings by the tax authorities.

**18. Accounting Standards**

**18.1 Accounting Standards Implemented in 2014 and Changes to Significant Accounting Policies**

The Company implemented the amendments to International Accounting Standards ("IAS") 32, "Financial Instruments: Presentation" and International Financial Reporting Interpretations Committee ("IFRIC") 21, "Levies" retrospectively in 2014. There was no significant impact on the Company's annual audited consolidated financial statements as a result of the implementation of these standards.

**Vendor Allowances** The timing of recognition of vendor allowances requires judgment to determine the point at which the Company has earned the allowance. In conjunction with the acquisition of Shoppers Drug Mart, management reviewed the timing of recognition of certain vendor allowances and has determined that it would be appropriate to align the policies of both companies. The Company has implemented the change retrospectively in 2014, as follows:

Consolidated Statement of Earnings and Comprehensive Income

| Increase (Decrease)<br>(millions of Canadian dollars except where otherwise indicated) | December 28, 2013<br>(12 weeks) | December 28, 2013<br>(52 weeks) |
|---|---|---|
| Cost of Merchandise Inventories Sold | $ 18 | $ 5 |
| Operating Income | $ (18) | $ (5) |
| Earnings Before Income Taxes | $ (18) | $ (5) |
| Income taxes | (5) | (2) |
| Net Earnings | $ (13) | $ (3) |
| Total Comprehensive Income | $ (13) | $ (3) |
| Net Earnings per Common Share ($) | | |
| Basic | $ (0.04) | $ (0.01) |
| Diluted | $ (0.05) | $ (0.01) |

Consolidated Balance Sheets

| Increase (Decrease)<br>(millions of Canadian dollars) | As at<br>December 28, 2013 | As at<br>December 30, 2012 |
|---|---|---|
| Accounts receivable | $ (39) | $ (32) |
| Inventories | 13 | 11 |
| Deferred Income Tax Assets | 8 | 6 |
| Total Equity Attributable to Shareholders of the Company | $ (18) | $ (15) |

### 18.2 Future Accounting Standards

In May 2014, the International Accounting Standards Board ("IASB") issued IFRS 15, "Revenue from Contracts with Customers" ("IFRS 15"). The new standard provides a comprehensive framework for the recognition, measurement and disclosure of revenue from contracts with customers, excluding contracts within the scope of the accounting standards on leases, insurance contracts and financial instruments. IFRS 15 becomes effective for annual periods beginning on or after January 1, 2017, and is to be applied retrospectively. Early adoption is permitted. The Company is currently assessing the impact of the new standard on its consolidated financial statements.

In July 2014, the IASB issued IFRS 9, "Financial Instruments", replacing IAS 39, "Financial Instruments: Recognition and Measurement." The standard had three main phases: classification and measurement, impairment, and general hedging. The standard becomes effective for annual periods beginning on or after January 1, 2018 and is to be applied retrospectively with the exception of the general hedging phase which is applied prospectively. Early adoption is permitted. The Company is currently assessing the impact of the new standard on its consolidated financial statements.

In December 2014, the IASB issued amendments to IAS 1, "Presentation of Financial Statements" ("IAS 1 amendments"). The IAS 1 amendments provide guidance on the application of judgment in the preparation of financial statements and disclosures. The IAS 1 amendments are effective for annual periods beginning on or after January 1, 2016. Early adoption is permitted. The Company is currently assessing the impact of the IAS 1 amendments on its consolidated financial statements.

## 19. Outlook

Loblaw's strategic framework is focused on delivering the best in food, best in health and beauty, operational excellence and growth. This strategic framework is supported by a financial strategy of maintaining a stable trading environment which targets positive same-store sales[3], [6] and stable gross margin; surfacing efficiencies; delivering synergies as a result of its acquisition of Shoppers Drug Mart; and deleveraging the balance sheet.

On a full year comparative basis, reflecting 2014 financial results for Loblaw and Shoppers Drug Mart, in 2015 the Company expects to:

- Maintain positive same-store sales[3], [6] and stable gross margin (excluding synergies) in its Retail segment;
- Achieve net synergies as a result of the acquisition of Shoppers Drug Mart approaching $200 million;
- Continue to drive net efficiencies across the core grocery business by achieving reductions in supply chain, administrative functions and IT, while still investing in key areas, like eCommerce;
- Grow adjusted operating income in its core grocery business, excluding synergies;
- Experience a decline in adjusted operating income[2] in its core pharmacy business, excluding synergies, as a result of investments in key projects and other factors;
- Grow consolidated adjusted net earnings[2] (including synergies) relative to 2014, with adjusted basic net earnings per common share[2] being moderated due to a significantly increased weighted average share count (approximately 412 million in 2015 versus approximately 380 million in 2014);
- Target a capital expenditure program of approximately $1,200 million; and
- Remain on track with its deleveraging target, expecting to meet its target in the first quarter of 2016.

The Company's expectations for 2015 also include the following:

- Competitive intensity expected to remain high, but relatively stable as industry square footage growth in supermarket-type merchandise moderates; and
- Continued pressure in our pharmacy business from the ongoing impact of healthcare reform.

## 20. Non-GAAP Financial Measures

The Company uses the following non-GAAP financial measures: EBITDA, adjusted EBITDA, adjusted EBITDA margin, adjusted operating income, adjusted operating margin, adjusted net earnings, adjusted basic net earnings per common share, free cash flow, adjusted debt and adjusted debt to adjusted EBITDA and with respect to Choice Properties: adjusted funds from operations. In 2014, the Company has introduced five new financial measures: adjusted net interest expense and other financing charges, adjusted income taxes, adjusted income tax rate, Retail segment adjusted gross profit and Retail segment adjusted gross profit percentage. The Company believes these non-GAAP financial measures provide useful information to both management and investors in measuring the financial performance and financial condition of the Company for the reasons outlined below.

Management uses these and other non-GAAP financial measures to exclude the impact of certain expenses and income that must be recognized under GAAP when analyzing consolidated and segment underlying operating performance, as the excluded items are not necessarily reflective of the Company's underlying operating performance and make comparisons of underlying financial performance between periods difficult. From time to time, the Company may exclude additional items if it believes doing so would result in a more effective analysis of underlying operating performance. The exclusion of certain items does not imply that they are non-recurring.

The Company enters into exchange traded futures contracts and forward contracts to minimize cost volatility relating to fuel prices and foreign exchange rates. Pursuant to the Company's derivative instruments accounting policy, changes in the fair value of these instruments are recorded in operating income. With significant fluctuations in fuel and foreign exchange rates, commencing in the fourth quarter of 2014 the Company has excluded the fair value adjustment on fuel and foreign currency contracts in calculating adjusted operating income.

In 2014, the Company restructured its fee arrangements with the franchisees of certain franchise banners. As a result of the restructuring, the Company re-evaluated the recoverable amount of the franchise-related financial instruments and recorded a reduction in previously recorded impairment.

The Company has adjusted for Choice Properties' general and administrative costs incurred in the first half of 2014. As Choice Properties' operations commenced on July 5, 2013, there were no comparative amounts.

With the acquisition of Shoppers Drug Mart, the Company converted certain Shoppers Drug Mart cash-settled equity-based compensation awards to cash-settled awards based on the Company's common shares. The Company is exposed to market price fluctuations in its common share price as these awards are settled in cash and the associated liability is recorded at fair value at each reporting date based on the market price of the Company's common shares. The Company excludes the fair value adjustment when calculating adjusted operating income. On November 10, 2014, the Company amended these compensation awards to be settled in shares and is no longer exposed to market price fluctuations.

As of the second quarter of 2014, the Company no longer excludes net interest expense incurred in connection with the financing related to the acquisition of Shoppers Drug Mart when analyzing consolidated underlying operating performance. These amounts were excluded from adjusted net earnings and adjusted basic net earnings per common share in periods prior to the closing of the acquisition of Shoppers Drug Mart.

Beginning in 2014, the Company no longer excludes the impact of equity-settled equity-based compensation when analyzing consolidated and segment underlying operating performance. As a result, prior year adjusted EBITDA and adjusted EBITDA margin, adjusted operating income and adjusted operating margin, and adjusted net earnings and adjusted basic net earnings per common share were restated to conform with the current year's presentation.

These measures do not have a standardized meaning prescribed by GAAP and therefore they may not be comparable to similarly titled measures presented by other publicly traded companies and should not be construed as an alternative to other financial measures determined in accordance with GAAP.

**Retail Segment Adjusted Gross Profit and Retail Segment Adjusted Gross Profit Percentage** The following table reconciles Retail segment adjusted gross profit to gross profit measures reported in the consolidated statements of earnings for the periods ended January 3, 2015 and December 28, 2013. The Company believes that Retail segment adjusted gross profit is useful in assessing the Retail segment's underlying operating performance and in making decisions regarding the ongoing operations of the business.

Retail segment adjusted gross profit percentage is calculated as adjusted Retail segment gross profit divided by Retail segment sales.

| (millions of Canadian dollars) | **2014 (13 weeks)** | 2013[4] (12 weeks) | **2014 (53 weeks)** | 2013[4] (52 weeks) |
|---|---|---|---|---|
| Retail segment gross profit | **$ 2,925** | $ 1,625 | **$ 9,734** | $ 6,961 |
| Add impact of the following: | | | | |
| Recognition of fair value increment on inventory sold | **69** | — | **798** | — |
| Charge related to inventory measurement and other conversion differences | **—** | — | **190** | — |
| Retail segment adjusted gross profit | **$ 2,994** | $ 1,625 | **$ 10,722** | $ 6,961 |

***Recognition of fair value increment on inventory sold*** In connection with the acquisition of Shoppers Drug Mart, acquired assets and liabilities were recorded on the Company's consolidated balance sheets at their fair value. This resulted in a fair value adjustment to Shoppers Drug Mart inventory on the date of acquisition representing the difference between inventory cost and its fair value. This difference was recognized in cost of sales as the inventory was sold, with a resulting negative impact on gross profit. In the fourth quarter of 2014, $69 million (2013 – nil) and year-to-date $798 million (2013 – nil), was recognized in gross profit and operating income, representing the full amount of the fair value adjustment.

***Charge related to inventory measurement and other conversion differences for the Company's corporate grocery stores*** As of the end of 2014, the Company had completed the conversion of substantially all of its corporate grocery locations and associated distribution centres to the new IT systems. The implementation of a perpetual inventory system, combined with visibility to integrated costing information provided by the new IT systems, enabled the Company to estimate the cost of inventory using a more precise system-generated average cost. The impact was estimated to be a $190 million (2013 – nil) decrease in the value of the inventory, which was recognized in gross profit and operating income in 2014. The Company is undertaking the conversion of its remaining grocery locations during 2015 and additional impacts may result.

**EBITDA, Adjusted EBITDA, Adjusted EBITDA Margin, Adjusted Operating Income and Adjusted Operating Margin** The following tables reconcile earnings before income taxes, net interest expense and other financing charges and depreciation and amortization ("EBITDA"), adjusted EBITDA and adjusted operating income to operating income, which is reconciled to GAAP net earnings measures reported in the consolidated statements of earnings for the periods ended January 3, 2015 and December 28, 2013. The Company believes that adjusted EBITDA is useful in assessing the performance of its ongoing operations and its ability to generate cash flows to fund its cash requirements, including the Company's capital investments program. The Company also believes that adjusted operating income is useful in assessing the Company's underlying operating performance and in making decisions regarding the ongoing operations of the business.

Adjusted EBITDA margin is calculated as adjusted EBITDA divided by revenue. Adjusted operating margin is calculated as adjusted operating income divided by revenue.

| | | | | | 2014 (13 weeks) | | | | | 2013[4] (12 weeks) |
|---|---|---|---|---|---|---|---|---|---|---|
| (millions of Canadian dollars) | Retail | Financial Services[7] | Choice Properties[5] | Consolidation and Eliminations | Consolidated | Retail | Financial Services | Choice Properties[5] | Consolidation and Eliminations | Consolidated |
| Net earnings | | | | | $ 247 | | | | | $ 114 |
| Add impact of the following: | | | | | | | | | | |
| Net interest expense and other financing charges | | | | | 169 | | | | | 141 |
| Income taxes | | | | | 91 | | | | | 41 |
| Operating income | $ 459 | $ 49 | $ 223 | $ (224) | $ 507 | $ 252 | $ 43 | $ 186 | $ (185) | $ 296 |
| Depreciation and amortization | 388 | 2 | — | 3 | 393 | 191 | 2 | — | 3 | 196 |
| EBITDA | $ 847 | $ 51 | $ 223 | $ (221) | $ 900 | $ 443 | $ 45 | $ 186 | $ (182) | $ 492 |
| Operating income | $ 459 | $ 49 | $ 223 | $ (224) | $ 507 | $ 252 | $ 43 | $ 186 | $ (185) | $ 296 |
| Add (deduct) impact of the following: | | | | | | | | | | |
| Amortization of intangible assets acquired with Shoppers Drug Mart | 124 | — | — | — | 124 | — | — | — | — | — |
| Recognition of fair value increment on inventory sold | 69 | — | — | — | 69 | — | — | — | — | — |
| Restructuring of franchise fees | (40) | — | — | — | (40) | — | — | — | — | — |
| Shoppers Drug Mart acquisition-related costs and net divestitures loss | 14 | — | — | — | 14 | 7 | — | — | — | 7 |
| Fair value adjustment on fuel and foreign currency contracts | 4 | — | — | — | 4 | — | — | — | — | — |
| Fair value adjustment on Shoppers Drug Mart's equity-based compensation liability | 2 | — | — | — | 2 | — | — | — | — | — |
| Fixed asset and other related impairments, net of recoveries | 1 | — | — | — | 1 | (42) | — | — | — | (42) |
| Restructuring costs | — | — | — | — | — | 32 | — | — | — | 32 |
| Adjusted operating income | $ 633 | $ 49 | $ 223 | $ (224) | $ 681 | $ 249 | $ 43 | $ 186 | $ (185) | $ 293 |
| Depreciation and amortization | 388 | 2 | — | 3 | 393 | 191 | 2 | — | 3 | 196 |
| Less: Amortization of intangible assets acquired with Shoppers Drug Mart | (124) | — | — | — | (124) | — | — | — | — | — |
| Adjusted EBITDA | $ 897 | $ 51 | $ 223 | $ (221) | $ 950 | $ 440 | $ 45 | $ 186 | $ (182) | $ 489 |

| | | | | | 2014 (53 weeks) | | | | | 2013[4] (52 weeks) |
|---|---|---|---|---|---|---|---|---|---|---|
| (millions of Canadian dollars) | Retail | Financial Services[7] | Choice Properties[5] | Consolidation and Eliminations | Consolidated | Retail | Financial Services | Choice Properties[5],[i] | Consolidation and Eliminations | Consolidated |
| Net earnings | | | | | $ 53 | | | | | $ 627 |
| Add impact of the following: | | | | | | | | | | |
| Net interest expense and other financing charges | | | | | 584 | | | | | 468 |
| Income taxes | | | | | 25 | | | | | 226 |
| Operating income | $ 497 | $ 164 | $ 568 | $ (567) | $ 662 | $1,180 | $ 142 | $ 370 | $ (371) | $ 1,321 |
| Depreciation and amortization | 1,453 | 7 | — | 12 | 1,472 | 809 | 9 | — | 6 | 824 |
| EBITDA | $1,950 | $ 171 | $ 568 | $ (555) | $ 2,134 | $1,989 | $ 151 | $ 370 | $ (365) | $ 2,145 |
| Operating income | $ 497 | $ 164 | $ 568 | $ (567) | $ 662 | $1,180 | $ 142 | $ 370 | $ (371) | $ 1,321 |
| Add (deduct) impact of the following: | | | | | | | | | | |
| Recognition of fair value increment on inventory sold | 798 | — | — | — | 798 | — | — | — | — | — |
| Amortization of intangible assets acquired with Shoppers Drug Mart | 417 | — | — | — | 417 | — | — | — | — | — |
| Charge related to inventory measurement and other conversion differences | 190 | — | — | — | 190 | — | — | — | — | — |
| Shoppers Drug Mart acquisition-related costs and net divestitures loss | 72 | — | — | — | 72 | 6 | — | — | — | 6 |
| Restructuring costs | 44 | — | 2 | — | 46 | 35 | — | — | — | 35 |
| Restructuring of franchise fees | (40) | — | — | — | (40) | — | — | — | — | — |
| Fixed asset and other related impairments, net of recoveries | 15 | — | 1 | — | 16 | (32) | — | — | — | (32) |
| Choice Properties general and administrative costs | (2) | — | 11 | — | 9 | — | — | — | — | — |
| Fair value adjustment on Shoppers Drug Mart's equity-based compensation liability | 7 | — | — | — | 7 | — | — | — | — | — |
| Fair value adjustments on fuel and foreign currency contracts | 4 | — | — | — | 4 | — | — | — | — | — |
| Defined benefit plan amendments | — | — | — | — | — | (51) | — | — | — | (51) |
| Choice Properties start-up costs | — | — | — | — | — | — | — | 3 | — | 3 |
| Adjusted operating income | $2,002 | $ 164 | $ 582 | $ (567) | $ 2,181 | $1,138 | $ 142 | $ 373 | $ (371) | $ 1,282 |
| Depreciation and amortization | 1,453 | 7 | — | 12 | 1,472 | 809 | 9 | — | 6 | 824 |
| Less: Amortization of intangible assets acquired with Shoppers Drug Mart | (417) | — | — | — | (417) | — | — | — | — | — |
| Adjusted EBITDA | $3,038 | $ 171 | $ 582 | $ (555) | $ 3,236 | $1,947 | $ 151 | $ 373 | $ (365) | $ 2,106 |

(i) Based on operations beginning July 5, 2013.

***Amortization of intangible assets acquired with Shoppers Drug Mart*** The acquisition of Shoppers Drug Mart in the second quarter of 2014 included approximately $6,050 million of definite life intangible assets, which are being amortized over their estimated useful lives. During the fourth quarter of 2014, $124 million and year-to-date $417 million of amortization were recognized in operating income. Annual amortization associated with the acquired intangibles will be approximately $550 million over the next ten years, and will decrease thereafter.

***Shoppers Drug Mart acquisition-related costs and net divestitures loss*** In connection with the agreement to acquire all of the outstanding common shares of Shoppers Drug Mart, in the fourth quarter of 2014, the Company excluded nil (2013 – $7 million) and year-to-date $60 million (2013 – $16 million) of acquisition-related costs in operating income. The Company recorded a net loss related to the completed divestitures in the fourth quarter of 2014 of $14 million and year-to-date of $12 million (grouped with acquisition-related costs). Although no further significant acquisition-related costs are anticipated, further adjustments for divestitures gain or loss will be made when the remaining three Shoppers Drug Mart stores are sold. In the third quarter of 2013, in connection with the issuance of $1,600 million of unsecured notes, the Company hedged its exposure to interest rates for the period prior to issuance. As the hedge did not qualify for hedge accounting, the resulting $10 million gain on settlement was recorded in operating income.

***Restructuring costs*** In the fourth quarter of 2014 and year-to-date, the Company recorded a charge of nil (2013 – $32 million) and $46 million (2013 – $35 million), respectively, of restructuring and reorganization costs primarily associated with the reduction of corporate and store-support positions, the departure of certain executives and the realignment of certain of the Company's central office functions.

***Restructuring of franchise fees*** In the fourth quarter and year-to-date of 2014, the Company restructured its fee arrangements with the franchisees of certain franchise banners. As a result of this restructuring, the Company re-evaluated the recoverable amount of franchise-related financial instruments and recorded a reduction in previously recorded impairment of $40 million (2013 – nil).

***Fixed asset and other related impairments, net of recoveries*** At each balance sheet date, the Company assesses and, when required, records impairments and recoveries of previous impairments related to the carrying value of its fixed assets, investment properties and intangible assets. In the fourth quarter of 2014, the Company recorded an impairment of $1 million (2013 – recovery of $42 million) and year-to-date $16 million (2013 – recovery of $32 million) related to fixed asset and other related impairments.

***Choice Properties general and administrative costs*** During the fourth quarter of 2014, the Company recorded nil and year-to-date $9 million of general and administrative costs incurred by Choice Properties in operating income. The Company has adjusted for Choice Properties' general and administrative costs incurred in the first half of 2014. As Choice Properties' operations commenced on July 5, 2013, there were no comparative amounts.

***Fair value adjustment on Shoppers Drug Mart's equity-based compensation liability*** In the second quarter of 2014, in conjunction with the acquisition, the Company converted certain Shoppers Drug Mart cash-settled equity-based compensation awards to cash-settled awards based on the Company's common shares. The Company is exposed to market price fluctuations in its common share price as these awards are settled in cash and the associated liability is recorded at fair value at each reporting date based on the market price of the Company's common shares. In the fourth quarter and year-to-date of 2014, the Company recorded a loss of $2 million (2013 – nil) and a loss of $7 million (2013 – nil), respectively. On November 10, 2014, the Company amended these compensation awards to be settled in shares and is no longer exposed to market price fluctuations.

***Fair value adjustment on fuel and foreign currency contracts*** The Company enters into exchange traded futures contracts and forward contracts to minimize cost volatility relating to fuel prices and foreign exchange rates. Pursuant to the Company's derivative instruments accounting policy, changes in the fair value of these instruments are recorded in operating income. With significant fluctuations in fuel and foreign exchange rates, commencing in the fourth quarter of 2014, the Company has excluded the fair value adjustment on fuel and foreign currency contracts in calculating adjusted operating income. In the fourth quarter and year-to-date of 2014, the Company recorded a net fair value adjustment loss on these fuel and foreign currency contracts of $4 million (2013 – nil).

***Defined benefit plan amendments*** In the first quarter of 2013, the Company announced amendments to certain of its defined benefit plans that impact certain employees retiring after January 1, 2015. As a result, the Company recorded a gain of $51 million in the first quarter of 2013.

***Choice Properties start-up costs*** In connection with the IPO of Choice Properties, the Company incurred certain costs to facilitate the start-up of the new entity. For the year ended 2013, the Company recorded $3 million of Choice Properties' start-up costs in operating income.

**Adjusted Net Interest Expense and Other Financing Charges** The following table reconciles adjusted net interest expense and other financing charges to net interest and other financing charges in the consolidated statements of earnings for the periods ended January 3, 2015 and December 28, 2013. The Company believes that adjusted net interest expense and other financing charges is useful in assessing the Company's underlying financial performance and in making decisions regarding the financial operations of the business.

| (millions of Canadian dollars) | **2014 (13 weeks)** | 2013[4] (12 weeks) | **2014 (53 weeks)** | 2013[4] (52 weeks) |
|---|---|---|---|---|
| Net interest expense and other financing charges | **$ 169** | $ 141 | **$ 584** | $ 468 |
| Deduct impact of the following: | | | | |
| Accelerated amortization of deferred financing costs | **(5)** | — | **(23)** | — |
| Fair value adjustment on Trust Unit Liability | **(20)** | (34) | **(17)** | (27) |
| Shoppers Drug Mart acquisition-related costs and net divestitures loss | **—** | (14) | **(15)** | (25) |
| Choice Properties IPO transaction costs | **—** | (1) | **—** | (44) |
| Early debt settlement costs | **—** | — | **—** | (18) |
| Adjusted net interest expense and other financing charges | **$ 144** | $ 92 | **$ 529** | $ 354 |

***Accelerated amortization of deferred financing costs*** In the fourth quarter of 2014, the Company recorded a $5 million charge and year-to-date a $23 million charge related to the accelerated amortization of deferred financing costs due to the repayment of $321 million and $2,271 million year-to-date of the unsecured term loan facility.

***Fair value adjustment on Trust Unit Liability*** The Company is exposed to market price fluctuations as a result of the Units held by unitholders other than the Company. These Units are presented as a liability on the Company's consolidated balance sheets as they are redeemable for cash at the option of the holder, subject to certain restrictions. This liability is recorded at fair value at each reporting date based on the market price of Units at the end of the period. In the fourth quarter of 2014, the Company recorded a loss of $20 million (2013 – $34 million) and year-to-date a loss of $17 million (2013 – $27 million) related to the fair value adjustment on the Trust Unit Liability.

***Shoppers Drug Mart acquisition-related costs and net divestitures loss*** In addition to the acquisition-related costs and net divestitures loss recorded in operating income noted above, during the first quarter and year-to-date of 2014, $15 million and during the fourth quarter and year-to-date of 2013, $14 million and $25 million, respectively, of additional net interest expense were incurred in connection with the financing related to the acquisition of Shoppers Drug Mart. As of the acquisition date, these costs are no longer excluded from adjusted net interest expense and other financing charges as they are now part of ongoing business operations.

***Choice Properties IPO transaction costs*** In addition to the start-up costs recorded in operating income noted above, in the fourth quarter and year-to-date of 2013, $1 million and $44 million, respectively, of transaction costs were incurred related directly to the Choice Properties IPO.

***Early debt settlement costs*** In the third quarter of 2013, the Company settled its remaining USD $150 million USPP note in advance of its May 29, 2015 maturity date and settled the related cross currency swap. The Company incurred early-settlement costs related to the prepayment of $18 million.

**Adjusted Income Tax Expense and Adjusted Income Tax Rate** The Company believes the adjusted income tax expense is useful in assessing the underlying operating performance and in making decisions regarding the ongoing operations of its business.

| (millions of Canadian dollars) | **2014 (13 weeks)** | 2013[4] (12 weeks) | **2014 (53 weeks)** | 2013[4] (52 weeks) |
|---|---|---|---|---|
| Adjusted operating income[i] | **$ 681** | $ 293 | **$ 2,181** | $ 1,282 |
| Adjusted net interest and other financing charges[i] | **144** | 92 | **529** | 354 |
| Adjusted earnings before taxes | **$ 537** | $ 201 | **$ 1,652** | $ 928 |
| Income taxes | **$ 91** | $ 41 | **$ 25** | $ 226 |
| Tax impact of items included in adjusted earnings before taxes[ii] | **50** | (1) | **403** | 6 |
| Adjusted income taxes | **$ 141** | $ 40 | **$ 428** | $ 232 |
| Effective tax rate | **26.9%** | 26.5% | **32.1%** | 26.5% |
| Adjusted income tax rate | **26.3%** | 19.9% | **25.9%** | 25.0% |

(i) See reconciliations of adjusted operating income and adjusted net interest and other financing charges above.

(ii) See the EBITDA, adjusted EBITDA and adjusting operating income table and the adjusted net interest and other financing charges table above for a complete list of items included in adjusted earnings before taxes.

Adjusted income tax rate is calculated as adjusted income taxes divided by the sum of adjusted operating income less adjusted net interest expense and other financing charges.

**Adjusted Net Earnings and Adjusted Basic Net Earnings Per Common Share** The Company believes adjusted net earnings and adjusted basic net earnings per common share are useful in assessing the Company's underlying operating performance and in making decisions regarding the ongoing operations of its business.

The following table reconciles adjusted net earnings and adjusted basic net earnings per common share to GAAP net earnings and basic net earnings per common share reported for the periods ended January 3, 2015 and December 28, 2013:

| | **2014 (13 weeks)** | | 2013[(4)] (12 weeks) | | **2014 (53 weeks)** | | 2013[(4)] (52 weeks) | |
|---|---|---|---|---|---|---|---|---|
| (millions of Canadian dollars/Canadian dollars) | **Net Earnings** | **Basic Net Earnings Per Common Share** | Net Earnings | Basic Net Earnings Per Common Share | **Net Earnings** | **Basic Net Earnings Per Common Share** | Net Earnings | Basic Net Earnings Per Common Share |
| | **$ 247** | **$ 0.60** | $ 114 | $ 0.41 | **$ 53** | **$ 0.14** | $ 627 | $ 2.23 |
| Add (deduct) impact of the following: | | | | | | | | |
| Recognition of fair value increment on inventory sold | **50** | **0.12** | — | — | **586** | **1.55** | — | — |
| Amortization of intangible assets acquired with Shoppers Drug Mart | **90** | **0.22** | — | — | **306** | **0.80** | — | — |
| Charge related to inventory measurement and other conversion differences | **—** | **—** | — | — | **139** | **0.37** | — | — |
| Shoppers Drug Mart acquisition-related costs and net divestitures loss | **9** | **0.02** | 17 | 0.05 | **73** | **0.19** | 27 | 0.10 |
| Restructuring costs | **—** | **—** | 24 | 0.09 | **34** | **0.09** | 26 | 0.09 |
| Restructuring of franchise fees | **(30)** | **(0.07)** | — | — | **(30)** | **(0.08)** | — | — |
| Fair value adjustment on Trust Unit Liability[(i)] | **20** | **0.05** | 34 | 0.12 | **17** | **0.04** | 27 | 0.10 |
| Accelerated amortization of deferred financing costs | **4** | **0.01** | — | — | **17** | **0.04** | — | — |
| Fixed asset and other related impairments, net of recoveries | **2** | **—** | (29) | (0.10) | **14** | **0.04** | (22) | (0.08) |
| Choice Properties general and administrative costs | **—** | **—** | — | — | **7** | **0.02** | — | — |
| Fair value adjustment on Shoppers Drug Mart's equity-based compensation liability | **1** | **—** | — | — | **5** | **0.01** | — | — |
| Fair value adjustment on fuel and foreign currency contracts | **3** | **0.01** | — | — | **3** | **0.01** | — | — |
| Defined benefit plan amendments | **—** | **—** | — | — | **—** | **—** | (37) | (0.13) |
| Choice Properties start-up costs and IPO transaction costs | **—** | **—** | 1 | — | **—** | **—** | 35 | 0.12 |
| Early debt settlement costs | **—** | **—** | — | — | **—** | **—** | 13 | 0.05 |
| Adjusted | **$ 396** | **$ 0.96** | $ 161 | $ 0.57 | **$ 1,224** | **$ 3.22** | $ 696 | $ 2.48 |

(i) Gains or losses related to the fair value adjustment on Trust Unit Liability are not subject to tax.

**Free Cash Flow** The following table reconciles free cash flow used in assessing the Company's financial condition to GAAP measures for the periods ended week periods ended January 3, 2015 and December 28, 2013. In the fourth quarter of 2014, the Company refined its definition of free cash flow as cash flows from operating activities less intangible asset additions, fixed asset purchases and interest paid. The Company believes that free cash flow is the appropriate measure in assessing the Company's cash available for additional financing and investing activities.

| (millions of Canadian dollars) | **2014 (13 weeks)** | 2013 (12 weeks) | **2014 (53 weeks)** | 2013 (52 weeks) |
|---|---|---|---|---|
| Cash flows from operating activities | **$ 952** | $ 738 | **$ 2,569** | $ 1,491 |
| Less: | | | | |
| Intangible asset additions | **42** | — | **90** | 12 |
| Fixed asset purchases | **358** | 304 | **996** | 865 |
| Interest paid | **113** | 98 | **506** | 370 |
| Free cash flow | **$ 439** | $ 336 | **$ 977** | $ 244 |

**Adjusted Debt** The following table reconciles adjusted debt, used in the adjusted debt to adjusted EBITDA ratio, to GAAP measures reported as at the periods ended as indicated. The Company believes that adjusted debt is relevant in assessing the amount of financial leverage employed. The Company changed its definition of adjusted debt in the second quarter of 2014 to include capital securities to better align with management's definition for deleveraging purposes. In the table below, the Company has also presented adjusted debt as at March 28, 2014, the date of the acquisition of Shoppers Drug Mart, as this is the baseline for the Company's debt reduction targets.

| (millions of Canadian dollars) | **As at January 3, 2015** | As at March 28, 2014 (unaudited) | As at December 28, 2013 |
|---|---|---|---|
| Bank indebtedness | **$ 162** | $ 295 | $ — |
| Short term debt | **605** | 605 | 605 |
| Long term debt due within one year | **420** | 902 | 1,008 |
| Long term debt | **11,042** | 11,262 | 6,672 |
| Trust Unit Liability | **722** | 703 | 688 |
| Capital securities | **225** | 224 | 224 |
| Certain other liabilities | **28** | 39 | 39 |
| Total debt | **$ 13,204** | $ 14,030 | $ 9,236 |
| Less: | | | |
| Independent Securitization Trusts | **1,355** | 1,355 | 1,355 |
| Independent Funding Trusts | **498** | 469 | 475 |
| Trust Unit Liability | **722** | 703 | 688 |
| Guaranteed Investment Certificates | **634** | 443 | 430 |
| Adjusted debt | **$ 9,995** | $ 11,060 | $ 6,288 |

Adjusted debt to adjusted EBITDA is calculated as adjusted debt divided by adjusted EBITDA.

**Choice Properties' Adjusted Funds from Operations** The following table reconciles Choice Properties' adjusted funds from operations to GAAP measures for the periods ended January 3, 2015 and December 28, 2013. The Company believes adjusted funds from operations is useful in measuring economic performance and is indicative of Choice Properties ability to pay distributions.

| (millions of Canadian dollars) | **2014[5] (13 weeks)** | 2013[5] (12 weeks) | **2014[5] (53 weeks)** | 2013[5],(i) (52 weeks) |
|---|---|---|---|---|
| **Net income** | **$ 87** | $ (6) | **$ 200** | $ 67 |
| Fair value adjustments on Class B Limited Partnership units | **51** | 112 | **(12)** | 147 |
| Fair value adjustments on investment properties | **(98)** | (69) | **(82)** | (144) |
| Fair value adjustments on unit-based compensation | **—** | — | **(1)** | — |
| Distributions on Class B Limited Partnership units | **50** | 46 | **191** | 89 |
| Amortization of tenant improvement allowances | **—** | — | **1** | — |
| **Funds from Operations** | **$ 90** | $ 83 | **$ 297** | $ 159 |
| Restructuring | **—** | — | **2** | — |
| Business start-up costs | **—** | — | **—** | 3 |
| Straight-line rental revenue | **(9)** | (8) | **(35)** | (16) |
| Amortization of finance charges | **—** | 1 | **50** | 1 |
| Unit-based compensation expense | **—** | — | **2** | — |
| Sustaining property and leasing capital expenditures, normalized(ii) | **(7)** | (11) | **(31)** | (16) |
| **Adjusted Funds from Operations** | **$ 74** | $ 65 | **$ 285** | $ 131 |

(i) Based on operations beginning July 5, 2013.

(ii) Seasonality impacts the timing of capital expenditures. The adjusted funds from operations calculation has been adjusted for this factor to make the quarters more comparable.

## 21. Additional Information

Additional information about the Company has been filed electronically with various securities regulators in Canada through the System for Electronic Document Analysis and Retrieval (SEDAR) and is available online at sedar.com and with the Office of the Superintendent of Financial Institutions (OSFI) as the primary regulator for the Company's subsidiary, PC Bank.

February 25, 2015
Toronto, Canada