5. Financial Performance

Basic net loss per common share for 2006 was $0.80, a decrease of $3.52 when compared to basic net earnings per common share of $2.72 last year. Basic net loss per common share was impacted in 2006 by the following:

- a charge of $2.92 per common share related to non-cash goodwill impairment;
- a charge of 20 cents per common share related to the Ontario collective labour agreement;
- a charge of 16 cents per common share related to inventory liquidation;
- a charge of 17 cents per common share for the net effect of stock-based compensation and the associated equity forwards;
- a charge of 11 cents per common share related to restructuring and other charges;
- a charge of 3 cents per common share related to a departure entitlement payment;
- income of 6 cents per common share related to the adjustment to future income tax balances resulting from changes in the Canadian federal and certain provincial statutory income tax rates; and
- income of 1 cent per common share related to the consolidation of VIEs.

After adjusting for the above-noted items, adjusted basic net earnings per common share[1] were $2.72 for 2006 compared to $3.35 in 2005, a decline of 18.8%, which for 2005 excluded the impact of the following:

- a charge of 22 cents per common share for the net effect of stock-based compensation and the associated equity forwards;
- a charge of 20 cents per common share related to restructuring and other charges;
- a charge of 10 cents per common share for Goods and Services Tax ("GST") and provincial sales taxes ("PST");
- a charge of 7 cents per common share for direct costs associated with supply chain disruptions;

(1) See Non-GAAP Financial Measures on page 40.

- a charge of 1 cent per common share related to the adjustment to future income tax balances resulting from changes in statutory income tax rates; and
- a charge of 3 cents per common share related to the consolidation of VIEs.

Results for 2006 were affected by the short term costs associated with one of the largest transformations in the Company's history. The need for this transformative process was driven by the Company's recent uncharacteristically poor financial performance, its assessment of a fast-changing retail environment and a strategic review of processes, structure and key drivers of its operations.

This strategic review highlighted both core strengths and issues to be addressed. The core strengths include a strong market share, control label products and a strong store network. A number of issues facing the business included unacceptable levels of on-shelf availability, the need to strengthen price positioning, insufficiently distinctive formats, a complex organizational structure with inconsistent procedures and standards which lacked clear accountabilities and insufficient focus on the customer. In response to these findings, the Company embarked on planning and developing an organizational transition which focuses on redesigning processes, a leaner administrative structure and a comprehensive strategy designed to fortify its competitive position and maintain its leadership role in meeting the food and everyday household needs of Canadian consumers. In pursuit of this strategy, the Company is refocusing the business around the three principles of Simplify, Innovate, Grow and took decisive action in 2006 to initiate tangible change. Additional steps taken in 2006 include the negotiation of a new four-year collective agreement with members of certain Ontario locals of the United Food and Commercial Workers union ("UFCW"), the liquidation of certain general merchandise inventory and the closure of certain underperforming stores.

Changes in 2005 included the restructuring of its supply chain network, the reorganizations involving its merchandising, procurement and operations groups, the establishment of a new National Head Office and Store Support Centre in Brampton, Ontario, which opened in 2005, and the relocation of general merchandise operations from Calgary, Alberta to the new National Head Office.

During 2005, the Company encountered challenges during the execution of planned changes to its systems, supply chain and general merchandise areas, including certain supply chain systems conversions which were initiated as part of the creation of a national information technology platform and the start-up of a new third-party owned and operated general merchandise warehouse and distribution centre for eastern Canada which handles general merchandise and certain drugstore products, primarily health and beauty care products. These challenges disrupted the flow of inventory to the Company's stores and caused the Company to incur additional operating costs and reduced overall sales as product availability impacted consumers at the store level.

During 2006, the Company continued to feel the effects from these changes. However, progress continued to be made in reducing the impact of the supply chain disruptions as follows:

- the third-party owned and operated general merchandise warehouse and distribution centre for eastern Canada posted slight productivity improvements and achieved improved service levels;
- six additional systems conversions were completed during the year with minimal disruption to continuing operations as part of the move to a national systems platform;
- food service levels continued at expected levels during 2006 and service levels for drugstore improved; and
- service levels for general merchandise showed signs of stability and improvement, and while slower than anticipated, progress has been made.

5.1 Results of Operations

Sales and Sales Growth Excluding the Impact of VIEs[1]

($ millions except where otherwise indicated)	2006 (52 weeks)	2005[2] (52 weeks)
Total sales	**$ 28,640**	$ 27,627
Less: Sales attributable to the consolidation of VIEs	**383**	415
Sales excluding the impact of VIEs[1]	**$ 28,257**	$ 27,212
Total sales growth	**3.7%**	6.1%
Less: Impact on sales growth attributable to the consolidation of VIEs	**(.1%)**	1.6%
Sales growth excluding the impact of VIEs[1]	**3.8%**	4.5%

(1) See Non-GAAP Financial Measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "*Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)*" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior years have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

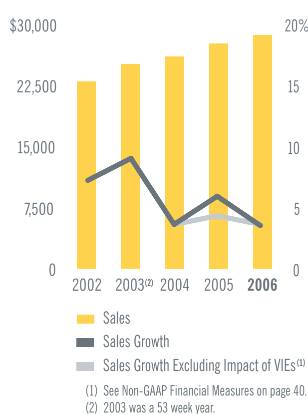
Sales

Full year sales in 2006 increased 3.7% to $28.6 billion from $27.6 billion last year, including a decrease of 0.1% or $32 million in sales relating to the consolidation of certain independent franchisees as required by AcG 15. In 2006, sales excluding the impact of VIEs[1], increased by $1 billion or 3.8% over last year.

The following factors further explain the major components in the change in sales over the prior year:

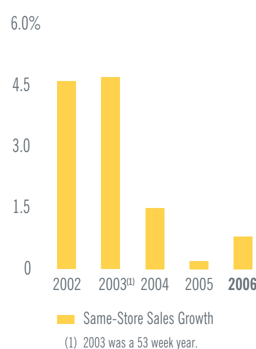
- food, general merchandise and drugstore sales posted gains over the prior year across all regions of the country;
- significant sales growth from the *Real Canadian Superstore* program in Ontario;
- same-store sales growth of approximately 0.8% compared to 0.2% in 2005;
- a decline in tobacco sales negatively impacted sales and same-store sales by approximately 1.2%;

Sales and Sales Growth
($ millions)



(1) See Non-GAAP Financial Measures on page 40.
(2) 2003 was a 53 week year.

Same-Store Sales Growth



(1) 2003 was a 53 week year.

(1) See Non-GAAP Financial Measures on page 40.

- national food price inflation as measured by "The Consumer Price Index for Food Purchased from Stores" ("CPI") was approximately 2.3% for the year compared to approximately 2.0% for 2005, with variances by region; the Company's calculation of food price inflation, which considers Company-specific product mix and pricing strategy, was reasonably consistent with that of CPI;
- an increase in net retail square footage of 1.2 million square feet or 2.5% due to the net effect of the opening of 37 new corporate and franchised stores and the closure of 33 stores inclusive of stores which underwent conversions and major expansions;
- sales per corporate store increased to $33 million in 2006 from $32 million in 2005 reflecting the introduction of larger stores which are expected to become ultimately more productive; and
- sales per average square foot of corporate stores of $585 in 2006 increased from $579 in 2005 as a result of an increase in sales which outpaced the increase in net retail square footage.

Sales of control label products for 2006 amounted to $6.2 billion compared to $5.9 billion in 2005. Control label penetration, which is measured as control label retail sales as a percentage of total retail sales, was 22.9% for 2006, compared to 22.4% for 2005. The Company introduced over 2,000 new control label products in 2006, including 1,400 new general merchandise products. The Company's control label program, which includes *President's Choice*, *PC*, *President's Choice* Organics, *President's Choice Blue Menu*, *President's Choice Mini Chefs*, *no name*, *Joe Fresh Style*, *Club Pack*, *President's Choice GREEN*, *EXACT*, *Teddy's Choice* and *Life@Home*, provides additional sales growth potential.

Loblaw expects that the following initiatives, coupled with continued focus on value-for-money, promotions and advertising where appropriate, will generate continued sales growth over the next few years:

- focus on on-shelf availability of product through an enhancement of customer focus and supply chain, and stronger store processes;
- restoring innovation as a competitive advantage both for control label products as well as unique environments in each retail format;
- refining three distinctive retail formats: Superstore, Great Food and Hard Discount, and making the *Real Canadian Superstore* the key platform for growth;
- increasing the number of stores carrying the *Joe Fresh Style* apparel offering;
- emphasizing a fresh first focus by raising presentation and quality standards; and
- training of employees to ensure they are focused on meeting customer needs.

Operating Income, Adjusted Operating Income[1], Adjusted EBITDA[1] and Margins[1]

($ millions except where otherwise indicated)	**2006 (52 weeks)**	2005 (52 weeks)	Change
Operating income	**$ 289**	$ 1,401	(79%)
Adjusted operating income[1]	**$ 1,326**	$ 1,600	(17%)
Adjusted EBITDA[1]	**$ 1,892**	$ 2,132	(11%)
Operating margin	**1.0%**	5.1%	
Adjusted operating margin[1]	**4.7%**	5.9%	
Adjusted EBITDA margin[1]	**6.7%**	7.8%	

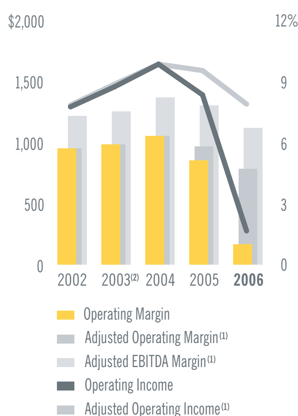
(1) See Non-GAAP Financial Measures on page 40.

Operating Income

Operating income for 2006 decreased $1.1 billion, or 79%, to $289 million resulting in a decline in operating margin to 1.0% in 2006 from 5.1% in 2005. Operating income in both 2006 and 2005 was adversely affected by a number of specific items as outlined below:

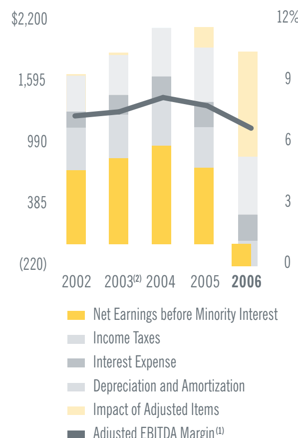
- A non-cash goodwill impairment charge of $800 million related to the goodwill established on the acquisition of Provigo Inc. in 1998 was recorded in 2006. The determination that the fair value of goodwill was less than its carrying value resulted from a decline in market multiples, both from an industry and Company perspective, and a reduction of fair value as determined using the discounted cash flow methodology, incorporating both current Company and market assumptions, which in combination resulted in the goodwill impairment. This non-cash goodwill impairment charge recorded in 2006 is expected to be adjusted if necessary in the first half of 2007. The Company expects no income tax deduction from this charge. A further discussion regarding the non-cash goodwill impairment charge can be found in the Critical Accounting Estimates section of this MD&A.
- During 2006, members of certain Ontario locals of the UFCW ratified a new four-year collective agreement which enables the Company to convert 44 stores in Ontario to the *Real Canadian Superstore* banner or food stores with equivalent labour economics, and the flexibility to invest in additional store labour where appropriate. As a result of securing this agreement, the Company recognized a one-time charge of $84 million in 2006, including a $36 million amount due to a multi-employer pension plan and a payment of $38 million which was due upon ratification. The Company expects this agreement to generate future economic benefits and to provide increased operating efficiencies, on a store by store basis, in a critical era of intensifying competition.
- As part of management's review of inventory levels, certain excess inventory, primarily general merchandise, was identified. Management's decision to proceed with the liquidation of this inventory resulted in a $68 million charge in 2006 reflecting the write-down of inventory to expected net recoverable values net of the associated costs of facilitating the disposition incurred to date. In addition, higher than normal mark downs in the range of $15 million to $20 million were taken in order to clear some of this excess inventory through stores particularly in the last quarter of the year.
- A $12 million charge relating to the departure of John A. Lederer from the position of President and Director of the Company was recorded in 2006. An additional $10 million was paid pursuant to various incentive plans, the majority of which was previously accrued.
- A charge of $37 million (2005 – $43 million) was recorded in 2006 for the net effect of stock-based compensation and the associated equity forwards.
- Income of $8 million (2005 – nil) from the consolidation of VIEs was recognized in 2006.

Operating Income and Margins
($ millions)



(1) See Non-GAAP Financial Measures on page 40.
(2) 2003 was a 53 week year.

Analysis of Adjusted EBITDA and Margin[1]
($ millions)



(1) See Non-GAAP Financial Measures on page 40.
(2) 2003 was a 53 week year.

Included in restructuring and other charges of $44 million (2005 – $86 million) within operating income were the following:

- As part of its assessment of store operations, management of the Company approved and communicated a plan in 2006 to close 19 underperforming Quebec stores, mainly within the *Provigo* banner, and 8 stores in the Atlantic region. This resulted in a charge in 2006 of $29 million for fixed asset impairment and other costs arising from these store closures and employee termination costs. In addition, as a result of the loss of tobacco sales following the decision by a major tobacco supplier to sell directly to certain customers of the Company, a review of the impact on the Cash & Carry and wholesale club network was undertaken. In 2006, management approved and communicated a formal plan to close 24 wholesale outlets which were impacted most significantly by this change. This initiative resulted in a charge of $6 million in 2006 for fixed asset impairment and other costs arising from these closures and employee termination costs. These closures are expected to be completed during 2007.
- A charge of $8 million (2005 – $62 million) was recorded in 2006 relating to the plan approved in 2005 concerning the restructuring of the supply chain operations, including the closure of six distribution centres and the relocation of certain activities to new distribution centres.
- A charge of $1 million (2005 – $24 million) related to the reorganization of the merchandising, procurement and operations groups, the establishment of a National Head Office and Store Support Centre and the relocation of the general merchandise operations from Calgary, Alberta to Brampton, Ontario, was recorded in 2006, all of which were approved in 2005.

A summary of restructuring and other charges is included in the table below:

($ millions)	**Costs Recognized 2006 (52 weeks)**	Costs Recognized 2005 (52 weeks)	Total Expected Costs	Total Expected Costs Remaining
Store operations	**$ 35**	$ –	$ 54	$ 19
Supply chain network	**8**	62	90	20
Office move and reorganization of the operation support functions	**1**	24	25	–
Total restructuring and other charges	**$ 44**	$ 86	$ 169	$ 39

Details regarding the nature of the above charges are described in Note 4 to the consolidated financial statements.

Additional items specific to 2005 included in operating income in that year are:

- A charge of $40 million related to potential liabilities for GST and PST which was not appropriately charged and remitted; and
- Approximately $30 million of direct costs associated with the supply chain disruptions experienced during the last two quarters of 2005.

After adjusting for the above noted items, adjusted operating income(1) was $1.3 billion in 2006 compared to $1.6 billion in 2005. Adjusted operating margin(1) was 4.7% in 2006 compared to 5.9% in 2005. Adjusted EBITDA margin(1) decreased to 6.7% from 7.8% in 2005. The $274 million decline in adjusted operating income(1) and the significant decline in adjusted operating margin(1) for 2006 over 2005 was due to a variety of factors as discussed below.

Early in 2006, operating income was adversely impacted by the effects of product supply issues, resulting from the implementation challenges arising from the 2005 conversions, and delays in program activities resulted in foregone sales and lost cost leverage on fixed components of operating and administrative expenses. The Company's supply chain performance in the areas of general merchandise and drugstore was not at acceptable levels. Therefore, management early in the year was focused on improving service levels and ensuring product availability at the store level to support merchandising programs. By the end of 2006, the supply chain had stabilized and delivered improved service levels.

(1) See Non-GAAP Financial Measures on page 40.

Throughout 2006, the continued investments in lower food prices to drive sales growth had a negative impact on operating income. Aggregate gross margin percentage softened as a result of this pricing investment, higher general merchandise mark downs, primarily in the fourth quarter, and higher inventory shrink, partially offset by improvements in buying synergies and improved mix of food, general merchandise and drugstore. Higher information technology investments in addition to store and distribution centre operational costs, principally labour, were incurred in order to stabilize the flow of product to the stores. Short term costs of additional third-party locations for storage of inventory were also absorbed.

A fixed asset impairment charge of $27 million was recorded in 2006 due in part to a decision to suspend plans for a number of sites scheduled for future development.

As mentioned previously, the new management team is refocusing the business through three principles: Simplify, Innovate, Grow, and has developed a Formula for Growth as a framework for a three year renewal plan. Business priorities for 2007 to return the Company to higher profitability include the following:

- simplifying the organization by more clearly defining accountabilities, eliminating duplication and establishing consistent, simple and efficient processes;
- restoring innovation as a competitive advantage; and
- focusing on retailing basics in the areas of store operations, supply chain and information technology including on-shelf availability and major investments in price to obtain maximum Credit For Value.

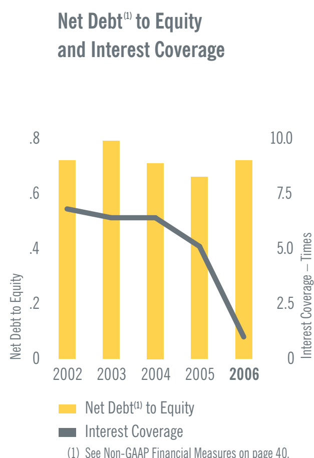
Early in 2007, the Company approved and announced the restructuring of its merchandising and store operations into more streamlined functions. Costs of this restructuring including severance, retention and other costs are expected to be in the range of $150 million to $200 million, the substantial portion to be recorded in the first half of 2007. The Company is also assessing the loss of drugstore-related operating income in 2007 arising from recently enacted legislative changes late in 2006 by the Ontario government, as more fully explained in the Operating Risks and Risk Management section of this MD&A.

Interest Expense

Interest expense consists primarily of interest on short and long term debt, the amortization of deferred financing costs, interest on financial derivative instruments net of interest income earned on short term investments and interest capitalized to fixed assets. In 2006, total interest expense increased $7 million, or 2.8%, to $259 million from $252 million in 2005.

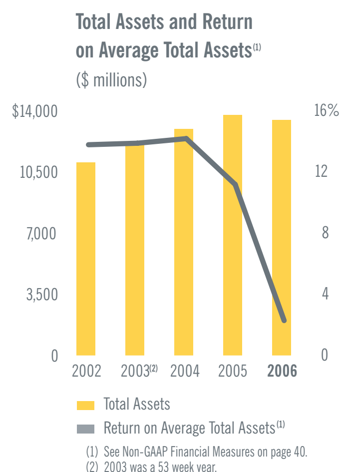
Interest on long term debt was $284 million compared to $290 million in 2005. The 2006 weighted average fixed interest rate on long term debt (excluding capital lease obligations) was 6.7% (2005 – 6.7%) and the weighted average term to maturity was 17 years (2005 – 17 years).

Net Debt[1] to Equity and Interest Coverage



(1) See Non-GAAP Financial Measures on page 40.

Total Assets and Return on Average Total Assets[1]
($ millions)



(1) See Non-GAAP Financial Measures on page 40.
(2) 2003 was a 53 week year.

(1) See Non-GAAP Financial Measures on page 40.

Interest on financial derivative instruments includes the net effect of the Company's interest rate swaps, cross currency basis swaps and equity forwards, and amounted to a charge of $7 million in 2006 (2005 – income of $6 million). The change in interest on financial derivative instruments was due mainly to an increase in Canadian short term interest rates. Net short term interest income in 2006 was consistent with last year's level at $11 million.

During 2006, $21 million (2005 – $21 million) of interest incurred on debt related to real estate properties under development was capitalized to fixed assets.

Analysis of Long Term Financing Costs

($ millions except where otherwise indicated)	**2006 (52 weeks)**	2005 (52 weeks)
Total long term debt at year end (including portion due within one year)	**$ 4,239**	$ 4,355
Interest on long term debt	**$ 284**	$ 290
Weighted average fixed interest rate on long term debt (excluding capital lease obligations)	**6.7%**	6.7%

Income Taxes

The Company's 2006 effective income tax rate increased to 826.7% from 34.8% in 2005. The increase was mainly the result of the non-deductible goodwill impairment charge, which accounted for 796.8% of the change over last year. The effective income tax rate before the impact of the non-deductible goodwill impairment charge as calculated in Note 8 to the consolidated financial statements decreased to 29.9% in 2006 mainly as a result of:

- a change in the proportion of taxable income earned across different tax jurisdictions; and
- a $16 million reduction to the future income tax expense recognized as a result of the reduction in the Canadian federal and certain provincial statutory income tax rates, the cumulative effect of which was included in the consolidated financial statements at the time of substantive enactment.

Net Earnings

In 2006, net earnings decreased $965 million to a net loss of $219 million from net earnings of $746 million in 2005 and basic net earnings per common share decreased $3.52 to a basic net loss per common share of 80 cents from basic net earnings per common share of $2.72 in 2005 due to the factors described in the preceding sections.

5.2 Financial Condition

Financial Ratios

The net debt[1] to equity ratio continued to be within the Company's internal guideline of less than 1:1. The 2006 net debt[1] to equity ratio was .72:1 compared to the 2005 ratio of .66:1. The non-cash goodwill impairment charge negatively impacted the net debt[1] to equity ratio by .10:1 as a result of an $800 million reduction to equity.

Cash flows from operating activities cover a large portion of the Company's funding requirements and in 2006 exceeded the capital investment program. In 2006, funding requirements resulted primarily from the capital investment program and dividends paid on the Company's common shares.

(1) See Non-GAAP Financial Measures on page 40.

In 2006, shareholders' equity decreased $445 million, or 7.6%, to $5.4 billion. The significant decline in operating income resulted in an interest coverage ratio of 1.0 times in 2006 compared to 5.1 times in 2005. The goodwill impairment charge is a significant non-cash item in operating income, which adversely impacted the interest coverage ratio by approximately 3.1 times.

At year end, the working capital position increased over the prior year. The 2006 return on average total assets[1] was 2.3% compared to 11.2% in 2005. The 2006 return on average shareholders' equity was (3.9)% compared to the 2005 return of 13.2%. Both 2006 returns were negatively impacted by the incremental costs and charges incurred in 2006 as outlined previously. The five year average return on shareholders' equity was 12.5% (2005 – 17.3%).

Common Share Dividends

The declaration and payment of dividends are at the discretion of the Board. The Company's dividend policy is to maintain a dividend payment equal to approximately 20% to 25% of the prior year's adjusted basic net earnings per common share[1], giving consideration to the year end cash position, future cash flow requirements and investment opportunities. Currently, there is no restriction that would prevent the Company from paying dividends at historical levels. The Company intends to maintain the current dividend level in 2007 putting annualized dividends above the historical range. During 2006, the Board declared quarterly dividends of 21 cents per common share. The annualized dividend per common share of 84 cents is equal to 25.1% of the 2005 adjusted basic net earnings per common share[1], which is consistent with the Company's dividend policy. Subsequent to year end, the Board declared a quarterly dividend of 21 cents per common share, payable April 1, 2007.

Outstanding Share Capital

The Company's outstanding share capital is comprised of common shares. An unlimited number of common shares is authorized and 274,173,564 common shares were issued and outstanding at year end. Further information on the Company's outstanding share capital is provided in Note 18 to the consolidated financial statements.

At year end, a total of 4,084,646 stock options were outstanding and represented 1.5% of the Company's issued and outstanding common shares, which was within the Company's guideline of 5%. Further information on the Company's stock-based compensation is provided in Note 19 to the consolidated financial statements.