The Kroger (NYSE:KR) Q4 2010 Earnings Call March 3, 2011 10:00 AM ET

**Executives**

David Dillon - Chairman, Chief Executive Officer and Member of Proxy Committee

Carin Fike -

J. Schlotman - Chief Financial Officer and Senior Vice President

Rodney McMullen -

**Analysts**

Edward Kelly - Crédit Suisse AG

Meredith Adler - Barclays Capital

John Heinbockel - Guggenheim Securities, LLC

Scott Mushkin - Jefferies & Company, Inc.

Karen Short - BMO Capital Markets U.S.

Robert Ohmes - BofA Merrill Lynch

Deborah Weinswig - Citigroup Inc

Charles Cerankosky - Northcoast Research

Charles Grom - JP Morgan Chase & Co

**Operator**

Good day, ladies and gentlemen, and welcome to the Q4 2010 The Kroger Co. Earnings Conference Call. My name is Michael, and I will be your coordinator for today. [Operator Instructions] I will now turn the presentation over to your host for today's conference, Ms. Carin Fike, Director of Investor Relations. You may proceed.

**Carin Fike**

Good morning. Thank you for joining us. Before we begin, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings, but Kroger assumes no obligation to update that information. Both our fourth quarter press release and our prepared remarks from this conference call will be available on our website at www.kroger.com. After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one topic with one question and one follow-up question, if necessary. Thank you for your cooperation.

This is my last earnings call as Kroger's Director of Investor Relations. And I would like to thank the investment professionals that I've met during the past seven years in my role. I appreciate the opportunity and have learned much from you.

I will now turn the call over to David Dillon, Chairman and Chief Executive Officer of Kroger.

**David Dillon**

Thank you, Carin. Thank you both for the introduction and also for your years of service as our Director of Investor Relations. We're very proud of you.

No doubt you'll miss reciting the Safe Harbor language, which you should know by heart by now. I want to welcome Cindy Holmes, our new Director of Investor Relations at Kroger. She brings a wealth of experience to the position, and I look forward to working with her in her new role.

And now I'd like to thank those of you listening via teleconference and webcast and thank you for joining us today. With us to review Kroger's fourth quarter and full 2010 results are Rodney McMullen, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

We are very pleased with our strong financial results in the fourth quarter. We believe these results are the outcome of our consistent approach to managing Kroger's business and following our Customer 1st strategy, which continues to connect with a broad range of shoppers. Our fourth quarter results reflect the balance we seek to achieve across our business, including positive identical sales growth, increased tonnage and loyal household count, good cost control as well as growth in earnings and earnings per share. We are encouraged by several improving customer and economic trends, which we hope signal the beginning of a return to a more normal operating environment.

Kroger's identical supermarket sales for the fourth quarter increased 3.8% excluding fuel. This is Kroger's 29th consecutive quarter of positive identical sales growth, excluding fuel. These results are due in large part to our fantastic Kroger associates, who work hard every day to deliver on our Customer 1st strategy and delight our customers.

As Kroger continues to outpace many of our competitors on identical sales growth, it's no surprise that we increased our market share in fiscal 2010. In a few minutes, Rodney will share some data on Kroger's market share increase.

Our fourth quarter identical sales was broad-based across the country and across supermarket departments. Each of our 18 retail divisions produced positive identical sales growth, excluding fuel. Every supermarket department also experienced positive identical sales growth in the quarter with the strongest increases in natural food, deli bakery, produce and meat. We were particularly pleased to see solid growth in our drug and general merchandise department where sales had softened during the recession as customers scaled back discretionary purchases. The fourth quarter is an especially important time of the year for this part of our business.

We focus on internal sales growth or identical sales growth, excluding fuel, because it powers our business model and generates earnings in free cash flow that rewards our shareholders. Kroger's business model is structured to produce annual earnings per share growth averaging 6% to 8% over a rolling three- to five-year time horizon. Including Kroger's dividend, the company's business model is expected to generate total shareholder return of approximately 8% to 10%. Our goal is to produce an average annual return for shareholders that matches or exceeds the S&P 500 Index over the time horizon that I described but with less volatility. Later, Mike will discuss Kroger's annual guidance for fiscal 2011.

In the meantime, I'd like to address a few important factors that will influence Kroger's business this year. First, the economic recovery continues to be slower and weaker than expected and we believe this will persist. We see some promising signs of improvement but the recovery remains fragile.

Unemployment is high in most of our markets and food stamp use continues at its peak. Rising food prices and fuel prices will affect customer shopping behavior. Rodney will talk more about food inflation shortly.

We anticipate the overall competitive environment in 2011 will be more rational but still challenging as retailers compete for customers' limited dollars. We believe our balanced business strategy will further widen the gap between Kroger and other retailers.

We expect to face approximately $200 million of incremental expense from rising pension and healthcare costs, continued cost reduction in other areas will help offset these expenses so we can invest in areas that matter most to our customers. And finally, margins in our retail fuel operations can be unpredictable and will affect our financial results.

For fiscal 2010, fuel margins enhanced Kroger's profits. Overall, we will continue to follow our business strategy and make adjustments as needed to weather these key factors. Rodney will now offer some insight into Kroger's strong business trends in the fourth quarter and some 2010 market share statistics. Rodney?

**Rodney McMullen**

Thank you, Dave, and good morning, everyone. Kroger's relentless focus on building our loyal customer base is working. I'd like to review some key measures of our progress in the fourth quarter.

Our number of loyal households increased once again, as did our total household count. Total units per basket were flat to slightly lower than the same period last year and customer visits were higher. As a result, we sold more units to both total households and loyal households compared to the fourth quarter last year. We believe these statistics reflect our customers' continued cautious spending.

Price per unit sold was higher in the fourth quarter compared to a year ago, reflecting the effect of higher prices from our vendors. The combination of more households, more visits per household and higher retail prices drove sequential improvement in identical sales compared to our trends earlier in 2010. When we dive deeper into Kroger's results for the quarter, we see that identical sales were positive for both total household and loyal households.

Identical sales growth among loyal households was stronger than the overall result. Kroger continued to see positive tonnage growth throughout the fiscal year on top of strong tonnage growth in fiscal 2009. Our promotional and pricing strategies are designed to deliver these sustainable results. The initiatives we implement focus on building long-term loyalty and expanding Kroger's competitive advantage.

In the grocery department, the fourth quarter tonnage increase was primarily driven by positive growth in national brands. Our stores also sold slightly more corporate brand units compared to the same period last year. For the quarter, corporate brands represent just under 35% of product units sold in our grocery department. This was a slight decline in share compared to the fourth quarter last year. Kroger's fourth quarter tonnage results highlight the balance we seek in increasing both sales of corporate brands and national brands at the same time.

Our multibillion dollar corporate brands portfolio is a competitive advantage because it gives our customers more choices and variety and value to complement national brand products. Kroger customers in all segments buy a wide assortment of corporate brand grocery and household items. This is particularly important as many shoppers continue to watch expenses and look for quality items at good prices.

Rising food costs are on the minds of our customers and investors today. Rising costs for many agricultural commodities are driving higher retail prices for packaged goods in the center aisles of our stores. Some of the inflation affecting our perishable departments, certain produce items, for example, is more seasonal and will cycle as additional sources of supply open up throughout the year.

For the fourth quarter, we estimate that Kroger experienced product cost inflation of roughly 2.3%, excluding the effect of retail fuel. This inflation was primarily driven by higher year-over-year costs in our Meat department.

We did see inflation across other store departments including Grocery for which product cost inflation approached 1%. This follows six consecutive quarters of deflation in the Grocery department. We are passing along product cost increases from national brand suppliers in grocery today and we plan to continue to do so.

As always, our popular corporate brand products will continue to offer customers thousands of quality, affordable choices that fit any budget. As Dave mentioned earlier, Kroger increased its market share in 2010, which is one of the important measures of our success.

According to the Nielsen Homescan Data, Kroger's overall share of grocery product sales in the markets where we operate grew approximately 80 basis points during fiscal 2010. This data also indicates that our share increased in 13 of the 19 marketing areas outlined by the Nielsen report, declined slightly in four areas and remained unchanged in two.

Wal-Mart supercenters are our primary competitor in 17 of the 19 marketing areas outlined by the Nielsen report. Kroger's overall share of grocery product sales in those 17 markets grew approximately 75 basis points during fiscal 2010. This Nielsen Homescan Data is generated by customers who self-report their grocery purchases to Nielsen regardless of the retail channel or grocery outlet. It illustrates not only is Kroger growing bigger among traditional grocers but we are also gaining ground in the larger retail market for grocery and consumable items, which includes many nontraditional competitors. This is very important because the competitive dynamics of our industry continue to evolve.

Supercenters remain a formidable competitor but several other retail formats have entered the arena also. If there is any consistent in our industry, it is change. Change in retail formats and change in customer behavior. Retailers that become more relevant with customers will survive and thrive in the long run.

Because of several key competitive advantages, Kroger is well positioned to be a successful long-term player in this operating environment. One advantage is our unwavering commitment to our Customer 1st strategy. Another is our strong market share position and our ability to leverage the scale of an $82 billion business.

Another advantage is Kroger's partnership with dunnhumby, which continues to help us increase customer loyalty through our family of stores. Of course, Kroger's associates play a big part in building long-term customer loyalty and we remain committed to investing in them.

These investments include providing good quality affordable benefits in ways that allow us to operate competitively with the non-union retailers in each of the market we serve. Because Kroger's financial results continue to be pressured by rising healthcare and pension costs, cooperation between Kroger and the local unions that represent many of our associates is essential. We have a shared objective, growing Kroger's business and profitability will help us create more jobs and opportunities for our associates.

With that objective in mind, we were pleased to ratify labor contracts in Seattle and Little Rock, Arkansas during the fourth quarter. In 2011, we'll be negotiating agreements with the UFCW unions in Southern California, Memphis and West Virginia, and with the Teamsters, who represent some of our associates in distribution and manufacturing operations in the Midwest.

Now Mike will offer more detail on Kroger's 2010 fiscal financial results and our 2011 guidance. Mike?

**J. Schlotman**

Thanks, Rodney, and good morning, everyone. Before I get into my prepared remarks, I want to personally thank Carin for her seven years in Investor Relations. She has been a key player in shaping our strategies. I also look forward to working with Cindy in her new role. Both of them have made big contributions in their respective areas and will continue to do so in the future.

Earlier today, Kroger reported fourth quarter net earnings totaling $278.8 million or $0.44 per diluted share. These results include a noncash charge resulting from a goodwill write-down for a small group of stores. Excluding this goodwill impairment charge, net earnings for the quarter would have been $290.8 million or $0.46 per diluted share. This compares to net earnings of $255.4 million or $0.39 per diluted share for the same period last year.

Kroger's fourth quarter FIFO gross margin, excluding retail fuel operations, was comparable to the same quarter last year as a rate of sales. This was mostly due to improvements in shrink and advertising expense as a rate of nonfuel sales.

Kroger supermarket selling gross margin rate increased one basis point excluding fuel. Kroger's fourth quarter OG&A rate, excluding fuel, was 39 basis points lower than the same period last year. This is an exceptional result given the ongoing pressure we face from rising credit card fees, healthcare and pension costs.

We were able to overcome these pressures through the combination of positive identical sales growth, good cost control and our ongoing implementation of operating efficiencies. Identifying and executing sustainable operating cost reductions allows us to invest in all four elements of our Customer 1st strategy, our great people, lower prices for our customers, our product offering and our customers' shopping experience.

Kroger's fourth quarter operating margin, excluding fuel and the goodwill impairment charge, rose 31 basis points as a rate of sales compared to last year. This was driven by the OG&A leverage I described and a couple basis points of leverage over rent expense. A higher LIFO charge in the quarter pressured Kroger's nonfuel operating margin by about 10 basis points.

While we encourage investors to look at Kroger's operating margin over a longer time period, usually on an annual time frame, it is important to highlight our fourth quarter results in this area. These results demonstrate sequential improvement as we transition back to a more normalized operating environment for our industry. Before I move on to discuss Kroger's full year 2010 results, I'll share some data on our retail fuel operations.

We were very pleased to celebrate the opening of Kroger's 1,000th supermarket fuel center. In the fourth quarter, Kroger's retail fuel operations continued to generate solid identical gallon growth at both our supermarket fuel centers and convenience stores. These outlets earned approximately

$0.102 per gallon compared to $0.094 in the final quarter of fiscal 2009. This part of our business had no impact on Kroger's year-over-year net earnings per share increase for the fourth quarter.

For the full year, the cents per gallon fuel margin was roughly $0.122 in 2010 compared with $0.106 in 2009. Higher fuel margins plus strong gallon growth provided roughly $0.06 of the year-over-year increase in Kroger's consolidated earnings per diluted share for fiscal 2010.

Let's turn now to Kroger's full year results for 2010. Net earnings were $1.12 billion or $1.74 per diluted share. The goodwill impairment charge incurred during the fourth quarter reduced our 2010 results by approximately $0.02 per diluted share. The tax benefits recognized in the second and third quarters of the year increased Kroger's net earnings by approximately $0.03 per diluted share.

Full year net earnings in the prior year were $1.71 per diluted share, excluding the asset impairment charges recorded in the third quarter of that year. Kroger's full year 2010 operating margin, excluding our retail fuel operations and adjusting for the impairment charges in fiscal 2010 and 2009, was 22 basis points lower than compared to the prior year. This performance does not reflect Kroger's long-term business model of slight nonfuel operating margin expansion on an annual basis. It does reflect the management of our operations in a consistent manner that has allowed us to grow Kroger's business through a severe recession and a very slow economic recovery.

Dave has shared Kroger's strategy with you. I'll outline some specific growth objectives for fiscal 2011. For the full year, we anticipate identical supermarket sales growth, excluding fuel, of approximately 3% to 4%. This will be driven by moderate tonnage growth and product cost inflation. Full year net earnings are expected to range from $1.80 to $1.92 per diluted share. While this range is narrower than our guidance for fiscal 2010, much uncertainty remains.

Improved operating results and share repurchases will produce Kroger's EPS growth in 2011. The amount of growth will be influenced by the factors that Dave described, the pace of the economic recovery, the impact of rising gasoline and food prices on customer spending, the competitive environment, higher pension and healthcare costs and retail fuel margins.

Our guidance for fiscal 2011 assumes a margin of approximately $0.115 per gallon for Kroger's retail fuel operations. This compares to our five-year historical average of $0.122 per gallon. Favorable developments in these areas could result in EPS growth toward the upper end of our guidance range. Conversely, unfavorable developments in these areas could lead to EPS growth toward the lower end of our guidance.

Kroger's earnings per share growth will also be affected by the pace and timing of our share buyback activity throughout the fiscal year. While we don't provide quarterly EPS guidance, we do like to share some insight on how our earnings per share growth rates will trend during the year. I want to point out that the growth rates in the second and third quarters will be lower than the full year rate due to the tax benefits recognized in 2010.

We expect Kroger's full year operating margin rate in 2011, excluding fuel, will be comparable to fiscal 2010 results. We recognize the need to expand Kroger's nonfuel operating margin rate over time. It remains our goal to do so as the economy and operating environment improve.

During 2011, Kroger plans to use cash flow from operations and cash on hand to fund capital expenditures, repay debt maturing on April 1, repurchase shares, pay dividends to shareholders and maintain our current debt rating.

We have reduced our previous capital spending plans for the year by approximately $100 million to $300 million to our current expectation for capital investment of $1.7 billion to $1.9 billion for the year. This reduction, plus not having to make a required contribution to Kroger's company-sponsored pension plan, should provide the incremental cash flow necessary to execute our financial strategy in 2011. I'll provide some additional details on Kroger's share repurchase program.

During the fourth quarter, we invested $253.4 million to repurchase 11.8 million shares of Kroger stock at an average price of $21.51 per share. Since the end of the fourth quarter and through the close of the market yesterday, Kroger invested $87.5 million to repurchase 3.9 million shares, leaving $11.6 million remaining under the $500 million stock repurchase program announced in June of 2010. We intend to invest this amount plus the additional $1 billion authorization announced earlier today to repurchase shares. The timing of the repurchases will vary according to market conditions and keep in mind that the ultimate numbers of shares repurchased will depend on Kroger's stock price.

This morning, we filed an 8-K summarizing the guidance and the financial strategy that I've just discussed and some additional items, including LIFO expense, pension contributions and expense and tax rate.

Now I will turn it back to Dave.

**David Dillon**

Thanks, Mike. I hope our comments today help outline our view for 2011 and our long-term business objectives. Remember that Kroger's strategy focuses on driving sales through increasingly loyal customers. We continue to grow our business in a difficult operating environment through our focus on all four areas of our Customer 1st strategy, our people, prices, products and shopping experience. Our unique customer insights help us understand and meet each shopper's needs.

In 2010, we achieved solid, positive identical supermarket sales and market share growth, which demonstrates that we can strengthen our business and reward shareholders by placing our customers' needs first.

Now we look forward to your questions.

**Question-and-Answer Session**

**Operator**

[Operator Instructions] And your first question comes from the line of Deborah Weinswig of Citi.

**Deborah Weinswig - Citigroup Inc**

What do you think will be the impact of inflation on spending? And I'm sure you've done a lot of work on this with dunnhumby.

**David Dillon**

It's going to be a little hard to read in advance, of course, because on one hand, you have some products that we know for sure, things like milk, when the retail price goes up, tonnage on that product has historically always gone down. But some other products don't seem to vary too much particularly if the price changes aren't significant. What we were particularly pleased with as we’ve begun to see some return of grocery inflation as opposed to the deflation we've been experiencing, we still saw in the fourth quarter solid tonnage growth, and of course, the identical sales were strong too. So I'd say I'm pretty bullish and optimistic about where this can lead. However, we're cautious because we do think we have a fragile economy, and we've seen many of our customers who are greatly affected by that. Rodney, you want to add anything?

**Rodney McMullen**

The only thing I would add is obviously that the amount of inflation would affect that so if it's 3% to 4% overall it’s one thing. If it happens to be 10% or above I think it's something different. The other thing that we believe and we see customers continuing to do this is as prices increase, our own corporate brand program offers an alternative. And at many times, that item will even be cheaper than where the customer was spending before when they were buying the national brand item. So we believe both of those things will help offset or minimize the impact. But obviously, the amount of inflation will drive that, in answer to your question, by a lot.

**Deborah Weinswig - Citigroup Inc**

Okay, and then we appreciate the color you provided on the number of markets that you're gaining share. Can you also provide some color on the categories that you plan to retain the most share in?

**David Dillon**

Well, I think probably the best insight to that is the departments that we identified when sales have grown although there are some of those, for instance, produce that have spotty inflation and means that would have driven some of that, but I think that's the best indication of where we're growing, for instance, Deli Bakery is a good example. We believe we've improved clearly, our market share, if you could even define market share there, of products, for instance, ready-to-eat products, those are things that often fastfood restaurants offer and other restaurants offer. And you pull some market share from those areas both for convenience and because of price.

**Rodney McMullen**

And the only thing I would add is it's very broad based. It's not just one or two categories driving it, but if you look across, all together we define about 250 categories. And by far, the majority of those categories would be gaining share.

**David Dillon**

And I think maybe the most clear picture are three facts. First is that all of our divisions had identical sales growth. Second is all of our departments had positive identical sales growth and third is that we grew both loyal and nonloyal customers as we calculate those, and that the nonloyals produced a proportionately stronger result.

**Deborah Weinswig - Citigroup Inc**

And then lastly, obviously we're in a difficult environment for the consumer as it relates to gas prices. I think you've always done a fantastic job as it relates to fuel rewards. Can you talk about anything that you're doing in terms of making sure the consumer is aware of your fuel rewards and anything you are doing differently in 2011 as it relates to that?

**David Dillon**

Well, we highlighted the thousand fuel stations at our supermarkets. And of course, we have many hundreds in our C-stores as well. And the convenience of having our gasoline is actually a big plus at a time when fuel prices are high, people look for having to drive less distance both for fuel and for food. And so we think that actually plays well, and of course, our fuel rewards are some help too.

**Operator**

Your next question comes from the line of John Heinbockel of Guggenheim.

**John Heinbockel - Guggenheim Securities, LLC**

Hey guys, couple of things. It sounds like both in word and practice, many companies are acting very rationally today in terms of inflation pass through in stark contrast to maybe where we were a year ago. Why do you think that is? Is it kind of lessons learned with regard to limited demand elasticity? And is it something that continues or do those lessons ebb over time? Because it is kind of stark the way people are acting today, competitors versus what a lot of people were doing a year ago.

**J. Schlotman**

I tend to think, John, that really what's happening is as we move from grocery in particular, a deflationary environment to more of inflation and it's persistent, that means it's across lots of items because it affects some of the ingredients that are going into the products. I think most people have seen that in order to make any kind of a decent result for the year, they're going to have to pass those things along as best they can. The real question for manufacturers is going to be what happens to tonnage. The advantage, as Rodney described, the advantage for us though is with Kroger brand, if the prices get too far out of whack more than what the costs justify, our Kroger brand has an advantage. And even if costs go up for both our brand and national brand, our brand also has an advantage because it’s a lower price. So I think the real question’s what happens with tonnage, but I think people are being more rational and I think it’s because they just recognize that, that’s the environment we're in and you have to be more rational.

**Rodney McMullen**

And the only other thing I would add is if you look at everything out there, it looks like the inflation is going to be there for a while. So if you go back and look at a year or two ago, an awful lot of the things where the inflation was happening look like something that was really only maybe a few months in duration and it wasn't permanent. For now, it just looks much more permanent in terms of the inflation as you look out six to 12 months, you just see actually more of it coming rather than less of it coming. So I believe that's probably driving part of the behavior.

**John Heinbockel - Guggenheim Securities, LLC**

And how do you gauge or get comfortable with your customers' ability to absorb food inflation, gas? I mean it sounds funny, you walk through any retailer and so towels going up and appliances are going up because there's input costs there too. How do you kind of gauge that and remain sensitive to their ability to absorb it now. And then going forward, is it possible to get to a point where just less of it can be passed through later this year, next year just because that, particularly the low-income customer’s under some stress?

**David Dillon**

I think the answer really is a much like what we found as we went into the recession. At first, customers make choices. They go through a rational way of thinking, how do I get through this. And sometimes they trade to different products, sometimes they trade to different retailers, sometimes they completely revise what they decide they're going to consume in their family. But the real advantage for us is the way we're able to get insight into segmented customer groups so that we can see that change of behavior. So for instance, the best illustration of this is that a number of our customers, mainstream and upscale kind of customers, are feeling a little better about the economy. We described that last quarter and it's still true today, things like Starbucks have improved within our stores. More said [ph] has improved, natural food is up strongly and is growing households as an example. So many of those areas continue just like we described before. But those are typically among customers who are feeling a little less affected by the economy. But there are many customers who are more price sensitive, who are greatly affected even still today, high unemployment and food stamps, illustrate that best. And the way we segment customers through our insight data allows us to see more clearly how that behavior changes. So we try to address that both with what we offer on pricing. We try to address that with what we do with our ads. We try to address it in what we offer in the stores.

**Rodney McMullen**

The only other thing, Dave, I'd add to that, if you look there's also categories that we can take business away from, if you look at like restaurant. Now you can come to one of our stores and get a high-quality good-for-you meal at a third to half the price a restaurant would be, that really doesn't take any longer to prepare than what it takes for a customer to drive to a restaurant and get to their home, back to their home to eat it. So there's a lot of business out there to be moved from completely outside of our channel back into our channel too.

**David Dillon**

And I think you also commented, with your comment about what happens with fuel prices and how does that affect behavior? That's important to note. That's one of the factors we have identified for this next year that could cause depending on, which way it goes, could cause a change in how we see the results either at the high end or low end of our results. And it illustrates why we think there's some uncertainty out there that we’ve got to be a little cautious about. But we intend to be flexible, we intend to adjust as we go and we intend to read the market as we go through it in order to make the year come out strong.

**John Heinbockel - Guggenheim Securities, LLC**

One final question. It doesn't look like there was a lot of forward bought inventory in the quarter, that may not be right, but to what degree are you seeing opportunities there? Do you think you will see opportunities in 2011, and is that significant?

**J. Schlotman**

There will be opportunities. We continue to do it whenever it makes economic sense. We would have a pretty elaborate model in terms of looking at the expected cost increases and the cost to actually handle the inventory and inventory it. So we would expect to continue to see opportunities there that isn't the piece that's going to drive our success one way or the other as you look to 2011 and the estimates.

**Operator**

Your next question comes from the line of Karen Short of BMO Capital.

**Karen Short - BMO Capital Markets U.S.**

Just wondering back to the inflation, the topic today. Within your 3% to 4%, can you just comment on what you're expecting in inflation for the year? And then could you also just elaborate a little bit on what the center-store inflation is within that guidance?

**J. Schlotman**

Karen, at this point what we would expect would be 1% to 2-ish% depending on the category like Rodney said earlier in the comments if you have -- we have a lot of inflation going on for instance right now and produce with the horrible weather we've had not only in the States and some important growing regions, but South America as well. Most things cycle themselves throughout the year as new areas of crops come to market and those will settle down. But our expectation for core inflation would be in the 1% to 2% range for the year.

**David Dillon**

And center store, certainly last year, we actually, as many of you, expected to see inflation arise earlier in the year in grocery, for instance, and it didn't. But we do think it's starting, well it obviously is starting to show up now and we do expect that will continue through the year.

**Karen Short - BMO Capital Markets U.S.**

Okay, and then looking just into the first quarter, I don't know if you could give some comments on sales trends and maybe also just elaborate within the first quarter and within the fourth, was there any benefit from storms?

**David Dillon**

Yes, I'd be happy to. Through so far year-to-date, we're through, what, about 4½ weeks, I guess. We've seen our sales consistent with what we saw in the fourth quarter and that would put them near the high end of the range of guidance we've given. We did see clearly some effects of snowstorms. We believe, although I don't know that I've gone to look actually at the data but I certainly have every reason to believe that the snowstorms produced a little bit of improvement in sales so far this quarter and also in the fourth quarter beyond what we achieved last year. So I think that probably brings you up to date.

**Rodney McMullen**

Karen, sorry. On the weather that people in the East have seen, we haven't had that extreme of a winter so I would agree completely with Dave's comments but the weather extremes that we've had in the West and Midwest...

**David Dillon**

Sometimes we forget where they are.

**Rodney McMullen**

It isn't anything like what the East has.

**J. Schlotman**

It helped, weather, but it was not the primary driver, by any means.

**Karen Short - BMO Capital Markets U.S.**

Okay, and then what are you guys seeing in terms of vendor support, in terms of helping you offset some of the price increases? Because it would seem that -- I mean Safeway vendor support in the fourth quarter was very high. I don't know if you could comment on that a little bit, about yours.

**J. Schlotman**

Yes. We would continue to see strong vendor support. I mean the vendors are working just as hard as what we are in terms of trying to improve the productivity of their business and making sure they minimize the cost increases just as what we would do. And you see a lot of that in terms of maybe increased list price but also increased promotional support and we would be seeing the same type of activity.

**Operator**

Your next question comes from the line of Meredith Adler of Barclays Capital.

**Meredith Adler - Barclays Capital**

I was wondering since we've been talking a fair amount about food inflation, I remember that mid-2007 you folks had talked about dry-grocery inflation, which seemed structural at the time, as being a modest tailwind. And then I think we continued to see that through most of '08 and even part of '09 but I don't think it had the same benefit. Can we talk a little bit about why that was different than you think it will be now?

**David Dillon**

Well, we, if I'm understanding your question right, we had deflation in the latter part of that time period that you were describing.

**Rodney McMullen**

Meredith, I think you're going further back, right?

**David Dillon**

Okay. So if you go back to where we had inflation, I think our view was when we had grocery inflation that it was a modest tailwind and I would describe it as a modest tailwind today too. And it's sort of clouded with some noise in the numbers too. One of the reasons we described to you the $200 million of healthcare and pension incremental cost in 2011 was to illustrate that, that sort of hides some of the benefits that we might get from that inflation. That's a pretty big barrier to get over. Now we think we're going to get over it, but we thought it was big enough that we should separately identify it. So I would say that it's just like we described back in '07 is we do expect to get some modest tailwind from this. Now some of the categories you can get inflation in can work to your disadvantage occasionally, and that's generally true in perishable products. Sometimes it's true in milk, and one of the time periods you described I think it was a milk issue, where the prices were strongly competitive in the market on milk. And when that happens, inflation may not be as much of a tailwind as we have described.

**Meredith Adler - Barclays Capital**

Okay, great. And then I have one very quick question and a slightly longer one. Does your 6% to 8% long-term outlook for earnings per share include the benefit of stock buybacks or is that before?

**J. Schlotman**

It would include any benefit of stock buybacks but would be before dividend.

**Meredith Adler - Barclays Capital**

Okay. And then just real quickly, you did renew a number of contracts in the fourth quarter, you don't have too many up for renewal this coming year. Are there any contracts that were -- haven't been renegotiated and just been pushed out, where the negotiation is taking longer than expected?

**J. Schlotman**

Not a whole bunch that would be material. And obviously, when you look at 2011, there's not a lot in numbers of contracts but there's a lot of associates that are involved in those contracts.

**Operator**

Your next question comes from the line of Scott Mushkin of Jefferies & Company.

**Scott Mushkin - Jefferies & Company, Inc.**

So I kind of go down this route sometimes because I was just down in Western Virginia and listening to people talk about not going to the supermarket but going to the Kroger. And it just always occurs to me, and I saw you guys set out, is the bar just being set too low? I look at your pricing and you're just as good as the mass merchants, especially to your best customers, your meats and produce are better, service is generally quite good. I obviously could go on. So I guess I just look at that 68%, which includes buybacks and it just occurs to me maybe it's just too modest. And I just guess wanted to get your thoughts on that.

**David Dillon**

Well, we obviously don't think it's too modest or we wouldn't have set the bar at that level. We obviously think that there is certainly upside potential to that but what we're trying to do is describe what we see as the operating environment over the foreseeable future really looking forward. And some of those barriers like the medical cost we talked about, get in the way of being able to jump past those kind of numbers like you were describing. But on the whole, I hope that you see it as rather than conservatism or setting the bar too low, I think we're pretty optimistic and we're trying to describe something more consistent and we're trying to describe something less volatile than what you often experience with other stocks in the S&P 500.

**Scott Mushkin - Jefferies & Company, Inc.**

Kind of as a follow-up and I don't think I saw anything on the release as far as like growth plans whether in market or out of market. And I'm also I'm including both store building and acquisition, I know you took down your CapEx a little bit but I was wondering what your -- if you have any plans, obviously you do, if you want to share any of your plans for kind of growth, generally speaking?

**Rodney McMullen**

Yes, we would be projecting a 1% to 1 ½% square footage growth, 130 to 140 remodels and around 30 or so net new relocated and expanded stores.

**Scott Mushkin - Jefferies & Company, Inc.**

And one final one if I could. I know you guys have mentioned, I think, in the prepared remarks some positive mix trends, natural organic, among others. I was wondering just that should be helping your margins but the one thing that stuck out to me, is that I think I heard that you said the basket really wasn't growing all that much. It's really coming from a lot of traffic unless I – I may have misinterpreted that. So I guess as I look at you're going forward, is trade-off and mix, could that completely maybe offset any per item retail to wholesale compression if you get a better consumer adding more to their basket?

**Rodney McMullen**

What I said was per visit it was a modest decline in number of items in a basket, but we're getting more visits. So when you look at a household over the month, we have strong growth in household over the month. And if you look at loyal households, that growth is stronger than it is in total. So the strength is in the loyals. But we believe a lot of that is just budgeting where people are not buying quite as much when they shop each time and they're shopping more frequently. Now if you look at the quarter overall, about half the growth was driven by spend per customer, half of it was driven by the number of visits we had overall for the quarter approximately.

**Scott Mushkin - Jefferies & Company, Inc.**

And any thoughts on whether trade-off could really -- and maybe more items in the basket could help you out if we get a lot of job growth next year?

**Rodney McMullen**

Well, job growth I think would be good for all of us if we get it, not just Kroger, but all retailers. And as Dave outlined in his prepared remarks, we really expect that growth to be modest. Anything above that I think would be tailwind and would be really for all of us to have but we're not depending on that to grow.

**Operator**

Your next question comes from the line of Robbie Ohmes of Bank of America.

**Robert Ohmes - BofA Merrill Lynch**

Really just two quick questions. I guess the first one is I was hoping you could maybe sort of reconcile the flat operating margin x fuel in 2011 on a 3% to 4% iden [ph]. Is the selling gross margin assumption sort of baked in to be down within that? Or is it strictly some of the expense pressures you mentioned? And then the second and sort of separate question would just be the natural food trend you pointed out, are any significant new initiatives in that category in 2011 that could accelerate that growth within your mix?

**David Dillon**

Well, the flattish operating margin for 2011 is really calling it how we see it in the current environment with some of the expenses that we described. And I think it's the headwind of those expenses that probably weigh pretty heavily on that but I wouldn't put too much on the idea of flat. We think that can vary depending on where we come in, in the range and depending on the factors that we outlined. We could do more. We could do better if those factors go our way. We certainly wouldn't rule that out and we're just calling it like we see it at the moment.

**Rodney McMullen**

On the natural food trend, there would be new initiatives, that's part of our plan. But we've had new initiatives on natural foods probably for the last five or six years for sure. I'm sure it's longer than that. And it would just be a continuation of understanding what the customer wants and needs are, trying to provide that and by providing that it's just one less place the customer has to go.

**Robert Ohmes - BofA Merrill Lynch**

And just a quick follow-up, David, so should we sort of expect the selling gross margin to generally still be under pressure in 2011?

**Rodney McMullen**

We're purposely not giving any guidance on selling, gross margin and OG&A rate and trying to get everybody to focus on the operating profit margin. And as Dave said, or currently the way we see it is flattish and it's primarily the result of the headwinds of those expenses we talked about. Keep in mind, $200 million of incremental expense in those two categories, that's $0.20 a share that we have to overcome before we make any new money next year and that's certainly weighing in on the estimates we gave you relative to all those metrics.

**David Dillon**

And I would also emphasize what Mike said in his prepared comments about that we recognize our need to expand operating profit margin over time as the economy and the operating environment improve.

**Operator**

Your next question comes from the line of Charles Grom of JPMorgan.

**Charles Grom - JP Morgan Chase & Co**

I was just wondering if you could kind of flush out the elasticity that you've seen in the grocery category as you've seen prices move up over the past few months.

**Rodney McMullen**

Well, if you look at the elasticity, it really is different based on the category. So if you look at like produce, you would have one set of elasticity. But part of that is driven because when produce prices go up, the quality goes down. If you look at meat, it wouldn't be so much the quality changes, it's just the higher price point, you'll see a lot of people switch from beef to pork, pork to chicken so they're switching proteins. If you look at milk, you still see people not buying milk and they'll be buying more soft drinks. So it really is different by category and the amount of elasticity is different by category. I realize that doesn't answer your question directly but it's very hard. Each category has a little different and that's one of the things that we try to make sure is that we give the customer a choice and we give the customer a high quality choice where they can switch as what meets their needs and budget versus what we try to force them to do.

**David Dillon**

The fortunate part is that many of the choices that they make are still within our store.

**Rodney McMullen**

Except for the restaurants and that's a switch to us.

**David Dillon**

Yes. That's a net plus.

**Charles Grom - JP Morgan Chase & Co**

And then just my second question is when you take a step back and look at 2010 operating margins, 2.7%, 60, 70 bps below where you were four, five years ago. Do you look at the 2.7% as sort of a reset, in other words that's kind of where the operating margin structure of the company is going to be over the next, say, three to five years or do you think that over time, you get back to that 3.3%, 3.4% range?

**David Dillon**

I would just repeat the comment that Mike made earlier that we recognize, clearly, we recognize the need to expand our operating profit margin over time. So we are not satisfied with, do not believe that today's level is a permanent position. And that we think that, that opportunity to expand will improve as the economy and the operating environment improve.

**Rodney McMullen**

The only thing that I would remind all of us to look at, if you just look at the face of the financials, fuel also has a very low operating margin. So some of that, depending which number you're using, part of that change is driven because fuel is a higher percent of the business. Now when you adjust out fuel, Dave's comment is absolutely correct. So I don't want to try to erase anything that Dave just said.

**David Dillon**

I'm glad you added that because I literally take fuel out and treat it as a separate item all the time and just mentally assume that you did too. And if you don't, you should. It's the only way to understand our business, is to take fuel out and look at it as a separate category.

**J. Schlotman**

Particularly with the growth in fuel sales dollars.

**Charles Grom - JP Morgan Chase & Co**

Then just my final question is when you look at the comp guidance 3% to 4%, let's say things come in better, let's say that your IDs are 5%, what's the

[Audio Gap]

**Rodney McMullen**

But it's not just one segment where our business is improving, it's improving across all the segments, which is one of the reasons why we wanted to make sure everybody understood that because we believe our strategy connects with all customers, not just a customer niche.

**Operator**

Your next question comes from the line of Ed Kelly of Crédit Suisse.

**Edward Kelly - Crédit Suisse AG**

My first question is on share repurchase. Mike, your tone seems to be a little bit better today than what I would say I've heard from you over the last few quarters. Would you agree with that?

**J. Schlotman**

Tone as far as...

**Edward Kelly - Crédit Suisse AG**

What you think the opportunity is you can do in share repurchase in the upcoming year?

**J. Schlotman**

Well, we spent $545 million or so this year in that neighborhood. We've modified our capital expenditure program by $100 million to $300 million and there's about $140 million contribution we made to the company pension plan last year that we don't have to make this year where the funding status doesn't require us to make a contribution. So when you look at what we were able to spend in '10 and still maintain and improve our net total debt-to-EBITDA ratio coverage, and the fact that those two items generate $240 to $440 of incremental free cash flow to spend on something else, clearly, we have devised a financial strategy in the short run to allow us to have that flexibility to spend a little bit more on stock.

**Edward Kelly - Crédit Suisse AG**

Okay, great. And Dave, kind of similar question for you. When I saw you guys in December or I should say you sounded more upbeat today than when I saw you in December and I was just curious, am I reading that right? And maybe you could talk about why?

**David Dillon**

The answer is yes, I am more upbeat and I think that, that's a direct result of what we saw in the fourth quarter from the time that we reported before to this time of reporting.

**Edward Kelly - Crédit Suisse AG**

And on the CapEx side, you lowered your CapEx guidance for this year. 2010 was below where you thought it was going to be initially. Could you talk about where the savings are coming from? And is there a possibility that this could come down further over time going forward?

**J. Schlotman**

Yes, we purposely didn't give any guidance on future years, which we've done in the past. Can it come down over time? Anything is possible. One of the things we continue to want to make sure of is the dollars we're spending on capital that we're generating the returns we expect to return. And so long as we continue to have satisfactory returns on capital, we'll maintain a fairly strong capital expenditure program and I think it's important to continue to remodel our stores. Another source of the savings is we want to focus on remodels probably a touch more than we have on net new and relocateds over the last several years. The other thing to keep in mind is unless you want to pay a penalty to get out of things you have in the pipeline, it takes a little while to temper a capital expenditure program, particularly as it relates to new, relocated and expanded stores. And we clearly aren’t in the position of having to raise cash so severely that we need to pay a penalty to do it. So we're being thoughtful on which projects get moved forward to the top of the list and which ones we have the ability to delay a little bit to create the incremental cash flow in the near term.

**Edward Kelly - Crédit Suisse AG**

Okay. Makes a lot of sense. And just very quick last question for you, multi-employer plans, your $300 million contribution in '11, how does that compare to '10?

**J. Schlotman**

$30 million to $40 million more than '10. So not a huge increase in the use of cash.

**Operator**

Your next question comes from the line of Chuck Cerankosky of Northcoast Research.

**Charles Cerankosky - Northcoast Research**

Looking at this fuel price inflation that might go away in a month but probably won't, when you look at the trade-off between convenience of the customer being able to buy fuel at your supermarkets or C-stores and the cost savings that they might get from being in the rewards program, but at the same time that, that inflation might be eroding their in-store purchasing power. How do you come down on that, Dave and Rodney and Mike, when you're evaluating that and providing an outlook?

**David Dillon**

Well, you described the right balance to think through. And on a relative basis, I think we come out as a net-net positive. The question is, though, how much money gets taken out of the system and how strongly does it affect consumer behavior? And while we really can't predict that, as we've described a lot of the trade-offs we saw in the recession time occurred in our store or from other places to our store. So it ended up actually working a little bit more favorable to us than you might have guessed. So even there, I'm cautiously optimistic.

**Rodney McMullen**

And certainly, if you look at a couple years ago when -- three years ago, when there was heavy increase in fuel prices, that was a net benefit for us. The economy is certainly softer today than it was then so how that affects will affect it today and depending on how job growth materializes, we think that will also affect it. So it's a great question but we still think it's pretty hard to answer.

**David Dillon**

Before we end the call today for everyone, I'd like to share some additional thoughts with our associates, who we encourage to listen in on the call.

On behalf of our leadership team at Kroger, I want to thank you for your hard work to produce such a great result in 2010. You each played a part in delivering these strong fourth quarter and fiscal 2010 results. It was a year of remarkable achievements despite a difficult economy, you rallied and found fresh exciting ways to connect with our customers. You are the reason Kroger increased customer loyalty and achieved consistent, positive identical sales results each quarter.

We expect 2011 to be similarly challenging, and I appreciate your efforts to continue to grow our relationship with our customers.

So thank you, and let's all go out and feed the people. That completes the call today. Thank you, all, for joining us.

**Operator**

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a good day.