The Kroger Co. (NYSE:KR) Q4 2015 Earnings Call March 3, 2016 10:00 AM ET

Executives

Kate Ward - Director-Investor Relations

W. Rodney McMullen - Chairman & Chief Executive Officer

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Analysts

Scott A. Mushkin - Wolfe Research LLC

Edward J. Kelly - Credit Suisse Securities (NYSE:USA) LLC (Broker)

Karen F. Short - Deutsche Bank Securities, Inc.

Meredith Adler - Barclays Capital, Inc.

Robert F. Ohmes - Bank of America Merrill Lynch

Rupesh Parikh - Oppenheimer & Co., Inc. (Broker)

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Vincent J. Sinisi - Morgan Stanley & Co. LLC

Kenneth B. Goldman - JPMorgan Securities LLC

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Kelly Ann Bania - BMO Capital Markets (United States)

Operator

Good morning and welcome to The Kroger Company fourth quarter earnings conference call. All participants will be in listen-only mode. Please note this event is being recorded.

I would now like to turn the conference over to Kate Ward, Director of Investor Relations. Please go ahead.

Kate Ward - Director-Investor Relations

Thank you, Laura. Good morning and 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 ir.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 question and one follow-up question if necessary. Thank you.

I will now turn the call over to Kroger's Chairman and Chief Executive Officer, Rodney McMullen.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Kate, and welcome to investor relations. Good morning, everyone, and thank you for joining us today. With me to review Kroger's fourth quarter and fiscal 2015 results is Mike Schlotman, Executive Vice President and Chief Financial Officer.

Let me just start by saying wow, what a year. I'm delighted to report that Kroger executed on our growth plan and delivered on our financial performance commitments in 2015. We delivered our 49th consecutive quarter of positive identical supermarket sales growth without fuel and our 11th consecutive year of market share growth. We met our goal to increase capital investment while improving return on invested capital. And excluding

Roundy's, we exceeded our commitment to slightly expand FIFO operating margin excluding fuel.

Our 431,000 associates make it all happen. I am very proud of our team. By keeping our focus on serving one customer at a time, we continue to deliver for our customers and for our shareholders with remarkable consistency. I also want to welcome the Roundy's associates in Wisconsin and Chicago to the Kroger family. Our merger closed in December and integration is well underway. As we've gotten to know the people at Roundy's, it is clear they share our values and desire to make a difference for our customers.

We continue to successfully expand the technologies that Harris Teeter and Vitacost.com brought to Kroger, which provide an even better shopping experience for our customers. We developed ClickList, our shop online, pickup at the store service based on what we learned from Harris Teeter's express lane. I am pleased to share that we've expanded ClickList from one market to seven markets. We continue to improve the offering and our customers and associates both are providing very positive feedback. We are testing Vitacost.com's technology and ship to home infrastructure in Denver through a pilot in our King Sooper's division. We are also testing a similar endless aisle experience in our new store format that we launched earlier this month in Gig Harbor, Washington.

We are very excited about this new community focused grocery store concept called Main & Vine. Main & Vine mixes local, specialty and everyday products, all at affording prices. It re-imagines the modern grocery shopping experience, placing in the middle of the store fresh produce and bulk items along with an event center where shoppers can enjoy cooking demonstrations, food and beverage tastings and find a new recipe idea for dinner tonight. Customer feedback has been very positive.

2015 was a big year for our Corporate Brands portfolio, accounting for more than $20 billion of our total revenue. During the quarter, Corporate Brands represented approximately 29% of total units sold and 26.2% of sales dollars excluding fuel and pharmacy. Simple Truth continues to grow at an incredible rate, setting sales records quarter after quarter. The brand reached $1.5 billion in revenue for the year. And already in 2016, Simple Truth expanded to be a true lifestyle brand with the introduction of Simple Truth household, personal care and baby products. We expect 2016 to be an exciting year of continued innovation throughout our Corporate Brands portfolio.

Needless to say, there's a lot going on at Kroger. We are creating a seamless experience for our customers, whether experimenting with new formats, driving digital engagement or launching new Corporate Brand products, we believe that combining Kroger's culture of innovation with our culture of opportunity will continue to support our growth.

Kroger has an incredibly strong management team and a deep bench of leaders throughout our business. We are incrementally investing in leadership development and training for all our associates including high volume store managers and future senior leaders. And we have created 9,000 new jobs last year at all levels, which means even more opportunities for current associates to grow and advance. For example, we established a new operating division, the Dallas division, which created dozens of new leadership opportunities.

Looking at the economy and customer shopping behavior during 2015, we noticed that customer sentiment held relatively stable throughout the year versus previous years in which their attitudes were more volatile. In the past few months, we've seen the top economic concerns shift from rising healthcare costs to the stock market. Customers have more disposable income as a result of significantly lower fuel prices, yet economic uncertainty remains, which typically causes people to cut back on discretionary spending. That said, an interesting insight is that our customers continue to spend with us. If you look at some of our high quality offerings, such as Murray's Cheese, Private Selection, Starbucks and Boar's Head, or at the strength of our wine and craft beer business, it is clear that customers across all demographics want a great food experience. Because Kroger is doing a better job offering high quality food at affordable prices, we continue to win with our customers even as they remain cautious about their overall spending.

2015 was an outstanding year for Kroger. We delivered on our performance targets and continue to expand our use of technology to drive growth. In 2016, we will continue making a difference for our customers and associates, growing our business and delivering value for shareholders.

Now, Mike will offer more detail on Kroger's financial results and outline our guidance for 2016. Mike?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Thanks, Rodney, and good morning, everyone. As Rodney said, wow, what a year. We exceeded all four of our financial performance commitments for the year. Identical supermarket sales and net earnings per diluted share growth, FIFO operating profit margin and return on invested capital were all better than our annual and long-term guidance. Market share growth continued, improving by 40 basis points with 17 markets of 20 markets outlined by Nielsen POS Plus data up and just one market down.

We had a lot of unique items in last year's fourth quarter, which make comparisons more complicated. So I would like to spend the next few minutes discussing the story behind the numbers for our fourth quarter and fiscal year, and to give you some color on those and the current operating environment. There's a lot of speculation about inflation or deflation or disinflation. We believe a deeper dive is required when the operating environment has increased volatility. When you look at identical supermarket sales, you should not come to the conclusion that less inflation is fundamentally a bad thing. In fact, if you look at our real growth in the fourth quarter, that is, identical supermarket sales less inflation, this year's fourth quarter result was stronger than last year's fourth quarter when identical sales were over 6%.

Tonnage stayed strong, with over 3% unit growth during the quarter. And the strong tonnage allowed us to grow FIFO gross profit dollars, excluding fuel and Roundy's by 4.4% in the quarter.

All but one supermarket department had positive identical supermarket sales, excluding fuel, during the quarter. Our natural foods, deli, and produce departments led the way. The meat department was slightly negative due to 5% deflation in the category. This deflation has allowed retail prices to return to levels where more customers can re-enter the category or increase their purchases. As a result of strong tonnage, the meat department had a great quarter with strong FIFO gross profit dollar growth. This is what we often refer to as good deflation.

Our operating costs as a rate of sales were down for the 11th consecutive year, however, they were up 23 basis points in the fourth quarter. This calculation excludes retail fuel operations and Roundy's, and excludes a $60 million contribution to the Kroger Company Foundation and $55 million contribution to the UFCW pension plan in last year's fourth quarter and a $30 million contribution to that same plan in this year's fourth quarter.

There were several expenses in the quarter that won't continue at the same rate in future quarters, including charge-backs related to the transition of our payment systems to EMV that we expect to level out throughout 2016. We also saw higher pension costs and healthcare costs due to an increase in the number of claims and higher healthcare cost claims that occurred during the fourth quarter. All that said, we can and will do a better job in some expense categories including shrink, completing our EMV rollout and benefit costs.

In December, we said that volatility and weekly fuel costs would influence our fourth quarter results. That was true for the fourth quarter, as our cents per gallon fuel margin was approximately $0.169 compared to $0.234 in the same quarter last year. Fuel in the fourth quarter only contributed about half as much net earnings per diluted share as compared to last year's fourth quarter. For the full year, the cents per gallon fuel margin was roughly $0.174 compared to $0.19 last year.

Our fourth quarter net earnings per diluted share increased 9.6% to $0.57 compared to $0.52 during the same period last year. This result was helped by the lower tax rate and lower LIFO expense, but our strong real growth contributed to our results.

Our 2015 cash flow generation was strong, allowing us to make $3.3 billion in capital investments during the year excluding mergers, acquisitions, and purchases of leased facilities. We repurchased $703 million of stock and returned $385 million to shareholders through our dividend. Net operating working capital declined $451 million, which also enhanced cash flow. Our net total debt to adjusted EBITDA ratio came in at 2.08 times compared to 2.14 times during the same period last year, even while investing approximately $870 million in our merger with Roundy's late in the year. Our balance sheet is as strong as ever.

I'll provide a brief update on labor relations. In 2016, we will negotiate agreements with UFCW for store associates in Houston, Indianapolis, Little Rock, Nashville, Portland, Southern California, and Fry's in Arizona. Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality affordable healthcare, and retirement benefits for our associates. Kroger's financial results continue to be pressured by rising healthcare and pension costs, which some of our competitors do not face. Kroger and the local unions, which represent many of our associates, have a shared objective, growing Kroger's business and growing it profitably, which will help us create more jobs and career opportunities and enhance job security for our associates.

Turning now to our 2016 guidance, we expect identical supermarket sales growth excluding fuel of approximately 2.5% to 3.5% for 2016, reflecting the lower inflationary environment. For full year net earnings, we expect 2016 to range from $2.19 to $2.28 per diluted share. Where we fall within the range will be primarily driven by the actual fuel margins. We expect margins will be at or slightly below the five-year average, with continued volatility. We expect our core business in 2016 to grow in line with its long-term net earnings per share growth rate of 8% to 11%. Shareholder return will be further enhanced by a dividend which is expected to increase over time.

In thinking about the cadence of our quarterly results compared to our long-term 8% to 11% guidance, the first quarter we would expect to be at the midpoint to high end, the second quarter below that range. And keep in mind, 2015 grew 26% for earnings per share last year. The third quarter at the midpoint and the fourth quarter at the midpoint. We expect capital investments excluding mergers, acquisitions, and purchases of leased facilities to be in the $4.1 billion to $4.4 billion range for 2016. We expect Kroger's full-year FIFO operating margin in 2016 excluding fuel to expand slightly compared to 2015 results.

Now I will turn it back to Rodney.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Mike.

2015 was an outstanding year. We delivered on our performance targets, grew market share, created 9,000 new jobs and even more opportunities for our associates, and we continue to expand the use of our technology to drive growth. We look forward to continuing that momentum in 2016. Obviously, lower inflation will be a headwind to sales. But when you look back over the past several years, we've had periods of high and low inflation. And we've shown that regardless of the environment, we consistently do our job to manage through it and maintain relative pricing. In doing so, we'll continue to deliver greater value for our customers and for our shareholders.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

Thank you. And our first question will come from Scott Mushkin of Wolfe Research.

Scott A. Mushkin - Wolfe Research LLC

Hey, guys, thanks for taking my questions. So I just want to dive into – good morning. I just wanted to dive into the near-term outlook. Mike, I think you said the tonnage was just fantastic during the quarter and actually better than last year's fourth quarter. Sequentially, did you see tonnage slow?

And then as you look at the cadence in the quarter, it does seem like things fell off a little bit as we got to the last four weeks of the quarter. Any thoughts there on what the current environment is? There's a lot of nervousness out there that deflation is really starting to bite and maybe the consumer – the volumes aren't quite as good.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Our volume continues to hold up very well, Scott. When you look at even coming into this year, when you look at shipments, case shipments out of our warehouses to replenish our stores, it remains very, very strong. If you go back to the commentary I had on the meat department, some of the categories, as we say, it's good deflation because we're getting back to retail price points where the customers can buy a lot more of that product. And while for the time being it's a slight headwind to sales when you just look at the top line, with the number of units we're selling at a good gross profit dollar rate per item, we're generating significantly more gross profit dollars.

When you look at the fourth quarter overall, you have to keep in mind a few things about your commentary about late in the quarter. We had significant snow events during last year's fourth quarter and as well as the Super Bowl shifting from the fourth quarter to the first quarter. And those on top of a department like meat with the deflation certainly play a factor in what the sales percentage growth is. But the unit growth continues to be very strong.

Scott A. Mushkin - Wolfe Research LLC

Okay, that's perfect. And so you didn't really notice any material change because you did come in a little bit below your guidance, I think, on the comp. And I guess in your mind, what changed a little bit there or maybe nothing did, it just was a little bit more severe than anticipated?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

I think the biggest change was that we had almost no weather at all in the quarter. Inflation ended up being a little bit lower than what we expected. But I think that by far the biggest part would be the weather. And basically we had no benefit of weather in the fourth quarter. And most of that would have obviously shown up later in the quarter.

Scott A. Mushkin - Wolfe Research LLC

So then, Rodney, this is – and then I'll yield, one just more longer-term type of question. The industry fundamentals, just generally, things seem to be changing rapidly. I know you guys expanded your ClickList. But you have a lot of, like I call them, alternate business models springing up, whether it's Green BEAN in the Midwest, which is delivering to the home, or something like a Blue Apron, obviously, the idea of click-and-collect or AmazonFresh delivering. Where do you see the industry going, and how do you see Kroger navigating that more long term? And then I'll yield, and thank you for taking my questions.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Scott. When you look at long term and if you look at several of the changes we've made over the last couple of years, it is really merging with people that have expertise in some of those areas so that we could bring that within Kroger. And what we're really working hard on, and I mentioned it in my comments, is trying to create it where it's a seamless experience for our customer. By no means do I think we have arrived, but what we're finding is some customers like to engage with us multiple ways and we're really striving to make sure that we have a model where we can let the customer decide how they want to engage with us versus us deciding that. So it's an exciting time to be in the industry. There is no doubt there's a lot of change going on and the changes that we have been making over the last couple of years we feel really good about positioning us to address where the customer is headed versus where they've been. Thanks, Scott.

Operator

The next question will come from Karen Short of Deutsche Bank. Okay, apologies. We have a question from Ed Kelly of Credit Suisse instead.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

Yeah. Hi, guys. Good morning.

W. Rodney McMullen - Chairman & Chief Executive Officer

Good morning.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

So a question for you. I just wanted to follow up on Scott's question on inflation. I guess, Mike, first of all, do you have the inflation number for this quarter? I don't know if you gave that or not.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Just give me one second, or whatever. It's about 60 basis points overall, but there's a lot of variability in that number. As I said in my prepared comments, the meat department was deflationary, deli was deflationary, seafood was deflationary. Grocery was a little bit inflationary. So it's a mixed bag overall. And as Rodney said – if you look at produce, it was actually inflationary. So, produce has been all over the map this year, deflationary in the first two quarters, about flat in the third quarter and now inflationary. And our job is to operate the best we can, given the environment we're operating in. And I think we've done a phenomenal job of managing our way through some of the volatility in the commodities that are out there. And in the backdrop of that, pharmacy continues to have inflation, although it declined throughout the year. It ended the fourth quarter at just under 5% inflation and it started the year at 10%, so it's a wide range of things that have happened throughout the year on the inflationary front.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

The question I really wanted to ask about this, if I look at your guidance for next year, 2.5% to 3.5% IDs, inflation, I think, in the 8-K said up 1% to 2%, which is not that different I guess than what 2015 is going to average out at. And you do have some difficult tonnage comparisons. You had such a great year in 2015. So I guess as we try to dissect this, is the difficult comparison in tonnage also playing a role in terms of how you're thinking about 2016? And maybe as part of all that, you can help us maybe understand why tonnage accelerated the way that it did last year.

W. Rodney McMullen - Chairman & Chief Executive Officer

A couple things. First of all, remember, when we merge with somebody, we immediately include that company in our identicals. And I know there's other companies out there that don't include merged companies for the first year. And when you look at that effect that will change the guidance by about 40 basis points to 50 basis points on identicals in terms of what our expectations are. The other thing is – and you never know until after the fact is how does the inflation happen. And we believe that early in the year we won't see much inflation. We believe later in the year we'll see a little bit more inflation versus being consistent throughout the year. And the inflation guidance is as much affecting the LIFO estimate as it is what we really think inflation is going to be if you volume weighted it throughout the year. There's no doubt that when you cycle good numbers, the cycling is a little bit tougher. But it would be more driven by the inflation that we expect during the year and the mergers. I don't know, Mike, anything you want to add to that.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

No, I absolutely agree with you. You go back into some of the fresh departments like produce. Produce inflation of almost 6% in the fourth quarter is not a good thing. That means there was probably short supply of product and the product that was there was not that high of quality. So, you can't just – one of the things we have been trying to encourage people to do is don't look at my 60 basis points of inflation. Try to dig down on the different components of it to understand how that can affect our business.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

Okay. Now, if I could just squeeze in one more, because I think it's an important one, and this is for you, Rodney. Could you maybe talk about how your M&A strategy is evolving? If I think about your company over the last few years, obviously, you've been more aggressive than you were prior. You did Roundy's, which I think is something that years ago, at least from a Street perspective, we would have thought was something that maybe you wouldn't want to do a turnaround in a new market. But maybe just talk a little bit about how things are evolving, and going forward, really what you're looking for as opportunity.

W. Rodney McMullen - Chairman & Chief Executive Officer

It really wouldn't. If you think about the comments that we make on merger opportunities over the last five or ten years, everybody should assume that we look at most opportunities, especially if it's in the U.S. We're really looking for companies that bring something to us that we don't have today. One of the things that we loved about merging with Roundy's was, as everybody knows, that we were looking at going into a new market. By merging with Roundy's, it allowed us to go into Chicago with a business that Mariano's has done a phenomenal job on connecting with customers, and their market share is in the low teens. And they entered that market in 2010. So, we felt like we could learn a lot, plus we started out a position of strength because of the success they have had.

When you look at Wisconsin, Pick 'n Save and cost has great market share across the state. We love Wisconsin. It's a market that we really like and we look forward to operating in it. So, it's really our partnership and synergies that we felt like we could bring to Roundy's and the strength that they have that we could improve from where everything was. So, it's a little different than a completely typical thing, how we've merged with somebody. But I wouldn't – I don't think you should read into that, that our strategies have just fundamentally changed in terms of the way we approach things.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

The other thing about Roundy's, particularly in Wisconsin, as Rodney said, not only did they have the very strong market share even though it's declined, the real estate sites they had were phenomenal. And we probably would not have considered a transaction like this if they didn't have outstanding real estate sites where we know we can grow their market share back to where it once was.

W. Rodney McMullen - Chairman & Chief Executive Officer

Yeah. Yeah, that's a good point, Mike. There is no doubt, if we didn't feel great about the real estate we would not have embarked on merging with Roundy's.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

Great, thanks, guys.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Ed.

Operator

And our next question comes from Karen Short of Deutsche Bank.

Karen F. Short - Deutsche Bank Securities, Inc.

Hi, guys. Having technological (28:47).

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Good morning. Karen, you're hard to hear.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay. Can you hear me?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Yes, barely. Go ahead.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay, sorry. I'm in Asia. I guess I'll be quick. CapEx for 2016 seems way higher than I would have expected. Can you give any color there? And I guess I was also wondering if you could give some puts and takes on how Roundy's might impact your comp for 2016 in terms of guidance?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Relative to the CapEx, as you know, we talked about our fill-in market strategy back in October of 2012 and we had expected a steady step-up in the CapEx. The guidance at that point in time didn't contemplate a merger with Harris Teeter and then a subsequent merger with Roundy's. Harris Teeter had gone into a new market, in the Washington, D.C./Baltimore area. We continue to fill in those markets with some very attractive sites. Another chunk of the increase in the CapEx is allocating capital to Roundy's not only to support the plan they had in place. There were a lot of plans they would have had that given their financial position they couldn't have executed on. So, there are dollars in there for us to go in and refresh and remodel some of their stores to show the folks in Wisconsin what they can expect going forward. The rest of it is really, we didn't start off as quickly on our fill-in strategy as we would have thought in 2012. It took us a little longer to get projects lined up, and we feel comfortable now that the pipeline of projects we have are starting to come to fruition. And the other thing that's in there for Roundy's is probably a little bit of capital for conversions and the like on systems and so forth.

W. Rodney McMullen - Chairman & Chief Executive Officer

And on the identical piece, I mentioned that mergers in total, if you look at our guidance we gave, you should assume about 40 basis points to 50 basis points as the impact from the mergers that we've done.

Karen F. Short - Deutsche Bank Securities, Inc.

And sorry, what, last follow-up in terms of CapEx is $4.1 billion to $4.4 billion, the new base that we should use and grow a couple hundred million off of that every year going forward? And then can you just give some update on what the pharmacy impact is on the comps in 2016?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

As far as the $4.1 billion to $4.4 billion, we will continue to increase our CapEx and execute our fill-in strategy so long as we're seeing the performance on the stores we're opening achieve the budgeted expectations so that they become the fuel for the engine. And from a granular standpoint, I don't think I'll get into department by department expectations for ID sales.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay, thanks.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Karen.

Operator

And our next question comes from Meredith Adler of Barclays.

Meredith Adler - Barclays Capital, Inc.

Hey, thanks for taking my question. I wanted to talk a little bit about some of the experiments in formats that you're doing. Obviously, you're looking at how to connect more broadly digitally with your customers, but I think – and maybe I missed a little bit of what you were saying, Rodney, but that the Main & Vine, maybe just talk a little bit about what the goal is with that test and where you think that can go.

W. Rodney McMullen - Chairman & Chief Executive Officer

We think it's always important to be trying different approaches to connecting with customers. As you know, we've had phenomenal success in natural and organic over the last several years and we really see customers continuing to see that as important. But with that said, there's certain items where the customer still wants to buy everyday stuff. And when you look at Main & Vine, what we're trying to do is to merge those two pieces but connect at a local level a little deeper than we normally would.

Meredith Adler - Barclays Capital, Inc.

And that would be a smaller store, 35,000 square feet, 40,000 square feet as opposed to what you build for most new Kroger's?

W. Rodney McMullen - Chairman & Chief Executive Officer

Yeah, the store would be probably more likely in the 22,000 square foot to 30,000 square foot type store.

Meredith Adler - Barclays Capital, Inc.

Okay. And then just the other – and I'm assuming that Main & Vine is not aimed at the lowest income customer. I know you've been testing Ruler. What are your thoughts about that format or whatever you need to do to extend the test? Aldi is going to be expanding, I'm not sure how significant it will be, but customer feedback is actually surprisingly good about Aldi. So maybe you could just talk about your dealing with that lower end customer.

W. Rodney McMullen - Chairman & Chief Executive Officer

Yes. If you look at Main & Vine and Ruler, they are definitely targeted to a different customer, so I would agree with your comment completely. On Ruler, we're still trying to understand the economics of the model to get to where it actually performs at an ROIC that we're happy with. We continue to make progress, but we do not think we've figured it out.

We have a tremendous amount of respect for Aldi and Lidl as well. We've spent as much time in Lidl stores as we have Aldi stores over the years, and Lidl has done a great job when you look at a lot of the European countries. So we have a lot of respect for those formats. There are certain customers that we believe likes to shop in that environment. Everything that we can tell, it's not all customers. It is a customer segment, and what we're trying to do is to serve that segment. And if you look at Main & Vine, it's the same thing. There's a customer segment that we don't think anybody out there is really serving, and we're trying to identify a model that will serve that customer.

Meredith Adler - Barclays Capital, Inc.

And then just as my follow-up question on Main & Vine, do those stores need to be located where the customer is lower middle income, or is it more that it's near a fair amount of population that isn't very affluent?

W. Rodney McMullen - Chairman & Chief Executive Officer

If you look at Main & Vine, it's very, very early. And we only have one store. And it's only been open a few weeks. From customer demographics, we would be looking more at a customer that would be overly influenced on speed and convenience for dinner, and a little bit more bent for natural and organic. So that would be the customer that we would be looking for, and it would be driven by – more by that than economics.

Meredith Adler - Barclays Capital, Inc.

Great, that's very helpful. Thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Meredith. And I think this is your last call. We really appreciate you following us over the years and best wishes on a beautiful retirement. And thank you for the partnership with Kroger and thank you for the friendship.

Meredith Adler - Barclays Capital, Inc.

Thank you very much, Rodney. That's very, very sweet of you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Take care, Meredith.

Meredith Adler - Barclays Capital, Inc.

Thanks.

Operator

And the next question will come from Robby Ohmes of Bank of America Merrill Lynch.

Robert F. Ohmes - Bank of America Merrill Lynch

Hey, thanks, guys. I'm going to cheat and sneak in two quick ones. Just another one on inflation, you guys commented on the protein deflation and then produce being inflationary this quarter. Can you give us any color on just what's playing out in center of store overall from an inflation or deflationary standpoint, any thoughts looking through 2016 here?

And maybe even tied into that, just competition, any update there? Walmart has been making efforts in produce in the Supercenters. Neighborhood Market actually had a very good comp still in the most recent quarter. Just anything competitively, maybe even specifically, versus Walmart you can comment on? Thanks.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

When you look at the grocery category from an inflation or deflation standpoint in the fourth quarter, it was slightly inflationary. I would remind you that for us, we categorize milk in the dairy case overall in the grocery category. If you were to take the effect of lower cost and lower retails of milk out, the grocery department would have been closer to 1% inflation.

And relative to the competitive environment, we pay attention to every competitor and what they're doing. As Rodney said, we get into a lot of our competitor stores. I think a lot of this, when we travel around, whether it's domestically or internationally, we probably often get into as many or more competitor stores as our own stores to keep an eye on what everybody else is trying to do. But what we really wake up every day trying to do is to make sure we're focused on our customers and understand what our customers want and try to deliver more on that every day. Certainly in the background is what the competitive landscape is. But with the knowledge and understanding we have of what drives our customers, that is our primary focus.

W. Rodney McMullen - Chairman & Chief Executive Officer

One other thing I would just add, and this is a Kroger comment. We've invested a lot in our fresh departments, especially this year. And we've invested a lot in labor to improve the experience for our customers. I know our customers are giving us good feedback on what we've done. I think every competitor is really working hard to get better. And the customer is telling us the changes we're making, they like what we do.

Robert F. Ohmes - Bank of America Merrill Lynch

Thanks. And just on the grocery inflation ex-milk, anything we should think about for 2016 that would make it different than what you guys saw in 2015?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

I guess I would answer that as who knows. You could have a weather disruption or any number of items that happen during the year. You could have a bumper crop of corn and wheat or a horrible crop of corn and wheat and it changes the dynamics of not only the fresh departments but the grocery categories.

I think when you look at our own ability or inability to predict where LIFO may wind up, when you really predict an inflation on one day at the end of the year and the amount of units you will have, it's just so volatile. Our job is we try to understand what's going on, on a regular basis and make sure we're delivering on our customers' wants and needs. Thanks, Robby.

Robert F. Ohmes - Bank of America Merrill Lynch

Great, thank you.

Operator

The next question is from Rupesh Parikh of Oppenheimer.

Rupesh Parikh - Oppenheimer & Co., Inc. (Broker)

Thanks for taking my question. So first I just want to start off. Mike, I know you talked a lot about and you gave us color on some of the expense pressures that you saw during Q4, and it sounds like many of them could be transitory. I just wanted to get a sense of what type of expense pressures do you expect in 2016 on your business.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

There are always expense pressures out there. And as I said in the prepared comments, there are some that we would expect to mitigate and go away over time, most likely by the end of the first quarter, things like the charge-backs from the EMV conversion. We can and will and need to do a better job on shrink control. We know that opportunity is out there and is staring us in the face. We have some processes and tools that we're testing today to make us more successful in that category.

We also understand that, as I said in our labor negotiations, pension and healthcare costs, there are some that we face that some of our non-union competitors don't face to the same extent. And we have to make sure that's front and center as we negotiate the list of contracts I spoke of that are up this year.

W. Rodney McMullen - Chairman & Chief Executive Officer

And when you look at the year overall, we would expect to be able to continue to manage where our costs are going down. And we have a ton of process changes that we're working on to take costs out of the business.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

I absolutely agree, Rodney. Our goal is year-over-year to be able to continue to reduce our total operating costs.

W. Rodney McMullen - Chairman & Chief Executive Officer

As a percent of sales without fuel.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Right.

Rupesh Parikh - Oppenheimer & Co., Inc. (Broker)

Okay, great. And then my follow-up question. Is it possible to get the quarter-to-date trends?

W. Rodney McMullen - Chairman & Chief Executive Officer

If you look at quarter to date on identicals, it would be a little bit below the bottom of the range. That's consistent with where we thought we would be at this point. The weather – the cycling of weather continues to be – because we just basically have had no weather benefits. But if you look at where we are, it's consistent with where we thought we would be so far.

Rupesh Parikh - Oppenheimer & Co., Inc. (Broker)

Thank you for all the color.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks.

Operator

Our next question comes from John Heinbockel of Guggenheim Securities.

John Heinbockel - Guggenheim Securities LLC

So, just curious if you guys can talk to the impact of the capital program. I guess specifically this year on the P&L and then also cash flow meaning will all the incremental footage, does that weigh on ex-fuel EBIT margin a bit? Is this the peak year for that? And then how does this impact utilization of free cash, particularly how you think about buyback?

W. Rodney McMullen - Chairman & Chief Executive Officer

I don't think this will be the peak year, but it will be getting close to the peak year. We're going to – when you talk about a 100 major store projects for us, we haven't done that many major projects in quite a while. They are typically a drag for a while before they start generating positive EBITDA. So I don't think we're there yet. It certainly – when we build our model, we certainly contemplate the effect of our capital program as well as making sure that we continue to get the contribution from those stores that are a year or two old today that should be throwing off some significant EBITDA to help us manage through the process.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Yeah. But it would be very close.

John Heinbockel - Guggenheim Securities LLC

And how about the cash flow impact?

W. Rodney McMullen - Chairman & Chief Executive Officer

Say that again?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Cash flow.

John Heinbockel - Guggenheim Securities LLC

Just the cash flow impact.

W. Rodney McMullen - Chairman & Chief Executive Officer

I think if you look at our free cash flow generation over the last several years, I think we're in a good spot relative to being able to continue to execute with the expanded CapEx, a strong dividend, and we expect it to grow over time, as well as executing a buyback strategy. We would expect to do all three of those.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Yeah. When you look at on a cash flow, we have also made great progress on improving working capital, which is funding part of it as well.

John Heinbockel - Guggenheim Securities LLC

And then maybe for you, Rodney, more strategically, when you think about the non-food side of the Marketplace, how would you – how do you think that will evolve? How would you like that to evolve? And is it possible you can get broad distribution of more brands that maybe you haven't been able to get to date?

W. Rodney McMullen - Chairman & Chief Executive Officer

Well, we would certainly expect over time that there would be more of the brands – bigger brands would sell to us. When those companies understand that we're going to treat their brand and respect their brand and support it just like they do. And we partner with a ton of great branded companies out there. And what we believe we can do over time is to show them that we're going to take care and grow and support their brand just like they do. If you look at the non-food side of the Marketplace store, we think it will continue to evolve over time. So it's one of those things where what we do today is different than what we did two years ago, what customers tell us is they like what we do today better than we did two years ago. But we still think there's still – it will never stop evolving.

But, as you know, when you look at the grocery side, it doesn't stop evolving either. And customers give us good feedback on that side of the store. Because it's things they pick up because they find a great value for what they find. It's something at a very reasonable price.

John Heinbockel - Guggenheim Securities LLC

Okay, thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, John.

Operator

And the next question will come from Vincent Sinisi of Morgan Stanley.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Hey, great. Thanks very much for taking my question. Good morning. I wanted to ask a bit further on Roundy's. Can you guys just give us a little bit more color in terms of now you're a month and a half or so in? What have you found to be kind of, let's take the main conventional banners for a second, in terms of the amount of work that needs to be done? Is it more kind of assortment? What percentage may need more true remodels or anything like that?

And then maybe on Mariano's, anything worth noting that needs to be done versus maybe just looking towards future expansion?

W. Rodney McMullen - Chairman & Chief Executive Officer

Yeah. If you look at Mariano's, that brand is incredibly strong and it's really supporting the brand that's been built and continuing to build out that. When you look at Wisconsin, it really reminds me of where Kroger was several years ago. And it's really embarking on the same journey that we have been over the last several years in terms of all the items that you talked about.

The two things – I guess three things. One, there's a lot of learnings that we can bring back into Kroger from Mariano's, if you look at some of the things that we're really working hard with Roundy's in total is bringing the synergies of $110 billion company to procurement and using 84.51° to help with insights there that we've obviously had a long successful journey on. I don't know, Mike, anything else you would want to add?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

No, we spent a lot of time in the Wisconsin market before we decided to go ahead with the merger. I don't think there's probably not a store in Wisconsin that some member of our senior management team hasn't been in and many of the stores we would have been in multiple times all over the state. We understood – we had a good understanding of what investments we're going to need to make in infrastructure, what improvements we may need to make from potential resets or incremental hours in stores to better serve customers. So, we factored in the things that before we could actually sit down across the table of what we thought we needed to do to bring them back to the market share they once had.

W. Rodney McMullen - Chairman & Chief Executive Officer

We really feel good about the people. And as you know, Roundy's had a tremendous amount of debt, which didn't give them the financial flexibility to do some of the things they would have liked to have done. And we really – the associates on Roundy's, they care so much about the customers. Senior leadership really does want to support the stores on improving the experience for customers. So, that's one area where I thought we would feel good about, but I actually feel even better than what we thought going in.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

That is helpful. Thank you. And maybe just one more quick one here. Just going back to Main & Vine and appreciate the color with Meredith's question there. But just to kind of help us picture until the folks on this phone can get into the store itself, but I know it's early, but can you just give us a little bit more sense for is there going be a lot of Simple Truth, private label offering kind of maybe a little bit more around the initial mix that you're testing at this point or – and anything else that would be helpful.

W. Rodney McMullen - Chairman & Chief Executive Officer

Probably the biggest thing that would be easy is if you look at the fresh departments, the amount of space dedicated to fresh departments would be very high. The other thing that we would do is really try to make sure we are doing all we can to support local food suppliers. So, local coffee, local cheeses, local bakeries, those items.

If you look at the grocery side that would really be – it would be Simple Truth in the store, but there would also be a lot of natural and organic. I don't – and I guess the other department that would be a little bit expanded would be on the health and wellness and cosmetics and some of those things and even supporting the local community.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Okay, very helpful. Thank you, guys.

W. Rodney McMullen - Chairman & Chief Executive Officer

Mike just made another point to me that we used our 84.51° insights to set what to carry in the store and how to set the store. And it's a store where we have completely used the data to determine that.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Great, thank you.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Thanks, Vincent.

Operator

The next question comes from Ken Goldman of JPMorgan.

Kenneth B. Goldman - JPMorgan Securities LLC

Hi. Good morning, everyone.

W. Rodney McMullen - Chairman & Chief Executive Officer

Good morning.

Kenneth B. Goldman - JPMorgan Securities LLC

I was a bit surprised to hear that the quarter to date ID number was light or lighter than I think some people hoped for, because I would have thought that the Super Bowl shift would have helped a bit. And I would have thought, just based on your guidance from 1Q to be better, that maybe the top line would have been better there. So maybe those things are true, but just a lack of favorable weather was bigger than we thought. I'm just trying to get some sense of the sizing of the impact of, I guess, football and weather on the quarter and also sort of an explanation, and maybe I just missed it, of how the comp sales are going to be lower but the EPS are going to be higher at the ends of your ranges.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

When you look at the quarter to date, it is – Super Bowl selling was great but almost every week or really every day when we get ID sales, it seems there's some geography that was up against weather last year and no weather this year. That's going to flesh itself out. Those things happen occasionally. It's our job to manage through it. Tonnage has remained strong. We feel good about where we're trending on those pieces. I don't think it's an issue from our tonnage or our growth or our customers coming in the store. We saw great trends in the fourth quarter when we worked up against weather when our total households that came to our stores increased, the visits per households in total increased and units per basket in the fourth quarter increased. And those kinds of things over time, that's the momentum you want to see going into a new year. So we'll work our way through that.

Relative to your question on IDs not where they were but EPS up, I would go back to my comment on the meat department where you just can't assume that if ID sales aren't as strong as they were, that's just a percentage calculation. What you have to understand is what's the cost of that product, what can I sell it for and how many gross profit dollars do I make off of that. In many instances, like meat, because of the pickup in the volume at lower retails, you wind up generating significantly more gross profit dollars and we would expect that to continue to play out in different categories throughout the year. Think about the effect I said of milk on the top line. Milk generated good profit in the year for us. Headwind to report at ID sales, absolutely. But overall, the generation of profitability in milk was strong for the year.

W. Rodney McMullen - Chairman & Chief Executive Officer

Yeah. And remember the other comment I made earlier is we would expect inflation to be lower in the early part of the year and higher later part of the year. But when you look at inflation overall, we have operated our business in low inflation and high inflation and we have been successful in both environments.

Kenneth B. Goldman - JPMorgan Securities LLC

Thank you. And then my follow-up on M&A. I think you said that your – and you've said this previously, you're always looking for something, whether it's capabilities or geography that you don't have today. I think one of the concerns out there is that Kroger may be more amenable to deals that would be considered, I guess, surprising to the Street than they used to be. Because looking for something you don't have today kind of leaves you open to almost anything. You could go in to a new format, a new country. So I'm just curious for investors out there listening, are there limitations to what you would buy, even if it's something that you would consider new in terms of what you don't have now?

W. Rodney McMullen - Chairman & Chief Executive Officer

I'll go back to what I said before. You shouldn't expect the way we would look at merging any different today than over the last several years. And as you mentioned in your comments, you should assume that we would look at most things. And I added a second ago in the U.S. So you shouldn't think that all of a sudden you're going to see us in some place that we have no knowledge or no synergies.

On the capability, we're really looking at things that are in our core business. So we're in the food business and we're in the health and wellness business. Those are the areas where we're going be focused on how do we get a deeper and better connection with our customers. So you shouldn't assume something that's out in left field.

Kenneth B. Goldman - JPMorgan Securities LLC

That's helpful. Thank you very much.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Ken.

Operator

Next question comes from Zack Fadem of Wells Fargo.

Zachary Fadem - Wells Fargo Securities LLC

Hi, good morning. Just to stick with Roundy's for a minute, how are you thinking about the timeline of just integration and investments throughout fiscal 2016? And have you started to roll out things like price investments and store improvements yet? And given the volatile deflationary environment, have you considered delaying price investments in certain categories?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

We have a timeline developed for how we're going to work with the Roundy's team, particularly in Wisconsin. I'm not going to get into what that timeline is, but you should assume it's not just a 2016 effort. It would be very similar to how we've done overall investments at Kroger, and it will be multifaceted over a fairly long time horizon.

I don't think there's anything in our minds that would cause us to delay what we think we need to do at Roundy's because of the current operating environment. As Rodney said, we're as bullish as we were six months ago when we were looking at this. It's only been two months. The deal closed December 18, so it's only been two and a half months. You certainly didn't disrupt our team or their team during the holiday selling season. So it was really after the first of the year where we first started sitting down one-on-one with them and developing plans and strategies. And we feel very good about what our plans are going forward.

W. Rodney McMullen - Chairman & Chief Executive Officer

And we've done a ton of work with research and working with the Roundy's team to try to understand the customer and understand the customer wants and needs. And the plan will actually be starting to execute against our understanding of the customer wants and needs. And some of it will be test and some of it will be to go do it.

Zachary Fadem - Wells Fargo Securities LLC

Great. And just as a follow-up, big picture, you've implemented a ton of productivity initiatives over the years in your stores, shorter checkouts, labor efficiencies. I'm curious where you think there's additional room for improvement in your stores. You mentioned shrink as one of them. Is there anything new planned for fiscal 2016 to drive better efficiency, particularly with so many remodels and expansion projects planned?

W. Rodney McMullen - Chairman & Chief Executive Officer

The short answer is yes. And I'm trying to figure out a way to help you get insight without giving away something that our competitors wouldn't know about. There are several projects that we have underway. Technology and process change would be a big part of those. And if you look at the things for 2016 that are being executed against and we're actually starting to work on some of the things that we will do in 2017 as well.

Zachary Fadem - Wells Fargo Securities LLC

Great, I really appreciate the color.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Zack.

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

Thanks, and we have time for one more question.

Operator

Okay. And that final question will come from Kelly Bania of BMO Capital Markets.

Kelly Ann Bania - BMO Capital Markets (United States)

Hi, good morning. Thanks for fitting me in.

W. Rodney McMullen - Chairman & Chief Executive Officer

Good morning.

Kelly Ann Bania - BMO Capital Markets (United States)

Good morning. I just wanted to go back to the guidance and the inflation outlook for a second. If I'm hearing you correctly, so the ID guidance 2.5% to 3.5% includes a 40 to 50 basis point drag from Roundy's. So if you take that out, you're in that 3% to 4% range, which is just what you guided to last year. And also, you also guided to a 1% to 2% inflation outlook last year. So am I right to think that it's really the same but that maybe the products within the categories are a little bit different and the pace may be accelerating throughout the year instead of decelerating throughout the year? Or what's really different, I guess?

W. Rodney McMullen - Chairman & Chief Executive Officer

You did a better job of explaining what we were saying. Really, that's what we would think is early in the year we're cycling a little the inflation higher last year, lower this year. We would expect as we get later in the year that we would be a little higher inflation, if you think about the dairy comment that Mike made. We'll soon start cycling lower dairy prices in some of those things. So your comment is absolutely correct on all those pieces.

Kelly Ann Bania - BMO Capital Markets (United States)

And then just in terms of the drag from Roundy's this year, is that something that we should think about for maybe a couple of years? Or what's a reasonable timeframe to expect that to maybe not get in line with the rest of the base but to be less of a drag?

W. Rodney McMullen - Chairman & Chief Executive Officer

If you just look at our own models, we would think it would take two to three years before we'd get to where it would look more like a typical Kroger division. If you look at our merger model, that's the type of the timeframe that we used. And we wouldn't see it any different today than, I don't know, Mike, any other insight that you would want to add?

J. Michael Schlotman - Chief Financial Officer & Executive Vice President

I agree with you. We aren't going to go too fast and we aren't going to go too slow. And if we were to have a bias towards one or the other, it would be a little bit slower than a little bit too fast because what we have seen in the broad spectrum of M&A out there is when folks try to go a little too fast, they're usually not as successful long term.

Kelly Ann Bania - BMO Capital Markets (United States)

Got it. And I just wanted to maybe end with just a question on Simple Truth. I think you said it was growing at an incredible rate. I think it's been in the double-digit range in the past. Just what are you seeing there? What are you expecting from Simple Truth in 2016? I think you mentioned some new categories that have been launched in the recent year. How are you thinking about even more categories, or what are you expecting really from that in 2016?

W. Rodney McMullen - Chairman & Chief Executive Officer

It has been incredibly strong, as I mentioned. It was $1.5 billion brand for us last year. And if you recall, three years ago was when we launched the brand. We're finding very good early results. We're really looking at it more as a lifestyle brand versus narrower just food. And the additional categories we have added, it's been very good initial customer connection. So, we really see continued growth opportunity for the brand. And probably even stronger than what we would have thought initially, so it's exciting.

Kelly Ann Bania - BMO Capital Markets (United States)

Great, thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Kelly.

Before we end today's call, I would like to share some additional thoughts with our associates listening in today. As you know, a lot of our associates listen into the call each quarter. Our strong results in 2015 are the result of your hard work and dedication to our customers, each other, and the communities that we serve. I want to thank each of you for what you do every day to make a difference for our customers. Sometimes even simple things make someone's day brighter. Like when Kroger associates in Tennessee worked with a community partner to deliver flowers to seniors, or when our Fry's team celebrated a special customer's 101st birthday at a Tucson store, just awesome. Our customers appreciate your thoughtfulness. Keep up the great work.

Across the country, we continue to listen to our associates' feedback. In addition to solid pay, healthcare, pension, and other benefits, you have told us that work-life balance is important too. That's why we are introducing advance notice work schedules for associates working in our stores. This means associates will have their work schedule further in advance every time. This is designed to help you plan and manage other important things such as school, family, and other events and responsibilities. Fourteen of our retail divisions have introduced this or are doing so now. And several others will have launched by the end of the first quarter. We worked closely with our union locals to introduce this. So far, feedback from our associates have been very positive.

As always, thank you again for your continued commitment to Kroger and our customers. That completes today's call. Thanks for joining.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.