The Kroger Co. (NYSE:KR) Q2 2014 Earnings Conference Call September 11, 2014 10:00 AM ET

Executives

Cindy Holmes - Director, IR

Rodney McMullen - CEO

Mike Ellis - President, COO

Mike Schlotman - SVP, CFO

Analysts

John Heinbockel - Guggenheim Securities

Rupesh Parikh - Oppenheimer

Karen Short - Deutsche Bank

Chuck Cerankosky - Northcoast Research

Scott Mushkin - Wolfe Research

Vincent Sinisi - Morgan Stanley

Robert Ohmes - Bank of America Merrill Lynch

Kelly Bania - BMO

Ken Goldman - JPMorgan

Kate Wendt - Wells Fargo Securities

Filippe Goossens - Mitsubishi Securities

Mark Wiltamuth - Jefferies

Meredith Adler - Barclays

Stephen Grambling - Goldman Sachs

Operator

Good morning and welcome to the Kroger Company Second Quarter Earnings Conference Call. All participants will be in listen-only mode. (Operator Instructions) After today's presentation there will be an opportunity to ask questions. (Operator Instructions) Please note this event is being recorded.

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

Cindy Holmes

Thank you, Laura. Good morning and thank you everyone for joining us today. 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 second quarter press release and our prepared remarks from this conference call will be available on our Web site 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.

We are hopeful that you can join us for our 2014 investor conference in Cincinnati, beginning on the evening of October 28 and ending early afternoon on October 29. Details will be coming soon and we are looking forward to seeing many of you then.

I will now turn the call over to Rodney McMullen, Chief Executive Officer of Kroger.

Rodney McMullen

Thank you, Cindy, and good morning everyone. And thank you for joining us today. With me to review Kroger's second quarter 2014 results are Mike Ellis, Kroger's President and Chief Operating Officer, and Mike Schlotman, Senior Vice President and Chief Financial Officer.

Kroger achieved a strong and balanced second quarter as we improved our connection with customers. We are also executing our growth plan and delivering on our key performance indicators all of which is fueling strong financial results for our shareholders.

Our second quarter performance highlights Kroger's continued growth momentum. We continue to deliver on the performance targets we outlined at our October 2012 Investor Conference including positive identical store sales growth, slightly expanding rolling four quarters, FIFO operating margins excluding fuel, and improving return on invested capital.

For the period, we achieved our 43rd consecutive quarter of positive identical supermarket sales growth. We exceeded our goal to slightly expand FIFO operating margins without fuel on a rolling four quarter basis. And we increased our return on invested capital while also increasing capital investment.

Based on our strong quarter results, we are raising our net earnings per diluted share guidance and our identical supermarket sales growth guidance for the year. We expect to deliver a net earnings per diluted share growth of 13% to 15% for fiscal 2014. As you know, this is partially due to the benefit of Harris Teeter. We expect to return to our long-term growth rate of 8% to 11% plus the dividend in fiscal 2012 -- 2015, sorry. Thanks, Cindy. And we are not done growing and differentiating to better serve our customers.

We are proud to welcome the incredible Vitacost.com team to the Kroger family. We are excited about the opportunity the merger creates to transform the customer experience and move Kroger directly into the e-commerce space much faster than we could have done on our own. The merger closed last month and our teams are hard at work developing our combined business plan. Mike Ellis will have more to say about Vitacost in a few minutes.

Our merger with Harris Teeter is going very well and we are learning a lot from each other and we can't say enough great things about our Harris Teeter associates.

We continue to see positive indicators in customer shopping behavior both what our customers tell us and what their actual shopping behavior says. Kroger's data suggests some greater confidence in the economy and less caution in spending consistent with what we saw in the first quarter. Even so, confidence in the economy and the economic recovery is not pervasive across the board. Many of our customers are still struggling and we continue to pursue our strategy of connecting meaningfully with all customers wherever they are in the economic spectrum.

It is worth noting that our definition of a loyal customer is based on a combination of how often a customer shops with us and the amount of products they purchase from Kroger. We have loyal customers in every segment of the customer spectrum, from value customers to upscale shoppers and everywhere in between. We continue to see our loyal households grow at a faster rate than total households.

As you know, we developed the four keys of our customer first strategy more than 10 years ago. Because we recognize that customers wanted a grocery retailer that would deliver not just one or two key advantages, but a total combination including a great overall shopping experience, excellent customer service, a full assortment of both national and corporate brand products and everyday low prices and promotional offerings.

Today our customer research tells us that this is even more important. Our customers don't want to compromise by choosing retailers who do only well in only one or two areas. In short, customers are looking for a food retailer that can offer it all. And that is Kroger's sweet spot. That is exactly where we've positioned ourselves to win. It is where we are winning. And it is where we intend to continue to win.

Now I'll turn it over to Mike Ellis to outline our operational performance. Mike?

Mike Ellis

Thanks Rodney. Good morning, everyone.

First I'd like to thank our associates for their solid performance. Strong and consistent execution is what allows us to continue making investments in all the four keys of our customer first strategy including investments in our associates and ongoing price investment.

As Rodney said, loyal households grew at a faster rate than total households which also grew for the quarter. This is important because it tells us that we are connecting with our customers across the entire spectrum and that we are connecting in the right areas: people, products and shopping experience and price.

As expected inflation continued to increase during the quarter especially in meat, dairy and in pharmacy, which continued to produce solid growth in both script count and ID sales. We estimate inflation excluding fuel and pharmacy was 2.4% in the second quarter and 2.8% with pharmacy. Even with higher inflation we saw strong tonnage growth during the second quarter.

Our corporate brands portfolio continues to resonate with our customers. During the second quarter corporate brands represented approximately 26.3% of total units sold and 25.2% of sales dollars excluding fuel and pharmacy. We saw strong double-digit unit and sales growth in Simple Truth and Simple Truth Organic. Our new entry-level price point brands and premium tier private selection brand all had strong positive sales and unit gains in the second quarter as well.

Another driver of sustainable growth is customer first innovation. For the past few quarters we have highlighted innovations that are improving our connection with customers and growing our market share. This quarter I would like to focus on our merger with Vitacost.com.

First I'd like to echo Rodney's welcome to the Vitacost team. You're now part of team Kroger and we couldn't be more excited about that. This is a compelling transaction because of the incredible potential for transformation and growth. We believe Kroger is uniquely positioned to blend the art of retailing and deep customer insights with a superb online experience. Vitacost people and extensive e-commerce platform coupled with Kroger's customer insights and loyal customer base will really be a powerful combination that we can leverage to create new levels of personalization and convenience for our customers. We intend to build on Vitacost's robust technology platform and integrate it with our existing digital footprint to do just that.

This is one of the reasons we recently asked Kevin Dougherty, who has been serving as Kroger's Group Vice President and Chief Supply-Chain Officer to lead this effort in a new role as Group Vice President of Digital and Vitacost. Kevin has been a leader on the Vitacost merger team from the beginning and for the past several years he has been increasingly focused on building our digital organization here at Kroger. We look forward to combining our teams to do great things for our customers, together.

Now I'd like to provide a brief update on labor relations. We recently completed several successful contract negotiations covering Food 4 Less associates in Southern California and Kroger associates in Cincinnati and Dayton. We are currently negotiating contracts with the UFCW for store associates in New Mexico, Toledo, and agreements with the Teamsters covering several distribution and manufacturing facilities.

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 should have a shared objective growing Kroger's business and profitably which will help us create more jobs and more career opportunities and really enhance job security for our associates.

Now, Mike Schlotman will offer more detail on Kroger's financial results and update our guidance for 2014. Mike?

Mike Schlotman

Thanks, Mike, and good morning everyone. When we outlined our accelerated growth strategy at our October 2012 investor conference, we also identified the key performance targets for shareholders to measure our progress. I'd like to spend a few minutes discussing the results in each metric.

Our first metric is identical supermarket sales without fuel. We're very pleased with our second quarter ID sales growth of 4.8%. This strong performance was supported by ID sales growth in every department and every supermarket division. Our natural foods department continues to grow in the double digits accelerated by significant household gains. Rolling four quarters FIFO operating margins excluding fuel and adjustment items expanded by 7 basis points. Over time, we expect our FIFO operating margins growth rate excluding fuel to return to slightly expanding on a rolling four quarters basis.

The third target metric is return on invested capital. We reported a return on invested capital on a rolling four quarters basis excluding adjustment items of 13.6% which was an increase from 13.5% in the same period last year. Increased capital investments will make it more difficult to grow ROIC in the near-term. However, we expect these investments to be accretive to ROIC as they mature. We expect our year-end ROIC which will factor in a full year of increased capital investments and fully reflect Harris Teeter in our calculation to show a slight decline compared to the end of fiscal 2013.

Now I'll share our second quarter 2014 results in more detail. Please note that this quarter includes Harris Teeter and Kroger's statement of operations so year-over-year percentage comparisons are affected as a result. In the second quarter, our net earnings totaled $347 million or $0.70 per diluted share. Net earnings in the same period last year were $317 million or $0.60 per diluted share.

As Mike said we are seeing higher inflation than originally anticipated. We recorded a $26 million LIFO charge during the quarter compared to a $13 million LIFO charge in the same quarter last year. We began fiscal 2014 estimating LIFO for the year at $55 million. At the end of the first quarter, we increased our LIFO guidance to a charge of $90 million. As reported this morning, we are increasing our LIFO estimate for the year to $100 million, which is an incremental penny charge to net earnings per diluted share in the second quarter and $0.05 to $0.06 for the full year.

As we have mentioned in the past, we managed the company without regard to our LIFO charge and many of the items we discussed are on a FIFO basis. So when we develop our expectations for every given year, we estimate LIFO last. The reason for this is LIFO is merely an accounting convention. Typically a higher LIFO charge would be a headwind to results but our strong sales helped us overcome the higher than expected charge and increase our guidance.

FIFO gross margins decreased 12 basis points from the same period last year excluding retail fuel operations. Operating, general and administrative costs plus rent and depreciation excluding retail fuel operations were essentially flat as a percent of sales compared to the prior year. Increases in workers compensation and general liability reserves negatively affected this comparison by 8 basis points.

Now for retail fuel operations. About half of our supermarkets have fuel centers today. In the second quarter are cents per gallon fuel margins was approximately $0.18 compared to $0.165 in the same quarter last year. Our long-term financial strategy continues to be maintain our current investment grade debt rating, repurchase shares, have an increasing dividend and fund increasing capital investments. Achieving a 2 to 2.2x net total debt to adjusted EBITDA ratio by mid-to late 2015 remains a key objective.

Kroger took on debt to finance the Harris Teeter merger and has not yet realized a full year of Harris Teeter EBITDA. This has caused a significant increase in the company's net total debt to adjusted EBITDA ratio which is 2.33 as of the close of the second quarter compared to 1.77 during the same period last year. This is however, an improvement from the 2.42 we reported last quarter.

Kroger's net total debt is $11.2 billion, an increase of $3.5 billion from a year ago. This includes the debt related to the Harris Teeter transaction and the share repurchases activity so far this year. Kroger's strong financial position allowed the company to return more than $1.9 billion to shareholders through share buybacks and dividends over the last four quarters.

During the second quarter Kroger repurchased 1.6 million common shares for a total investment of $78 million. All $500 million of the buyback authorization in June – granted in June is still available.

Capital investments excluding mergers acquisitions and purchases of leased facilities totaled $672 million for the second quarter compared to $507 million for the same period last year. We continue to expect capital investments to be in the $2.8 billion to $3 billion range including Harris Teeter for fiscal 2014.

Now I'd like to update our growth objectives for 2014. Based on our strong second quarter results, we raised and narrowed our adjusted net earnings per diluted share guidance to a range of $3.22 to $3.28 for fiscal 2014. The previous guidance was $3.19 to $3.27 per diluted share. The company's long-term net earnings per diluted share growth guidance remains 8% to 11% and shareholder return will be further enhanced by a dividend expected to increase over time.

We raised our identical supermarket sales growth guidance excluding fuel to 3.5% to 4.25% for fiscal 2014, the previous guidance was 3% to 4%. We're optimistic as we look forward to the remainder of the year, but keep in mind we had a very strong fourth quarter last year to compare to.

Now I will turn it back to Rodney.

Rodney McMullen

Thanks Mike. I've said this before. This is an exciting time to be at Kroger. We are accelerating growth in our core business and investing in unique competitive positioning for today and the future. Integration with Harris Teeter is going exactly the way we would hope and we continue to learn from each other in ways to improve our customers' experiences.

We see transformational potential in Vitacost's e-commerce platform. We are currently hiring to fill an estimated 20,000 positions in our supermarkets stores. Next week, we will open our 2000 fuel centers location and we are well on our way to exceeding our long-term earnings per share growth rate for fiscal 2014.

Now, we look forward to answering your questions. Laura, we'll take our questions now.

Question-and-Answer Session

Operator

Thank you. (Operator Instructions) And our first question will come from Steven Forbes of Guggenheim Securities.

John Heinbockel - Guggenheim Securities

It's John Heinbockel. So two questions. Number one, how much of the inflation that you saw in the quarter do you think you actually pass through maybe on a percent basis you pass 50% of it through or 75 or what's the general thought there? And then given Rodney, your comments about the economy I would think you probably could get a lot more of that pass-through here in the third quarter or was that not right?

Rodney McMullen

On your second question, I wouldn't necessarily agree or disagree with that. And as you know, inflation you really do have to look at it item by item. And as Mike mentioned, even with the inflation we still had strong tonnage growth and we're very happy with the results in total. A lot of the inflation right now in the perishable areas, the fresh departments, and that as you know is very seasonal. And if you look at like some of the produce inflation, as soon as the next crop comes on that could heavily affect it.

On a percentage, I would hesitate to give it because on some areas, we feel comfortable we're probably past 100%, others not so. And as you know, overall as I mentioned tonnage is strong. We continue to reduce our pricing for our customers as we take costs out of the business to do that.

John Heinbockel - Guggenheim Securities

Okay. And then secondly, if you think about Harris Teeter, how much scope is there for that organization to accelerate unit growth? I know there's a lot of potential for new stores, but I know that spread out over more years. Can they accelerate unit growth? And if they can if there's the capacity to do that given the lead time on real estate when would that be? Is that a 2016 or 2017 timeframe or sooner?

Mike Ellis

John, I think you'll see Harris Teeter have a little bit higher store growth over the next several years than they otherwise would have. They had a lot of projects in the pipeline as the two companies came together with the merger. And the nice thing about joining Kroger for them is it gives them a little bit more capital capacity to be a little faster on getting some of those store projects up and running. It is true in many of the markets they operate where we have growth opportunities, the DC area, the Baltimore area, markets like that, the lead time is a little bit longer, but they've always had a very strong and forward thinking capital plan. It's really just the ability now for them to accelerate some of those a little faster than they may have on their own. So we would expect that their unit growth will kick up from where it has been historically.

Mike Schlotman

On average, the lead time is probably what, one to two years longer than what we've been traditionally used to unless you go to the West Coast.

John Heinbockel - Guggenheim Securities

Okay. Thank you.

Rodney McMullen

Thanks John.

Operator

And our next question will come from Rupesh Parikh of Oppenheimer.

Rupesh Parikh - Oppenheimer

Thanks for taking my question. So I wanted to dive a little deeper into your expenses for the quarter. Compared to the past few quarters we saw less expense leverage and I know you guys called out the more difficult comparison. Was there anything else that was unusual this quarter and were the expenses in line with your internal plans?

Mike Schlotman

They were generally in line with our internal plans. The item that we called out in both that I just spoke of in the conference call some increases in workers' comp and general liability reserves, a little bit of increase for this year as well as some prior year increases in the allowances for that caused about an 8 basis point negative effect on the OG&A lines. So we would have had a little bit better improvement, we would have shown some improvement if not for the need to increase those allowances and I can tell you that is certainly a point of focus for our operators and our loss prevention folks. The key to that isn't the dollars it's making sure the accidents never happen.

Rupesh Parikh - Oppenheimer

Okay. Then shifting to e-commerce, we've seen a lot more noise lately whether it's from Amazon or Whole Foods and some of your competitors and you guys have clearly made investments in Vitacost. I mean how do you feel about your current capabilities versus the competition right now?

Rodney McMullen

It's a good question. I would say we feel very good but we're not satisfied. And the changes that we've made over the last couple of years, we feel increasingly happy about what we're seeing. As you know, it's one of the things when we merged with Harris Teeter that we were really excited about. They have an incredibly strong click and collect operation that we're spending a lot of time on. And as you know when we announced merging with Vitacost, they have a great group of people from a talent perspective and a great infrastructure that we think we can grow off and expand.

So I feel very comfortable where we are positioned from a food standpoint relative to our competition. I feel even more excited about some of the things that we put in place to take advantage of the future. I don't know, Mike or Mike if you want to add…?

Mike Ellis

Nothing other than the fact that the merger just closed a month ago and we are working hard to bring both companies together and see all the benefits we can come up with here.

Rupesh Parikh - Oppenheimer

All right. Thank you. Good luck next quarter.

Rodney McMullen

Thank you.

Operator

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

Karen Short - Deutsche Bank

Hi.

Rodney McMullen

Hi.

Karen Short - Deutsche Bank

I just wanted to dive a little bit into gross margins. So obviously, there's been a lot of news and press about Harris Teeter taking prices down and it's hard to know how much that would have impacted your gross margins on your P&L. But by my math, your core FIFO margins excluding Harris Teeter could actually have been up this quarter. Is that a fair statement? And then I guess maybe talk a bit how generics might have impacted your gross margins and other points that might be relevant.

Mike Schlotman

Relative to Harris Teeter I won't go to that level of transparency. Harris Teeter's not the only place that we continue to invest in price. It's been fairly public about the price reductions they've done and where they've done them. But we continue to refine our pricing strategy in all the geographies that we operate. And our goal always remains to grow our operating profit margins on a rolling four quarter basis slightly. We were 7 basis points and I've never given a specific number although Rodney and Cindy both kidded me a little bit yesterday that I've always said by that it's a handful or less and most people can count how many digits are on both of my hands and it would be one hand not two.

So that's why we said we actually exceeded that goal a little bit this time and that's as you know what we always focus on and when we get the operating leverage, we can accelerate things that we plan to do later and if things aren't quite trending the way we want to grow operating profit margin we can slow a few things down, we become very nimble in that arena which has been a huge help.

Karen Short - Deutsche Bank

Okay. So then just on your quarter in general did you guys -- you guys came in above plan in the second quarter? Is that fair to say? And then I guess it was ahead of plan on earnings. Was that more gas margin related? And I guess I'm wondering because you didn't beat the Street by much but your gross margins came in quite a bit higher. And yet you're raising your full-year guidance on the low end by $0.03?

Mike Schlotman

Well, I think it's a combination of things, Karen, the strong sales certainly are encouraging for us and that momentum is always good. If you look at everything that has happened and the fact that we've increased our LIFO charge by what will amount to $0.05 or $0.06 more charge than we expected at the beginning of the year, we have now raised our earnings guidance twice. We've now raised our ID sales guidance. It's the combination of those factors that has allowed us to remain quite positive.

There were – while we only beat the Street by $0.01, LIFO cost us $0.01. And the 8 basis points from workers' comp and general liability would've been somewhere between $0.015 and $0.02, probably at least $0.02 depending on how things round. So despite those headwinds the underlying strength of our core businesses we're very happy with.

Karen Short - Deutsche Bank

And the top line strength has continued into the third quarter?

Rodney McMullen

Yes. So far through the third quarter, it's very similar to where we were in the first and second quarters, and pleased with the continued progress.

Karen Short - Deutsche Bank

Great. Thanks very much.

Rodney McMullen

Thanks Karen.

Operator

And next, we have a question from Chuck Cerankosky of Northcoast Research.

Chuck Cerankosky - Northcoast Research

Good morning everyone. Nice quarter.

Rodney McMullen

Thanks Chuck. Thank you.

Chuck Cerankosky - Northcoast Research

If we look at the P&L just for the third quarter, are there any Vitacost acquisitions expenses worth calling out, Mike?

Mike Schlotman

We haven't really called out any merger related expenses for Harris Teeter for a while. We had some actually leading up to the merger. There's been a few small ones out there, nothing amounting to much of anything although a lot of the heavy lifting on as we convert systems and maybe happen to write some of the assets off of their books that they have capitalized as we convert to our system those things might face us in the future, but those aren't cash expenditures, they're things that were spent in the past. And Vitacost is just so new, sure, there were was a handful of expenses leading up to the merger, why we use downside count so we didn't use an outside financial advisor so it's not like we had any kind of a fee to pay a third-party in that so there really wasn't much at all.

Chuck Cerankosky - Northcoast Research

And then in your guidance for the remainder of the year, Mike, how much dilution from Vitacost is built into that number?

Mike Schlotman

It's negligible for the back half of the year. And it's certainly contemplated in our guidance. They were actually operating here very recently at very close to a breakeven kind of a level. And we have a little bit of dilution built-in but nothing dramatic that we don't think we can overcome with the strength of the underlying operations.

Chuck Cerankosky - Northcoast Research

So something like less than $0.05 per share?

Mike Schlotman

Yes, sir.

Chuck Cerankosky - Northcoast Research

All right. Thanks.

Mike Schlotman

Less than a handful of pennies.

Chuck Cerankosky - Northcoast Research

Less than a handful of pennies? All right.

Operator

And the next question will come from Scott Mushkin of Wolfe Research.

Scott Mushkin - Wolfe Research

Hey guys, most of my questions have been asked. But I just wanted to delve into the balance sheet. Mike, I know you talked about 2.33 and your 1.7, I probably get the numbers all messed up, but you want to get down to 2. But, clearly there's been a lot of activity in the space. I just wondered from your perspective, does your balance sheet right now preclude you from doing other things or would it – it's a factor or how are you thinking about your balance sheet given the fact that there has been so much activity in the space vis-à-vis M&A?

Mike Schlotman

We were 1.77 last year. We were 2.33 this year, which was 9 basis points down from the first quarter. We feel very comfortable. We're on track to get to the 2 to 2.2x. And we'll be happy at the high-end of that range. We don't necessarily have to get to the 2.0x, Scott. That's just a range we wind up giving. And I don't know that our balance sheet necessarily precludes us from doing anything.

If the right opportunity is out there and we go to the rating agencies and they understand the uniqueness of an opportunity like they clearly did with Harris Teeter. And our follow-through when we make a commitment to them, that we actually follow through on what we do whether it's how we expect to grow the dividend, how we expect to use cash flow to buy in shares, how we expect to use capital to grow our business organically.

We're very open with the rating agencies and follow-through and the commitments we make and if it's the right set of assets with the right growth opportunity like Harris Teeter was with all the new markets, I don't think we would be precluded from continuing to participate in industry consolidation.

Rodney McMullen

The other thing is the 1.77 was unusually low because we had stopped buying back stock and some other things because we had already announced the Harris Teeter merger and we wanted to position ourselves relative to being able to merge with Harris Teeter.

Mike Schlotman

That's an excellent point. We were actually out of the market on shares for quite a while as we are blacked out while we were looking at it as well so with a combination of factors.

Scott Mushkin - Wolfe Research

That's perfect and if I could have one more, I think you guys recently opened up 121,000 square foot in Athens, Georgia. And I think the comment what I read is that there's a bigger one to come down there. You guys are really the only ones opening up bigger stores even Wal-mart is shrinking what they're trying to do. Can you kind of give us a reason why you're so comfortable with opening up these large stores and what you see what maybe other people don't see?

Mike Ellis

Well, we've had good success with our marketplace format. It is driving a lot of our sales and growth right now. So really pleased with how they are performing. Although we are still working on small format stores, we're doing some work and research around that. So really trying to stay open to what's the customer looking for in terms of a shopping experience. And so far they've been really pleased with the selection that we have in the big store. And we're really pleased with the results.

Rodney McMullen

When we look at our customer first tracker, customers can rate us very high in our marketplace stores. So it's really the combination of our associates and their connection with our customers and what we've put inside those boxes really connect well with the customer.

And I realize 120,000 square feet, it depends on where you start from it's a good-sized store, but it's not so big that you can't manage getting around the store reasonably easy either. And it gives you a lot of flexibility from a space utilization standpoint. And obviously, the key is making sure what you put in it, it's exciting and something the customer wants.

Scott Mushkin - Wolfe Research

Thanks, guys. Appreciate it.

Rodney McMullen

Thanks Scott.

Operator

And the next question is from Vincent Sinisi of Morgan Stanley.

Vincent Sinisi - Morgan Stanley

Good morning. Thanks very much for taking my question.

Rodney McMullen

Good morning.

Vincent Sinisi - Morgan Stanley

Good morning. Wanted to ask a little bit more about Harris Teeter. If you guys can give further color in terms of the order online pick up at store capability that obviously was one of the big draws from Harris Teeter. Where are you in that process today? And any color that you can give in terms of maybe as you roll that capability out further?

Rodney McMullen

It's still pretty early in the process. I can tell you that our teams have spent a ton of energy, but it's not something that we are to a point of announcing publicly. But, I can tell you we're progressing along and we're very pleased with where we are. And we're very pleased with the progress that Harris Teeter continues to make as well. I don't know – okay…

Vincent Sinisi - Morgan Stanley

On – in the Harris Teeter brand itself, has there been further rollout?

Rodney McMullen

Yes. Harris Teeter has continued to roll it out and they've continued to have strong growth in where they already have it, so it's really both pieces.

Vincent Sinisi - Morgan Stanley

Okay. Great. Thanks and just a quick follow-up switching over to Vitacost. I know obviously also very early in the stages, but any color that you can give in terms of when it was announced you said that of the 45,000 SKUs that Vitacost carries, you had about 10,000 overlap. Any work that's been done so far that you can just kind of incrementally share in terms of maybe what some of those other products when we may start to see them flowing onto the shelves throughout your banners, your other banners?

Mike Ellis

Well again, we just really closed the transaction and we're right in the middle of putting plans together and going through all of the steps that you would during a merger of this sort and size. And really trying to develop our plans for the future and how do we grow the platform, the Vitacost business? And we're learning a lot from Vitacost on what to do within the Kroger footprint also. So we're still in that discovery phase, but there is a lot going on and we're learning every day that there's more to learn.

Vincent Sinisi - Morgan Stanley

Okay. All right. Thank you very much. Good luck.

Rodney McMullen

Thanks Vincent.

Operator

Ad our next question comes from Robert Ohmes of Bank of America Merrill Lynch.

Robert Ohmes - Bank of America Merrill Lynch

Morning. Thanks for taking my question. For Rodney or Mike and Mike, the guidance obviously implies a little bit of a slowdown in the ID sales x fuel in the back half. Can you guys just maybe talk about why ID's would slow? Maybe what some of the support was? Is your expectation of support from fuel rewards potentially slowing? Is there an expectation of less benefit from inflation, or is there an expectation that tonnage could slow? Just sort of any color we could should think about as far as your opportunity to continue to beat those ID guidance you're giving us? Thanks.

Mike Ellis

Thanks, Robert. First of all obviously we're going to strive to make sure the identicals are as strong as we can. If you remember the fourth quarter of last year we had a lot of whether benefits. We didn't really talk about it that much in the earnings call, but there were quite a bit of weather benefits. Until you actually have it, you don't know whether it's going to be a headwind or a tailwind.

So really the biggest reason for the conservatism in identical guidance would be really cycling fourth quarter last year and not knowing how weather would be. It's really nothing should read anything in it other than that. So we really don't see inflation changing that much. We really don't see the economy changing that much. We're not seeing customer behavior changing either.

Robert Ohmes - Bank of America Merrill Lynch

And then in terms of the sort of contribution from fuel rewards has that been healthy and is that expected to continue to incrementally support ID's as well?

Rodney McMullen

It's a great question and it's a little harder to answer because it's hard to isolate just one piece and what it does for identicals. It's really the whole shopping experience so we continue to make progress on the freshness of our product. Our associates continue to make progress on connecting with their customers from a friendliness standpoint.

So it's really hard to say this piece of improvement causes this much of the identicals. Overall, as you know it's just one more reason for somebody to shop at Kroger and it's part of the overall package of what we're trying to deliver for our customer.

Robert Ohmes - Bank of America Merrill Lynch

Great. Thanks very much.

Rodney McMullen

Thanks Robert.

Operator

And next, we have a question from Kelly Bania of BMO.

Kelly Bania - BMO

Hi. Good morning. Thanks for taking my questions. Was wondering if you could just talk a little bit about category performance. I think you mentioned a little bit on private label, but I think if I'm correct, correct me if I'm wrong that you had been trending with all departments kind of in the positive territory. So just curious, if you had any update on that.

Mike Ellis

It was a well-rounded quarter. Corporate brands had a very nice quarter. If there was any pickup at all in and it's not even a hiccup, but obviously, the high dairy prices has an influence on how many units of milk wind up getting sold. So that was a bit of headwind on corporate brands because so much of the milk that we sell is processed in our own dairies. But tonnage overall was very, very strong. All departments had positive ID sales. All geographies had positive ID sales and once again natural foods would have been the leader in the departments with continued double-digit ID sales growth in that department.

Rodney McMullen

Pharmacy was strong. A lot of departments were strong.

Mike Ellis

Good broad-based performance.

Kelly Bania - BMO

Great. That's very helpful. And then just curious if you could elaborate a little bit on the signs of the less cautious behavior that you're seeing and sounds like most parts of your store. Is that more any trading up activity, is it more items you're seeing in the basket? Is it less focused on couponing and promotions? Or just any color you can provide would be helpful.

Mike Ellis

It's as much an art as it is a science. But it's looking at things that would be discretionary. What kind of performance are we having there, so if you think about Starbucks, or Boar's Head, some of our cheeses, some of our upscale items, customers continue to engage in a much more positive way than before. And that's performance that's year-on-year.

Also if you look at some of the non-foods, general jewelry, all those types of discretionary items, customers continue to be willing to spend money. And then we also survey our customers on their perception and customers are continuing to tell us they feel the economy is a little bit better, but they continue to be nervous in terms of their outlook on things. So it's cautious optimism, I think is probably the best way to put it.

Kelly Bania - BMO

Thanks.

Mike Ellis

Thanks Kelly.

Operator

The next questioner is Ken Goldman of JPMorgan.

Ken Goldman - JPMorgan

Good morning everyone. I have two questions if I can. You slipped in a mention of DC Baltimore today. Can you update us on what your plan is for your expansion into new markets where you're most focused? You're looking to hire 20,000 new permanent employees. Is that a sign you are getting closer to that, or is that not the right way to look at the press release?

Mike Ellis

I wouldn't say the 20,000 new hires really has anything to do with any announcement of going into new geography. Those are by and large, almost entirely if not completely jobs that are open today and geographies where we already operate or have plans over the next year to open stores in existing geographies. So those are actual current needs we have to have to fully staff our stores to the level we want staffed and be able to have schedules written the way we need them written and our associates want to work inside of our stores. We continue to think about our new market activity a lot of activity going on around that. But we aren't going to be premature in announcing where that's maybe.

Rodney McMullen

Obviously merging with Harris Teeter put us in a lot of new markets.

Mike Ellis

A lot of new markets. And relevant to the earlier question that I think John asked, we would expect they're relatively new to DC Baltimore, so for Harris Teeter, those were new markets and there are significant opportunities to increase our footprint in those markets.

Ken Goldman - JPMorgan

Okay. And then the drought in California, it continues to become I guess more worrisome. So as you think about some of the fruits and nuts and so forth that you source from there. I mean you look into next year some of these items might be in shorter supply. Are you planning more differently than what you might usually do? Do you have options from other geographies? If I guess certain items from the U.S. are harder to find, or is it just too early to even think about that?

Mike Ellis

I think it's probably too early to think about that although we have the same sort of issue whether it's orange juice from Florida, or other commodities from around the world that we'll have short supply from time to time and we just have to deal with that as best we can. And we buy from around the world in so many cases today whether it's in the fresh departments or other parts of our business. So we just have to deal with that as it comes, I think.

Ken Goldman - JPMorgan

All right. Thanks everyone.

Rodney McMullen

Thanks Ken.

Operator

And next, we have a question from Kate Wendt of Wells Fargo Securities.

Kate Wendt - Wells Fargo Securities

Yes. Thanks and good morning. So you're not showing organic sales growth has remained obviously pretty consistent here and strong. I'm curious how you're thinking today about this notion of the industry may be reaching a point where there's too much supply at retail for demand? Or do you think instead that the piece of the pie in terms of people interested in natural and organic is only continuing to broaden and deepen?

Mike Ellis

Well, it appears to us that the natural organic customer is changing and growing in numbers. And those that shop the grocery store are also crossing over and the blurring of grocery and natural foods is becoming more and more difficult when you look around the store and you can see organic items on the regular grocery shelves. So it seems that the customer base is getting much larger for these types of products. I don't know where the end is. It might be a lifestyle change for our customers that they are just deciding to eat better. And make different choices for their families, but we love the growth and we're going to continue to make sure that we have the products our customers looking for.

Rodney McMullen

We don't find that customer's an either/or shopper. There's a small percentage of customers that are only organic and natural, but most of our customer base actually buys across the whole store.

Kate Wendt - Wells Fargo Securities

I guess that was my follow-up. Do you have any data that you can share on what percent of your customers are buying some natural organic products today and maybe how many just started over the past couple of years? Or maybe even what type of households where you're seeing the most growth in the category in terms of whether it's middle income or upper middle incomes anything that you can share on that would be really helpful.

Rodney McMullen

It would be well over half our customers would buy something. That continues to increase. And the thing that I think is so hard is there's a lot of product innovation in that space as well. So some of the customers maybe buying products there, because of the innovation not necessarily because of organic or natural. It's just because it's a new item and it tastes good. So how much of it is driven by one piece versus the other? I think it would be just speculation.

Kate Wendt - Wells Fargo Securities

Interesting. And anything in terms of the sort of household income profile? Are you seeing that kind of dip down into the middle incomes or where you're seeing kind of the most growth?

Rodney McMullen

It's really all customer types. It's not exclusive to one specific customer might by no means.

Kate Wendt - Wells Fargo Securities

Okay, great. Thanks so much.

Rodney McMullen

Thanks Kate.

Operator

And our next is from Filippe Goossens of Mitsubishi.

Filippe Goossens - Mitsubishi Securities

Yes. Good morning. Many thanks for taking my call. Actually I have two questions this morning if I may. First one is for Michael Schlotman. Michael, if I look at your outstanding debt, still a few items with high coupons. Can you maybe conceptually talk about how you think about liability management?

And then my question for Rodney is kind of a follow-up on an earlier question with regard to smaller store formats. We are obviously monitoring with great interest the Family Dollar saga. We're also monitoring what's going on in the U.K. market where companies like Wm Morrison are using convenience stores as a way to compete with all these and the leaders of the world. Can you maybe just kind of talk a little bit more about how you think about the convenience store format? Is that something that down the road may be part of your plans or you're still very happy with your current portfolio? Many thanks.

Mike Schlotman

Okay. If you look at the smaller stores, obviously we've been in the convenience store itself for years and years and years. It came to Kroger when we merged with Dillon. We would look at – we are following Dollar General Family Dollar everyday as well. We consider both of them competitors. I can tell you all of us get into those stores on a regular basis trying to learn what they do and how they connect with their customer and what are they doing good and what can we learn from them?

And we think it will be important over time to have even a smaller store that's part of the profile that's probably a convenient store, not necessarily a convenience store. But it's something we continue to work on. We haven't figured out how to make money the way we'd like to make money there. But we haven't given up either. Mike, do you want to talk about the debt?

Mike Ellis

From a liability management standpoint, Philippe, we constantly look at some of those higher coupon pieces of debt that are out there. Many of those are 30-year debt, what was 30-year debt at the time we issued it. When we look at the net present value of making a tender offer for those, it just doesn't often come out where it's an NPV positive on a cash flow basis. It may help accretion. It may be accretive to earnings per share on that basis. But the upfront amount you have to pay because of the premium that they'd be trading at, you wind up spending a lot of cash upfront.

So we'll constantly look at it. I wouldn't say we have any plans in the near-term to do anything about them and our approach has been over time to continue to manage our liability and have dollars coming due every year. So we can be accessing the markets on a regular basis. We've actually taken a few hundred basis points out of our average interest portfolio.

When we look at upcoming debt issuance activity, we do often times enter into hedging agreements to lock in current interest rates and in advance of actually issuing the debt. And as we get closer to those, that is a type of transaction we often use.

Filippe Goossens - Mitsubishi Securities

Great. Thank you very much, Michael and look forward to seeing you next week, then. Thank you.

Rodney McMullen

Thank you.

Mike Schlotman

Thank you.

Operator

And our next question comes from Mark Wiltamuth of Jefferies.

Mark Wiltamuth - Jefferies

Hi. Good morning.

Rodney McMullen

Good morning.

Mark Wiltamuth - Jefferies

Your comments that the recovery has not really been pervasive across the board if you also look across at the discounters that have not been showing strong grocery performance, it sounds like the weakness is really in that lowest income customer bracket. Is that true? And can give us some insight on what's going on with that group are they just not responding to lower pricing at this point?

Rodney McMullen

Well, I would say that we're very happy with how we are connecting with that customer. If you look at their economic situation, incomes have been very slow to recover. And employment has been slow to recover. So it's really when I make the comment it's referring to the situation they're in. And we continue to try to make sure that we're able to address pricing and help their budget go further both on the introduction of more entry price point items, and absolutely just lowering pricing too. So we're very happy with our performance for that customer segment, but that customer segment continues to be under a lot of economic strain.

Mark Wiltamuth - Jefferies

Okay. Great. And then switching over to store growth, you've done a lot of consolidation of underperforming stores in recent years and that's put some pressure on your net store growth. But it sounds like you're coming to some end of that process. Is there a square footage growth rate you can commit to in future years that's a little more robust?

Mike Schlotman

I incorrectly predicted last year that our absent Harris Teeter that our unit growth would expand a little bit. So I'll probably be hesitant to repeat that great prognostication here. Obviously, we've been very aggressive on trimming some of the underperforming assets of our portfolio which has slowed our store count. The question earlier on an average store opening up at 121,000 square feet there are times that was not a case, but there are times where we opened a store like that and then may replace a couple of 40,000 or 50,000 square foot stores. So our square footage actually goes up, but our store count goes down by one as a result.

I think going forward, if our guidance has been in the range of 2% of square footage growth excluding the operational closings. And I don't want to get married to a square footage growth on a net basis and not make the right decision on operationally closing a store. So we kind of look at our investments in new relocated and expanded stores separately from what activity should happen on operational closings and looking at those separately. So we continue to increase capital, we'll increase it $200 million next year. Would expect to open up more stores next year than this year and I think it will be a continued progression up in both our store count and our square footage.

Mark Wiltamuth - Jefferies

So improving but something under 2% it sounds like?

Mike Schlotman

On a net basis I would think so. Yes.

Mark Wiltamuth - Jefferies

Okay. Okay. And then lastly --

Mike Schlotman

But Mark keep in mind, that square footage is significantly more productive when you look at on a sales per square footage basis. We're up roughly 50% on improvements in productivity in our stores since we started this customer first journey 10 years a go. At the end of the day I'd rather have more productive square footage than more square footage that's a little less productive.

Mark Wiltamuth - Jefferies

Okay. And then, lastly as you're looking at click and collect and some of the other models, maybe you could comment's a little on some of these personal shopping services that are out there from third parties, have you looked at the Instacart and the Google Express and some of these other ones that are out there? What are your thoughts there?

Rodney McMullen

You should be very comfortable that we've looked at all of them. And it's really trying to make sure we understand what our customers' wants and needs are. Some of the places where we believe that will be more successful our places where we don't have stores, but it is something we continue to look at and evaluate and look at partnering with as appropriate.

Mark Wiltamuth - Jefferies

Okay. Thank you very much.

Rodney McMullen

Thanks Mark.

Operator

And our next question comes from Meredith Adler of Barclays.

Meredith Adler - Barclays

Hey, guys. Thanks for taking my question.

Rodney McMullen

Good morning.

Meredith Adler - Barclays

Good morning. I wanted to go back to comment about ROIC and the fact that there are a lot of investments not just including Harris Teeter, but other investments that are dampening it now, but we will see improvement. And I was just wondering, if you can give us a better sense of not specific numbers, but kind of in terms of magnitude, whether we're talking about remodels, new stores, and then a sense of how we should expect the benefits of those investments to flow in? Is it going to be 2015 or is there more in 2016? How is that all going to work out?

Mike Schlotman

Meredith, absent the Harris Teeter being in there for a full year this year and if you can think about how an ROIC calculation works and we started to go down this path in the conference call and took the language out. So I guess I'll go down it in a Q&A. Right now we only have half of the Harris Teeter assets in the calculation because it's a beginning of the year and end of the year average assets that you return is calculated on.

So right now it's about half of years of EBITDA and half of their assets. If you think about an ROIC number for Harris Teeter based on the purchase price it would have been an ROIC number below what Kroger have been generating. So a full year of Harris Teeter in here will reset the bar for ROIC slightly. It won't be dramatically lower, but we do expect it to be a little bit lower. Absent that, even with the increased CapEx we've been investing in the business, we would have expected ROIC to grow slightly albeit somewhat slowly as we ramp this up.

You typically see a couple to three year lag and a better growth of ROIC as you begin to increase your capital expenditures. So we're about midway into that two to three-year timeframe so sometime in 2015, 2016 we should start to see a bigger benefit from those investments we've made 18 months ago and are starting to mature now and they'll overwhelm the new investments we make in 2015 and 2016 from a return standpoint.

Rodney McMullen

Typically on expansions in new stores, Mike, and the first year actually hurts ROIC. The second year it gets almost neutral, but hurts a little third year, it starts helping.

Mike Schlotman

Right.

Rodney McMullen

If you look at our maturity.

Meredith Adler - Barclays

Okay. And when you look at the performance of the projects that you've done, are they all following the pro formas that you had built? You feel like are they beating them?

Mike Schlotman

Well, it's like anything. All would be an overstatement of all hitting that overperforming, it's a mixed bag. Some are a little below. Some are exceeding it in a big way, but by and large, most of them, many of them are right at the kind of expectations we laid out. The key there will be to continue to generate the sales and the EBITDA that those stores were expected to generate. And then in turn hold our divisions accountable to give that EBITDA back to our shareholders. And either back to us to continue to invest in the business or back to the shareholders, so we can grow it. But clearly as a group, these stores are performing very well and I would say are at the point right now of exceeding our expectations as a group.

Meredith Adler - Barclays

And then my final question would be, is it right to think about this level of investment as being something that will continue? I know you don't want to talk about moving into a new market or we should receive this as sort of opportunistic and we'll see a moderation in say, 2017?

Mike Schlotman

I would not expect to see a moderation in the capital plans. We've got some great markets where we have average market shares or below average market shares when you look at some of our stronger markets. And the strong connection we see between market share and return on invested capital is one of the reasons we've gone down the fill-in strategy format. And I would expect to continue to see us having a very strong capital expenditure program.

When we laid it out in 2012, we expected a couple hundred million dollar increase for five years. And it was going to start in 2013. So that really gets you to the 2017, 2018 kind of timeframe and as we go through that process, we'll go through the report card you like you just asked on the stores we've opened and to the extent we continue to be happy with those investments as a group because in the end that's what affects our shareholders is the group. We'll make ongoing decisions about how much we'll invest in capital, but based on where we are right now, I don't see any cause for pause.

Meredith Adler - Barclays

Great. Thank you very much.

Mike Schlotman

We'll have time for one more question.

Rodney McMullen

Thanks Meredith.

Operator

And that question will come from Stephen Grambling of Goldman Sachs.

Stephen Grambling - Goldman Sachs

Hey, good morning. Thanks for sneaking me in.

Rodney McMullen

Good morning.

Stephen Grambling - Goldman Sachs

So as we – I guess following up on Kate's questions earlier on natural and organic, you mentioned innovation is a big part of some of the growth that you're seeing in the channel and the response from the consumer. Can you just provide a little bit more detail on the number of SKUs you've added in these categories, what additional rollouts are still planned and maybe how much of the sales you think has been incremental? And then kind of as a corollary there, how you think about margin associated with this category versus other areas of the store? Thanks.

Mike Ellis

Well, in terms of incremental it's hard to say. It was a lot of switching that goes on today between natural and basic type of products. As we've mentioned, we expect our Simple Truth brand to be a $1 billion brand this year. So customers are as interested today and as engaged in natural and organic as they've ever been.

Also, we don't talk a lot about organic produce, but that's a category that continues to grow. Could probably grow faster, if supply was better, but we continue to enjoy large sales growth in that particular area.

Stephen Grambling - Goldman Sachs

And so just again on the – I guess any additional SKUs that you're planning to rollout on top of what you've done already, and also how you think about the margin in these categories, I guess now and going forward? Thank you.

Mike Ellis

SKU count continues to increase. And the departments continue to grow in many cases both on the private-label side as well as the branded side. Margins I tell you what, there's more margin pressure now on natural and organic than there's ever been. It seems that it's becoming more and more of a competitive category. And so although margins tend to be better in natural and organic, I don't know that's going to continue for the foreseeable future.

Stephen Grambling - Goldman Sachs

That's very helpful. Thanks so much.

Rodney McMullen

Thank you. Before we end today's call, I'd like to take a moment to acknowledge that this morning is the anniversary of the attacks of September 11th. We all continue to mourn the loss of the brave men and women who perished on that tragic day. And I know that many of the folks on the call today were personally affected by those events. We continue to honor the memory of the fallen through our support of police, firefighters, the military, and their families. On behalf of all of us here at Kroger, we want to say our heartfelt thank you to the everyday heroes who worked every day to keep us all safe.

Finally, I'd like to share some additional thoughts with our associates listening in today. September is hunger action month. And I'd like to take this opportunity to thank our associates across the company who helped support our customers and neighbors in need. According to our partners at Feeding America, the nations largest hunger agency, there are 46.5 million Americans who don't know where their next meal will come from. Together, we are working to combat poverty in partnership with the 106 local Feeding America food banks.

Last year alone, Kroger contributed the equivalent of 200, that's right, 200 million meals nearly 4 million meals every week to feed hungry families in our community, which I just find an amazing number and my hats off to our team. Of that, our perishable donations partnership program provided more than 50 million pounds of fresh meat, produce, dairy and bakery items directly to local food banks in 2013. Our associates play a vital role in helping us get this fresh healthy food to those who need it most. Without your help and support, our perishable donations partnership would not be possible. Thank you. That completes our call for today and thanks for joining us.

Operator

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