Kroger Co. (NYSE:KR) Q4 2018 Earnings Conference Call March 7, 2019 10:00 AM ET

Company Participants

Rebekah Manis - Director, IR

W. Rodney McMullen - Chairman and CEO

J. Mike Schlotman - EVP and CFO

Gary Millerchip - CEO of Kroger Personal Finance

Conference Call Participants

Karen Short - Barclays Capital

Edward Kelly - Wells Fargo

John Heinbockel - Guggenheim Securities

Paul Trussell - Deutsche Bank

Chris Mandeville - Jefferies

Scott Mushkin - Wolfe Research

Gregory Badishkanian - Citi

Operator

Good morning, and welcome to The Kroger Company Fourth Quarter Earnings Conference Call. All participants are in a 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 Rebekah Manis, Director of Investor Relations. Please go ahead.

Rebekah Manis

Thank you, Laura. Good morning and thank you for joining us. Before we begin, I want to remind you that today's discussions 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, that 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

Thank you, Rebekah and good morning everyone. Before we get started, I want to acknowledge that the team here at Kroger realizes that we have our work cut out for us as the market points out this morning. We realize business transformations are hard, but I want to emphasize we are on track to deliver on our Restock Kroger commitments. We look forward to our time together to take your questions and try to better lay things out for you.

Joining me on today's call are Mike Schlotman, Executive Vice President and Chief Financial Officer; and Gary Millerchip for the first time, Mike's successor who will become Kroger's CFO on April 4. As previously announced, Mike will continue to serve as EVP and a member of our senior team until the end of the year. We can't say enough how grateful the entire Kroger team is for Mike's service, leadership, and stewardship of the company for the last 34 years, especially during the last 19 as CFO. We are also incredibly fortunate to have Gary, whose deep finance and business background combined with his successful track record of creating shareholder value as a member of our senior officer team, makes him the right person to carry Kroger forward. This is especially true as Kroger transforms from grocer to growth company.

I've talked before about the need for retail companies to constantly reinvent themselves in order to remain relevant. This constant reinvention takes place at least every decade. Gary has been instrumental in helping us think through our transformation as part of Restock Kroger and beyond. He is uniquely positioned to be Kroger's Chief Financial Officer of the future, and as such will also help shape the future of our omnichannel experience and reporting. During today's call, Mike will provide the financial and operations recap for the fourth quarter and full year 2018, and Gary will outline Kroger's guidance for 2019.

In October 2017, we introduced Restock Kroger, our three-year plan to create shareholder value by serving America through food inspiration and uplift. The plan has four main drivers; redefine the grocery experience, partner for customer value, develop talent, and live our purpose. Combined, these drivers come together to create shareholder value. Specifically, we committed to $400 million in incremental FIFO operating profit growth and $6.5 billion in cumulative Restock cash flow by the end of 2020.

I'm pleased to report that Kroger solidly delivered on our key year one Restock Kroger commitments. When you look at the full year, we delivered against our FIFO operating profit and our Restock cash flow goals which sets us up to reach our 2020 targets. We improved identical sales and delivered EPS near the high end of both our original and adjusted guidance range giving us both business momentum heading into 2019. And I'm especially proud that we achieved an unprecedented cost savings of more than $1 billion through process improvements in 2018.

Restock Kroger is fueled by cost savings that we will invest in associates, customers, and infrastructure. We continue to make significant investments to build an omnichannel platform that will deliver customers anything, anytime, anywhere. At the end of 2018, 91% of Kroger households have access to pick up or delivery. By the end of 2019, with full integration of Kroger Ship into our ecosystem, we will reach 100% of America.

We are very pleased with the growth of digital sales at Kroger. In 2018, our digital sales run rate was about $5 billion. Going forward, we are trending towards a run rate of approximately $9 billion. Kroger also grew our brands to reach a record 30.5% unit share in the fourth quarter. We introduced a 1,022 new items in 2018, which helped drive strong year-over-year sales lift across our portfolio of brands.

Simple Truth continued to lead the way with a 15.3% sales growth in 2018 making it a $2.3 billion brand. Kroger unveiled several transformative partnerships to create customer value in 2018. Home Chef continues to grow and shape today's meal solution space. In February, we announced Home Chef's expansion to 500 more locations and six new store divisions. Our pilots with Walgreens, Microsoft, and Nuro continue to generate great customer insights. The Nuro pilot in Scottsdale is nearly complete and we are planning to enter another market early this year.

We remain optimistic about all the ways our partnership with Ocado will set Kroger up for accelerated growth in the future. In February, we announced Florida and the mid Atlantic region is where we plan to build the next two Ocado sheds in addition to the first location planned for Southwest Ohio.

In 2018, we accelerated investments in associates and significantly improved employee retention in one of the tightest labor markets in years. And we were thrilled to be recognized on Fortune magazine's Change The World 2018 list for using Kroger’s scale for good, engaging our business to solve society's most complex issues through Kroger’s Zero Hunger, Zero Waste social impact plan. This groundwork positions us to deliver on our 2020 Restock Kroger targets including financials and transform the company for long-term growth.

I want to take a few minutes to talk in more detail about our alternative businesses. Successful long-term businesses constantly explore new directions and adjacencies to grow their top and bottom lines. That's why in February we announced the appointment of Stuart Aitken to the newly created role of Senior Vice President, Alternative Business. In this new role, Stuart is assuming oversight for Kroger's successful existing alternative profit businesses including 84.51 in Kroger Personal Finance. Stuart will also lead the development of a full portfolio of alternative businesses to support the transformation of Kroger's business model and to better support our customers in supermarket business.

Kroger Personal Finance, 84.51, and Media all beat their operating profit targets for the year. This was very encouraging as these are the biggest line items in our alternative profit businesses. We used some of the excess profit to invest into other new alternative profit streams to begin seeding our margin-rich, asset-light businesses of the future.

In 2019 we expect 20% profit growth in our alternative businesses and we will also launched a few more new businesses that are both symbiotic to our core and deliver high margins. Plainly stated Restock Kroger is all about transforming our growth model. We will grow market share by creating a virtuous cycle built on our grocery business. At the core is a winning combination of unmatched local presence coupled with a digital ecosystem that enables us to offer our customers anything, anytime, anywhere. We are enhancing the customer ecosystem with partnerships that are helping us to redefine the customer experience by building incredible physical and digital experiences, a fantastic offering, and an unprecedented convenience.

A constantly improving customer ecosystem generates traffic, customer data, and insights which then fuel the growth of adjacent alternative profit streams. We see tremendous potential in these asset light margin rich businesses built on the foundation of an omnichannel grocery experience. The profits generated by these businesses will create shareholder value and generate cash to invest in Kroger's core so we can further redefine the grocery customer experience. This is how Kroger's new growth model is a virtuous cycle.

Above all Restock Kroger positions Kroger to create long-term shareholder value. We have a clear path to achieve the 400 million in incremental FIFO operating profit growth and $6.5 billion in cumulative Restock cash flow by the end of 2020. We finished 2018 with sales and business momentum. We expect earnings growth and an improving supermarket business in 2019. Now here is Mike to share more details on our fourth quarter and fiscal 2018 results, Mike.

J. Mike Schlotman

Thanks Rodney and good morning everyone. Reflecting on Rodney's comments to start the call it's kind of surreal to know that this is my 77th and final earnings call as CFO. I'm thrilled to be transitioning the role to Gary who is a terrific partner and will be an excellent Chief Financial Officer. Looking at our results for 2018 I'm very proud of the entire team at Kroger for delivering on the key Restock Kroger commitments we made back in October of 2017. Planning the first year of a three year plan is always the toughest and most critical since everything that follows builds on the foundation that gets built. We feel great about the foundation we have build which sets us up to create shareholder value while continuing to make strategic investments to grow the business.

There were a variety of factors that affected fourth quarter on either the OG&A or gross profit line. As a result of better retention and higher average hourly rate our vacation accrual was a $0.02 headwind in the quarter and incentive pay because of achieving the ID sales we did and the EPS was a $0.06 headwind. Both of these affected OG&A. As I said, our incentive plan was primarily based on the grid of EPS and ID sales. As EPS got closer to the top end of the range we were incentivized to continue to make sustainable investments in our business to grow sales. Some of these investments were in our supply chain for both supermarket business as well as Kroger Ship. On a combined basis this was about $0.04 per share. These items affected gross profit. When you add these together it was about a $0.12 headwind to the fourth quarter, a lot of which is something that we're going to be able to build on for the future.

Our cents per gallon fuel margin in the fourth quarter was $0.34 compared to $19.08 in the same quarter last year. The average retail price of fuel was $2.34 versus $2.46 in the same quarter last year which affected total revenue. For 2018 our cents per gallon fuel margin was $25.02 compared to $20.06 for the year before. The average retail price for fuel for 2018 was $2.66 compared to $2.36 in 2017. The solid investments that we've made in 2018 will help the supermarket business have a better 2019 overall. We do however expect fuel to deliver lower operating profit margin in 2019 compared to 2018.

Identical sales momentum continued into the fourth quarter where our ID sales result was about 10 basis points improvement over last year's fourth quarter. There's no doubt that weather events and the acceleration of SNAP disbursements helped ID sales results in the fourth quarter. It's difficult to distinguish between the two because they occurred at essential the same time. Combined snow and snap helped ID sales by 44 basis points in the quarter. We continue to feel good about our ability to meaningfully connect with customers who rely on SNAP to supplement their food purchases.

While space optimization was a slight headwind versus a slight tailwind we expected, we saw a strong progress. Stores that have been open for 12 weeks and unaffected by new competitor had positive results in the quarter. And admittedly this is taking longer than we originally expected but we are pleased to see this resolved. In 2018 we completed the most disruptive of the remodels. As we go through 2019 the work will be more targeted and therefore less disruptive to our customers. All in all the time for space optimization is turning as we head into 2019.

FIFO operating profit for the fourth quarter was $621 million compared to $782 million in the same period last year without the 53rd week and in 2018 and 2017 adjustment items. For the full year FIFO operating profit was 2.84 billion compared to 3.13 billion in the same period last year without the 53rd week and the 2018 and 2017 adjustment items and excluding the convenience stores. This was above our goal for the year and as Gary will discuss in a few minutes we expect to grow again in 2019 and we remain committed to reaching our Restock Kroger goal in 2020.

Kroger's financial strategy is to use its free cash flow to drive growth while also maintaining its current investment grade debt rating and returning capital to shareholders. The company actively balances the use of cash to achieve these goals. Over the last four quarters Kroger has used cash to invest a combined $589 million in Ocado Securities and Home Chef, contribute $185 million pretax to a company sponsored pension plan, repurchase 79 million common shares for $2 billion which includes 1.2 billion repurchased with after tax proceeds from the sale of Kroger's convenience store business under an accelerated stock repurchase plan.

We paid $437 million in dividends and invested $3 billion in capital excluding mergers, acquisitions, and purchase of lease facilities. We remain committed to generating the 6.5 billion of Restock cash flow by 2020 as part of Restock Kroger and in 2019 we delivered 1.9 billion. Kroger's net total debt to adjusted EBITDA ratio on a 52 week basis is 2.83. We intend to use our free cash flow to bring the leverage ratio back into the target range of 2.3 to 2.5 times. The company's intention is to not buy stock back until we get into that range as we did in the third and fourth quarters of 2018.

We're investing in incremental $500 million on our associates over the three years of Restock Kroger. This is happening in a variety of ways including investments and wages, training and development. In 2018 we made significant investments in wages and used tax reform dollars to invest in our educational systems program, Feed Your Future. We also increase the 401K match for non-union associates among other benefits aimed at an improved associate experience. This was in addition to our continued efforts to rebalance paying benefits while also focusing on certifications and performance incentives, clear opportunities, and training. The average hourly rate for our store associates is more than $18 per hour when you factor in our comprehensive benefits that many competitors do not offer.

Looking now at labor contracts we recently ratified a new labor agreement with the UFCW covering Smiths in Albuquerque. We are currently negotiating with the UFCW for contracts covering the store associates, at King Soopers in Denver, Fred Meyer in Portland, Ralston in Southern California, and Kroger in Memphis. Looking ahead we have several major negotiations in 2019 including contracts for UFCW store associates in Seattle, Las Vegas, Indianapolis, Louisville. 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. We continue to strive to make our overall benefit package relevant to today's associates. Our financial results continue to be pressured by inefficient healthcare and pension cost which some of our competitors do not face. We continue to communicate with our local unions and the international unions which represent many of our associates on the importance of growing our business in a profitable way which will help us create more jobs and career opportunities and enhance job security for our associates.

Before I hand it off, I want to reiterate again that the first year of a three plan year -- a three year plan is it's difficult to land the first year. But when you step back to review the full year we feel great about delivering on our financial commitments while continuing to make the investments that will position Kroger for growth in the future. This solid foundation sets us up to transform Kroger and to deliver in 2019 and 2020. And now I'll turn it over to Gary to discuss how we are building this momentum in 2019. Gary.

Gary Millerchip

Thanks Mike and good morning everyone. It's a pleasure to join the call today and more specifically speak to Kroger's upcoming year about what we are committing to and how it aligns with the Restock program. The 2019 identical sales growth excluding fuel we are targeting identical sales that range from 2% to 2.25%. We expect net earnings to range from $2.15 to $2.25 per diluted share and FIFO operating profit to range from $2.9 billion to $3 billion for 2019. The low end of our range is above the current consensus estimate for 2019.

Kroger's EPS growth is expected to come from FIFO operating profit growth in 2019 which positions us well to deliver the incremental 400 million in FIFO operating profit by the end of 2020 through Restock program.

I'd like to spend a few moments underscoring Kroger's future growth model because the clear path to $400 million in incremental FIFO operating profit includes alternative profit streams. And although these high margin and asset life businesses going to have a major impact on our top line in the near term, they play a significant role in helping us achieve bottom line growth.

I have made it a priority to join Mike and Rebekah already for several investor meetings. We as an Investor Relations team recognize and appreciate the request to better understand how to model alternative profit streams going forward. Please know that our finance team is spending time on this very topic including a review of industry best practices with the goal of providing more detail in the future.

In 2018 there were several Restock Kroger successes that have created tailwinds we believe will help us continue to grow sales and achieve incremental FIFO operating profit in 2019. We pulled forward price, digital and store investments in 2018 in part using tax reform dollars which will create tailwinds for sales and operating profit in 2019. We achieved significant cost savings in 2018 and have plans to accelerate this momentum in 2019. Our largest alternative businesses Kroger Personal Finance, 84.51

and Media all beat their operating profit targets in 2018 and our plans for continued growth. And while investing to build a seamless ecosystem remained a headwind to earnings in 2018, that dynamic is beginning to shift.

As Mike shared in his comments earlier fuel is expected to be a headwind in 2019 compared to last year. The strength of fuel margins in 2018 helped us make investments that set the supermarket business up well for 2019. But we do expect softer fuel results this year.

Looking at the cadence of EPS throughout the year we expect the first quarter to be comparable to the first quarter of 2018. The second and third quarters to be within our annual guidance range and the fourth quarter to be above the guidance range which will allow the full year to align within the range. We anticipate that momentum will build throughout the year and put Kroger in a position of strength going into 2020. We laid the foundation in 2018 which we will now building in 2019 to deliver our 2020 commitments. This includes Restock cash flow. We delivered what we expected in 2018 setting us up to meet our 6.5 billion cumulative Restock cash flow commitment by the end of 2020. We expect capital investments excluding mergers, acquisitions, and purchases of lease facilities to range between 3 billion and 3.2 billion in 2019. This number will likely grow in future years as we announce Ocado shares.

As Mike also shared earlier in the short-term our intention is to use free cash flow to bring our leverage ratio back into our target range of 2.3 to 2.5. AND finally we anticipate Kroger's 2019 tax rate to be approximately 22%.

Before I turn it back to Rodney let me say that I'm incredibly grateful to Mike who has put together a thoughtful week-by-week transition plan. He really has been the best partner I could ask for when transitioning to the role of Kroger's future CFO. Thank you Mike. I'm personally very energized to be in a sector that is transforming as quickly as grocery retail. The way we think about the fundamentals of retail is rapidly evolving which will make the next few years incredibly interesting for the financial stakeholders who follow this space. And now I will turn it back to Rodney.

W. Rodney McMullen

Thank you Gary. As America's grocer Kroger has the winning combination of local presence plus a digital ecosystem enhanced by strategic partnerships enabling us to offer our customers anything, anytime, anywhere. We are transforming from grocer to growth company by deploying our assets to serve even more customers and create margin rich alternative profit streams. We are well positioned to deliver on our Restock Kroger vision to serve America through food inspiration and uplift. Now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions]. Our first question will come from Karen Short of Barclays.

Karen Short

Hey, thanks. So I guess the question I have and I know you try to encourage us not to look at your business in terms of the core and fuel and alternative profits, but you did kind of give us the slide at the Analyst Day with that depicted so it's hard not to look at your business this way, but when I look at the full year 2018 and I try to break out what the core business actually did, the decline was fairly significant, like I'm kind of backing into almost 30% decline in the quarter. And I guess can you help me understand what the components of that are that are maybe just transitory? And then the second part I would just ask is obviously we were trying to think of you in a way that you're thinking of yourselves meaning as a growth company, but you need stability in your core to have the credit in your valuation for being a growth company. So maybe a little color on how you can attain that I guess stability and/or grow your core?

W. Rodney McMullen

I'll take that one Karen. Well obviously a lot of -- we have made a lot of investments in 2018 which affects a wide variety of different lines, and it's difficult to say obviously fuel had a good quarter and a good year. When you look at trying to back into the core, what do you do with digital which has been a headwind and we continue to invest in digital. If you don't back that headwind out and put that in the growing a new business category, yes that would drive the core down the way you do it. But if you look at the digital investments we've made along with the other investments we've made in the fourth quarter, I talked about, the new warehouses that we opened up to support our digital business. If you look at that all in the core, yes, the core declined. I won't go into a specific number, but it really is how you slice and dice all of this. All that said and I wouldn't necessarily discourage you from looking at the different pieces of the business because we do have to do a better job of helping you all understand and explain where the alternative profit streams are going to come from because some of them won't affect the top line, some of them will just be a profit, but when you're trying to transform the company and you have a first year of a plan, we take all of the pieces and all the available flows of profitability together and then decide how to invest them in which business which is what we did in 2018.

J. Mike Schlotman

And with that said and Gary mentioned it, we will definitely do a better job helping you be able to see that insight because we certainly understand the question and it makes total sense.

Karen Short

Okay, and I guess just a follow-up then, so if we look at the 3.5 billion for 2020, I mean you're looking at an EBIT growth of 17% which is not something I've ever seen any grocer do in a year but is there anything that has changed in terms of each of the streams versus where you're at on your Analyst Day in terms of the growth rate?

Gary Millerchip

Hi, this is Gary. I think we feel as I mentioned in the prepared comments we feel very good about the 2019 plans that we have for the business and kind of referring back to your question Karen that you asked and Mike answered, there's a lot of noise obviously in 2018 when you're going through a major year of transition, and we feel that as we head into the second year of the plan, as the pieces come together and we have the tailwinds from some of those investments that we made, we have a strong plan in place that we feel is going to make a difference to the way in which growth is occurring across the organization and where you'll see that in the results that we report out as we shared in the prepared comments.

I do think that as we head through 2019 and we're building on the plans that we put in place through Restock Kroger, we expect to see the investments that we made in 2019 start to come out in -- sorry, 2018 come through in 2019. And we have a very clear plan of what we expect those benefits then to deliver in 2020. So, I think we appreciate Rodney's comment that we have to give you a clearer view into how all those pieces fit together, but I wouldn't say there's anything materially changed in the plan that we have for the three years and that we're not seeing all the pieces come together in largely the way that we expected.

Karen Short

Okay, that's helpful, thank you.

J. Mike Schlotman

Karen, one more thing I would add on the calculation of the decline, and you may have done this but I would remind you that last year had a 53rd week, and you need to take -- obviously take that out when you compare 2017 and 2018 and I think last year we said that the extra week was worth $0.09 or so.

Karen Short

Yeah, no, no we backed everything out.

J. Mike Schlotman

Because I wouldn't come up with a number anywhere near where you are.

Karen Short

Okay, maybe we can follow up on this.

Operator

The next question will come from Edward Kelly of Wells Fargo.

Edward Kelly

Yeah, hi guys, good morning. First thing I wanted to maybe just follow up on where Karen was going with this, I mean on the $400 million goal, if we just think about how you started year one which you say is on track but EBIT fell over $200 million, and it would've been down more if not for an epic fuel year. And the biggest decline was in Q4 even if you adjust for that extra week, and I know that you are reaffirming this target, but if you look at 2019 guidance it's got about $100 million improvement, and it does sound like and this is off of a big investment year, and it does sound like there are some things that should come back to you which implies a $550 million improvement in 2020. So why isn't there more progress I guess in 2019 given what you're going to lap, and then can you give us more comfort around how you see this growth in 2020, I mean obviously your stocks are down quite a bit today because I don't think the market's seeing progress, the market is kind of seeing the opposite. So if you could just help us to some extent here I think it would be good?

J. Mike Schlotman

Ed a couple -- lot of thoughts there in your question. You know one of the one of the things I would point to relative to progress we're making is what Gary said in his prepared comments were if you look at operating profit guidance for next year it is above where the current consensus estimate is. So, in our mind that does demonstrate progress. When you talk about why wouldn't 2019 grow more given the investments we made in 2018, we are expecting a more usual year for fuel margins in 2019 versus 2018. We believe it would be -- it wouldn’t be prudent to budget 2019 to replicate 2018 in fuel. So the core business and the alternative profit streams, digital not being as big of an investment. In fact, a little bit of a tailwind when you look at expected investments year-on-year. We first have to overcome in 2019 lower expected operating margin in fuel and then grow off of that. And as we've built the business plan with the 2 to 2.25 EBITDA or ID sales, that still gets us to an operating profit margin that's above Wall Street, and if you look at the high end of that range, it's essentially right at what Wall Street would be predicting for 2020.

W. Rodney McMullen

Ed, I mean we clearly understand your question and just in answer a little bit with what Mike and Gary was talking about, digital we do expect it to turn to tailwind versus a headwind. As you know we accelerated a lot of investments into 2018 that we expect those to pay off in 2019. Mike talked about some of those obviously space optimization is one of those. We continue to make great progress on taking cost out of the business. And when you look at all of those together then as Mike mentioned we also expect fuel to be a headwind when you look at next year total. So totally understand the question and when we look through in modeling all the pieces I do think it's important to note when you look at fourth quarter by itself the incremental $0.12 of charges that Mike talked about, most of which will not reoccur next year. Or if they do they'll be spread out throughout the year versus just in one quarter.

Edward Kelly

Okay, and a quick follow-up on the gross margin. The gross margin is down 93 basis points, it was certainly surprising, I mean it does sound like there are some onetime things in here, but can you just give us a little bit more detail on what happened, what is mix by the way, and what did you do in supply chain and then how do we think about the gross margin in 2019 because it's hard to get to your EBIT guidance without I think anyway flat to positive FIFO gross margins ex-fuel?

J. Mike Schlotman

Yeah, if you look at the fourth quarter decline about a third of it, maybe a little less than a third of it was from price investment, so kind of what we've been experiencing all year long. The other two thirds of it is a combination of start up costs for some new warehouses that negatively affected warehouse and transportation line, that expense line that's in the gross profit. As well as continued growth in primarily our Kroger Specialty Pharmacy team had a great year, very strong sales growth out of them. That is a high growth business that has as compared to our core business a dramatically lower gross margin rate. But because of the price of each one of those prescriptions is so high it generates very strong operating profit dollars in that business. So, those last two were about two thirds or so of the margin erosion and pricing was about a third.

Edward Kelly

And just for next year.

J. Mike Schlotman

I don't think I'm going to give guidance for OG&A and gross profit for next year. If you look at the ID sales, if you look at their earnings per share guidance and we gave you operating profit there are assumptions that you're going to have to make about where OG&A and gross profit are going to go next year. As Rodney said, some of those investments we made this year won't be as dramatic as next year. Things like digital not being a headwind and being a tailwind will help margins as well. So, we won't be opening new warehouses like we did in 2018 and those start up costs are what cost us on the margin line.

Edward Kelly

Okay, thanks guys.

W. Rodney McMullen

Yes, thanks Ed.

Operator

And our next question comes from John Heinbockle of Guggenheim Securities.

John Heinbockel

Let me start, when you think about over the next couple of years the alternative profit stream impact on margin rate, EBIT margin rate right, is the greater impact going to be on the gross margin line or the expense ratio line? And then when you guys talk about ex-fuel margin does that include the alternative profit streams today and will it in the future or you'll break that out?

Gary Millerchip

On the first question as I alluded to we are doing a lot of work right now to really decide how we best can share that story with you. Because I think as we've mentioned in the past the alternative businesses that we talk about have grown up a little bit as a legacy over the way they would have been within the Kroger business prior to what it was in 2017, identifying this as a big strategic growth area for the company and how do we truly leverage all the data and the knowledge that we have about the customer to try those alternative businesses across Kroger Personal Finance, the Media business and some of the other areas that we shared at the Analyst Meeting. So right now it would be reporting a number of different areas of the business and what we really want to do is to make sure that we're very deliberate in identifying and helping you -- provide you with a clearer picture of how you could see that more clearly as the business continues to accelerate growth in 2019 and 2020.

W. Rodney McMullen

And John if you look at the OG&A and the margin rates excluding fuel, it would include those businesses. We would have a really long list of things to pull out if we didn't do it any other way.

John Heinbockel

Alright, so then as a follow-up is it possible based on what you said Gary, is it possible that there will be an alternative profit stream segment because again it's getting so significant and so different in the core business it doesn’t make sense to break out separately for all of them combined, revenue and EBIT, is that something you're thinking about or amenable to? And then the last thing if you think about the core business what comp do you think you need to actually grow EBIT in the core business, is it 2, is it given the cost pressures is it higher, is it 3, what do you think?

Gary Millerchip

Yeah, I think to the first part of the question we are not rolling anything out right now, we're not committing either to what the answer would look like. We really want to make sure that we're deliberate about thinking through the best approach to make sure that we manage this business effectively but also can clearly demonstrate and show the story of the value it is driving to the bottom line. But certainly committed to reaching some conclusions on that and being clear in 2019 about how to think about this either.

W. Rodney McMullen

And certainly when you look at the longer term model 2% to 3% we would certainly agree with that and would see the same number. For the next couple of years that might be a little on the low end of that to drive earnings growth but overtime the sustainability of the model really needs 2% to 3% identical. I think it is important to note John that if you look at our productivity gains during the year not only from the great year we had from reducing our turnover which means we increased retention, as well as some operational efficiencies inside the store. Our productivity pretty much offset the higher investments we made in associates in the store.

John Heinbockel

Okay, thank you.

Operator

And next we have a question from Paul Trussell of Deutsche Bank.

Paul Trussell

Good morning. Just wanted to touch base on the top line, the IDs over the past year were more in 1.5 to 1.9 range, and just wanted to be just maybe help us better understand the expectations to see acceleration in the business. to kind of above to maybe just speak give a little bit more color on what you're seeing in the stores that have gone through the optimization and we will start there? I have a follow-up, thank you.

W. Rodney McMullen

Love the question, look at the last part of your question on space optimization and as Mike mentioned in the prepared remarks it certainly has been I think longer than we expected but for the stores that have opened, then opened or remodeled longer than 12 weeks we're finally starting to see where that positively adds to our identical. And so it's been slower than we expected but it's nice to finally see. So obviously that's a piece of but we also expect to continue to see improvements from the investments that we made in 2018. If you look at tonnage in 2018 was actually stronger than what the identical sales growth would be and we continue to see people trading off in products and in size of products as well. So when you look at the maturation of remodels that we've done, continuing to improve the way we've significantly improved in stocks and some of the core business pieces. And tying that all together with the investments we've made is what gives us confidence in the 2% to 2.25% that we shared.

J. Mike Schlotman

One other thing I will add to that Rodney is when you look at quarter to date we are essentially right on top of where the fourth quarter was and the split between the core supermarket business and the alternative businesses is very similar to where the fourth quarter ended. I know there's a lot of rhetoric out there the pull forward of SNAP means we've started the year out more slowly. But we're essentially right on top of where the fourth quarter ended so far. We are in the first quarter now, it's a 16 week quarter, a long way to go but we are off to a start that helps us feel good about the guidance.

W. Rodney McMullen

And Mike's point on SNAP definitely -- there were definitely a pull forward and when you look at SNAP by itself the first period of the year would be a headwind but if you look at other piece…

J. Mike Schlotman

It would be a headwind but we've filled that headwind with other sales in the supermarkets.

Gary Millerchip

Just maybe one another piece of color to add to, as you think about the journey from Restock Kroger in 2018 and a lot of initiatives that we landed during the year that created some of the noise that Mike referred to, but really should start to build tailwinds into 2019. Rodney you mentioned that the turning point from a profitability impact of digital but as we continue to grow digital sales at the rates that we're seeing on a much bigger number that continues to have a bigger influence as we head into the outer years of Restock Kroger on the ID sales performance of the business. And then the work that we did in 2018 to invest in our own brands and driving significantly high customer engagements and as customers continue to deepen their relationship with our own brands is an important piece of the I think the opportunity that we see in 2019. And then finally the merger with Home Chef and what we're doing to expand the fresh food experience in the store and the meal kits opportunity, obviously only came in part way through the year and represents another opportunity that we see to ready build momentum in 2019 from 2018.

Paul Trussell

Thank you, that's helpful color and somewhat related, curious what you're seeing over the past few months and what you're forecasting ahead on the inflation front and if you could just kind of comment a bit more on how we should think about price points given the higher input costs, are you seeing price points go higher and also to what extent or how would you describe kind of the price environment out there, is the environment rational? Thank you.

W. Rodney McMullen

I don't know if I'll get -- the environment to rational or irrational. This is a competitive industry, it has always been a competitive industry. And we always built a business plan assuming it's going to be a little more competitive versus less competitive and if we get surprised when it's not more competitive it winds up being the help. If you think about inflation just in the fourth quarter and you take out few in pharmacy, cost inflation was less than that, it was about 39 basis points. When you added the pharmacy it get kicked up to 1.08 basis points. For the year it is actually without pharmacy with slight deflation on the year from a cost basis which may not reconcile with everything you're hearing about cost increases coming through. Our team has done a phenomenal job of going after cost of good savings in a variety of ways and keep in mind the numbers I'm talking about is what we pay for products based on how many of those units we have this year and last year and the price this year and last year. So, we've done a great job of being able to offset some of those cost increases you hear about.

Gary Millerchip

Yeah, the other thing that I would add and we've talked about this before but when you look at some of the companies they've raised prices more than what the true cost is. And it really helps that our own brands are so strong because what we find is when somebody does that they end up giving up market share. And they give up market share to our own brands and over time we make more profit on our brands than we do selling the national brand. Now we're going to always give the customer a choice and we want to earn whatever we get but if somebody is pushing costs through more they'll end up giving up share when they do that.

Paul Trussell

Thank you, best of luck.

Operator

The next question comes from Chris Mandeville of Jefferies.

Chris Mandeville

Hey, good morning. Can we just start off again with 2019 guidance here, how much of this 100 million to 200 million EBIT growth is essentially going to be coming from your core grocery versus your alternative revenue streams and how are you thinking about the fuel margin in 2019? And then I suppose Mike, I can certainly understand that you don't want to go line for line on guidance but clearly the market is reacting to the negative 93 basis points gross margin results. So maybe just at the very least you could hold our hands a little bit going into the first half of the year on gross margins and how to think about that as alternative revenues become a greater component of your EBIT?

J. Mike Schlotman

Yeah, I understand your request to hold your hand a little bit but we're going to stick with the guidance we've given. And not get specific on gross margins and things like that. I would say a big chunk of the growth in operating profit margin for next year would be coming from the core business with ID sales like we talked about. We do expect as I said fuel to be a pretty dramatic headwind next year which leads us to the bottom line result of the guidance Gary talked about in his section.

Gary Millerchip

On fuel we would be pretty close to using our three year average on margin in terms of expectations of fuel. We do skew that a little bit to more recent times but it's pretty close to the three year average. On gross margin you should not expect a 93 basis point reduction in gross margin.

J. Mike Schlotman

That I agree with. And if you look at the model overall as you know we've accelerated a lot of the investments and some of the things showing up in growth is just the way the accounting shows in terms of warehouse and transportation costs. So those types of things we would not expect that same headwind.

Chris Mandeville

Okay, so I suppose my quick follow-up to that just really is, we were expecting to see far less than 93 basis points in Q4 based on Q3 comments. So, just to be clear so long as we don't receive any type of material tailwind from fuel which we are very unlikely to receive in Q1 there should be some sequential improvement in your gross margin degradation, correct?

J. Mike Schlotman

Correct.

Chris Mandeville

Okay, and then my follow up would be just I've spent quite a bit of time in Vegas this last couple days at Shop Talk and we've been speaking to a lot of folks within micro fulfillment. So Rodney I guess I just want to get your take here again as it relates to relationship with Ocado, can you can help us think about a few items here just why you think this is the right technology going forward, have you spoken to them with respect to their own micro fulfillment option now called Zoom and then maybe does that actually afford you some flexibility with respect to the 20 CFC that you dedicated yourself to with them?

W. Rodney McMullen

In terms of first of all somebody on the Ocado team and the Kroger team would actually be talking daily. Now if you look at a broader strategic conversation those would be happening probably on a monthly type basis. The thing -- one of the reasons that we were incredibly excited about partnering with Ocado is Tim and his team continually pushed themselves. And what they have today they'll continue to get better and they will continue to look at different approaches and alternatives. And when we signed the agreement with them one of the comments we made was that we're not signing it based on what you have today, we're signing it based on what we think you're going to have in three to five years because of the talent they have, their drives that keep getting better, and some of the things they have on the drawing board. So I feel very comfortable that if there's a model out there that's more efficient and gives the customer what they want, the partnership with Ocado we will be able to discover that and we will be there when it needs to be there as well.

Chris Mandeville

Thank you.

Operator

The next question comes from Scott Mushkin of Wolfe Research.

Scott Mushkin

Hey guys, thanks for letting me ask a question. And then Mike gosh, it's been years so congratulations. I can't believe you're going to be not on the call.

J. Mike Schlotman

Yeah, my 77th one as I said.

Scott Mushkin

Yeah, I don't think I've done 77 but I've done a few myself so congratulations.

J. Mike Schlotman

Some days it feels like you've done more than that Scott.

Scott Mushkin

So market share, you guys usually ran through market share on the fourth quarter and I was just wondering if you could give us some thoughts on what's happening with the market share during the year and then I wanted to follow up?

J. Mike Schlotman

Yeah, when you think about market share the way it's traditionally calculated our market share did grow in the year as Rodney talked about our tonnage was actually better than what our ID's sales were. And as you invest in price and things like that it can distort the top line but you're moving, you continue to grow tonnage. But it does slightly improve for the year.

Scott Mushkin

Market share.

W. Rodney McMullen

Yes.

Scott Mushkin

And when you're talking tonnage when we look at the ID's you're excluding about 50 basis points from specialty pharma contribution, is that correct or no?

J. Mike Schlotman

Let me understand you, I don’t understand your question exactly.

Scott Mushkin

Oh, I thought you put specialty pharma into the comp, I forget what quarter you did that, was it first quarter of last year…

W. Rodney McMullen

No, we started at the beginning of the year. Yeah on tonnage what we try to do is just look at the absolute number of units that's flowing through our stores. So the toilet paper counters; one, whether it's a one pack or club pack size. But it's just looking at the units that are flowing through our stores is how we try to track it

Scott Mushkin

Perfect and my follow up question is, I know you guys have been working on alternative revenues for a while so I assume in 2018 numbers is a chunk of that EBIT that's alternative revenues, I was just wondering if you could size how big the year-over-year gain was and how big the alternative revenues are already?

Gary Millerchip

I think as we as we mentioned a few minutes ago we saw a really nice growth in alternative profits year-over-year, the two biggest areas as you know from the Analyst Meeting, our Media, and Kruger Personal Finance and both of those grew profitability by over 20% joining 2018. As I kind of referred to earlier, we are still really wanting to work through What is the best way to be able to give you the full picture around alternative profit going forward is becoming obviously a bigger and more meaningful part of our business. As Mike mentioned, Mike Schlotman mentioned earlier with the fuel being a headwind in 2019 we expect both, what you traditionally think of as the core business and alternative profits both to be contributing to the improvement in FIFO operating profit in 2019 with the head win that we're facing in fuel. But at this point we're really taking a step back and determining what's the best way to ready share the alternative profit story in a meaningful way. So all of you to make sure that we connect the dots for everybody. And if you remember back at the Investor Conference here in 2018 Stuart Aitken had a slide that showed the slope of the growth of alternative profit. Admittedly it didn't have the dollars on it. But if you take a look at that slide it shows how we expected to continue to build over time and as that momentum starts. You'll see even more growth out in the future.

Scott Mushkin

Alright guys, thank you, thanks very much.

W. Rodney McMullen

We have time for one more question.

Operator

The next question will come from Gregory Badishkanian of Citi.

Gregory Badishkanian

Great, thanks. So just a follow-up on that food inflation you've mentioned it was 39 basis points. So I am just wondering how much -- how you'd expect that to trend in 2019 and also just your ability to pass that amount or even may be a greater than that in terms of customer?

W. Rodney McMullen

Yeah, our expectations for inflation in 2019 is relatively benign. But I would say the way it gets passed on depends a lot about where the inflation comes from. Is it in a category where we have a specific pricing program that we want to stay committed to or is it in a category where it might be a little easier to pass on and others are passing it on along as well. So, it really depends exactly where you wind up seeing the inflation whether or not it gets passed along and how quickly gets passed along.

Gregory Badishkanian

Right, makes sense and then just you know with a lot of discussion in the press about Amazon opening up physical stores, how would you characterize the level of risk to larger conventional food retailers from that move and what are kind of things that are maybe embedded in terms of your competitive positioning and your footprint that would help to offset that?

W. Rodney McMullen

Well a couple of things. First of all as you know we embarked upon creating an omnichannel experience for our customers almost five years ago now. And if you look at the feedback our customers give us we're increasingly being able to help it -- help the customer make it easier for them to get what they want. And what we find is when customers are engaged digitally they still come into the physical store and they also spend more with us in total. So our teams have done a great job of being able to create that and make sure that we keep that customer connection and continuing to improve that customer connection. The thing that we've had for years is we have 4060000 associates out there that are just every day working hard to serve our customers and each other. The quality of our fresh product continues to get better and better and it's a competitive advantage. When you take all of those things together and we have a lot of great physical locations that are high quality sites that have been accumulated over several years, it's really all of those things together. In terms of what will cause a customer to want to come from us and partner with us and for us to be able to give them an experience they can't get somewhere else. And very excited about where we are and as Gary mentioned in the prepared remarks from a digital standpoint we would expect that to become a tailwind in 2019.

Gregory Badishkanian

Great, thank you.

W. Rodney McMullen

Thanks Greg, appreciate it. As always thank you for everyone's call. As I mentioned at the beginning we understand and acknowledge that we have our work cut out for us in the market showed at this morning. But I want to emphasize that we are incredibly confident about the future of Kroger especially with Restock Kroger. One of the exciting things about our earnings call also is that many of our associates listen in to better understand and gain insight on our business. And of course many of our associates are shareholders as well.

So as always before we end today's call I'd like to share a few comments directed toward them. As I mentioned earlier in our prepared remarks Kroger believes in strengthening the communities where we do business, within our supply chain, across our communities, and in our stores. And you don't have to look far to see how much that strength comes from women. This month we're excited to recognize all the women across the Kroger Enterprise who worked day in and day out to exemplify our purpose to feed the human spirit. Kroger employs more 250,000 women who work in our stores, manufacturing, and distribution plants, and offices. A growing number of nearly 500 women owned businesses here in the U.S. are Kroger suppliers and through our commitment to source foods that are fair trade certified as part of our simple truth product line. We are proud to support women owned cooperatives and businesses internationally including women led tea farms in Rwanda. Kroger is proud to join in today's celebration of the International Women's Day and we are lighting up our headquarters building in Cincinnati tomorrow to celebrate.

Thank you to all of our customers, associates, and suppliers who make our business successful every year of every day -- every day of every year. I also want to have one last thank you for Mike, 77 calls is a heck of a lot of calls. Mike has been a great friend and partner in this journey and Gary, congratulations I'm incredibly looking forward to working with you and for you to be able to build on the things that Mike has put in place and working with his team. So congratulations. That completes our call today, thanks for joining.

Operator

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