Kroger Co. (NYSE:KR) Q3 2018 Earnings Conference Call December 6, 2018 10:00 AM ET

Executives

Rebekah Manis - Director, IR

Rodney McMullen - Chairman and CEO

Mike Schlotman - EVP and CFO

Analysts

Vincent Sinisi - Morgan Stanley

Karen Short - Barclays

Edward Kelly - Wells Fargo

Michael Lasser - UBS

Ken Goldman - JPMorgan

Chris Mandeville - Jefferies

Rupesh Parikh - Oppenheimer

Judah Frommer - Credit Suisse

Paul Trussell - Deutsche Bank

Robby Ohmes - Bank of America Merrill Lynch

Operator

Good morning, and welcome to The Kroger Company Third Quarter Earnings Conference Call. [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 third 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.

Rodney McMullen

Thank you, Rebekah. Good morning, everyone and thank you for joining us. With me to review Kroger's third quarter 2018 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

At our investor conference at the end of October, we shared several big ideas. The defining idea is that we are transforming our business model through Restock Kroger and then beyond. We will grow market share by both redefining Kroger customer experience and alternative profit streams through complementary businesses and partnerships.

Redefining the customer experience means offering customers incredible physical and digital experiences, a fantastic offering, and friendly and caring associates. Delivering an exceptional customer experience through the Kroger ecosystem creates incremental new profit streams, which in turn drives the economic model that makes the seamless experience possible.

In this way, our new growth model will be a virtuous cycle. This all means that Kroger is also reinventing our financial model. We're moving from a traditional grocer to a growth company with both a strong customer ecosystem that offers anything, anytime, anywhere, and asset light high margin alternative partnerships and services. I will break it down a bit in more detail. Successful long-term businesses constantly explore new directions and adjacencies to grow their top line.

At our investor conference, we highlighted one of the most successful to-date Kroger Personal Finance as well as several businesses under our 8451 portfolio including our Kroger Precision Marketing media offering.

Kroger Personal Finance delivered record year-to-date profit and is on track for the most profitable year ever. Our high-margin media business is strong and growing. Revenue for Kroger Precision Marketing powered by 8451 is up more than 150% year-to-date. One service line, our boosted products and search business, where advertisers can influence how their products show up on our sites benefited advertisers with more than 700 million product impressions in the third quarter alone, personalized to Kroger shoppers with click to conversion rates that are 2x to 3x the industry standard. We see tremendous potential in these asset-light, margin rich businesses, build off of a robust grocery supermarket experience which is being redefined everyday at Kroger.

Nowhere is this more obvious than digital. Our digital sales grew by over 60% in the third quarter. Our seamless coverage area now reaches more than 90% of Kroger households. This includes Kroger Pickup and Delivery. Kroger Ship is now available in all supermarket divisions. Ship customers can shop from a curated selection informed by 8451 data and insights of more than 50,000 grocery and household essentials that matter the most to our customers plus there are 4,500 Our Brands products available only from Kroger.

We are aggressively investing to build digital platforms because they give our customers the ability to have anything, anytime, anywhere from Kroger, and because they're a catalyst to grow our business and improve margins in the future.

As we stated at our Investor Day, we expect to be able to cover not only 100% of our customers but also the entire U.S. population. Our Brands continue to perform exceptionally well with customers and is one of the most profitable parts of our supermarket business. Our Brands made up 28.7% of unit sales and 26.6% of sales dollars, both of which are record third quarter results. Our Private Selection and Simple Truth brands saw strong sales, units, and gross margin gains in the third quarter.

Simple Truth and Simple Truth Organic is our fastest growing brand, with sales up double digits again in this third quarter. As we've shared previously, Our Brands account for 4 of the top 5 items sold through Kroger Pickup, and 41 of the top 50 items sold on Kroger Ship.

We have now been executing for three quarters our Restock Kroger plan to create shareholder value by redefining the grocery customer experience, partnering for customer value, developing talent, and living our purpose.

We feel good about the progress and how everything is coming together. We are proactively investing for the future in stores and online and in our customers and associates. We're using our assets especially, our love of people and our love of food to transform our business in ways that drive sustainable competitive advantage.

Now, here is Mike to share more details on our third quarter results and to update you on our guidance for the fourth quarter of 2018. Mike?

Mike Schlotman

Thanks, Rodney and good morning, everyone.

We are pleased with our net adjusted operating earnings per diluted share result of $0.48 for the third quarter. Strong fuel margins and continued execution of Restock Kroger contributed to this result. We continue to make several Restock Kroger investments in the third quarter. These included investments in price, especially in support of our brands and in space optimization, store remodels, and technology enhancements.

Part of these investments will allow customers to buy anything, anytime, anywhere from Kroger. As we discussed at our investor conference, space optimization is a massive undertaking, and we continue to expect to end the year with 600 stores completed.

Our ID sales for the third quarter were in line with our expectation. ID sales were led by natural foods, pharmacy, seafood, produce, and deli departments. Looking at gross margin, we were pleased to see that our shrink rate continued to improve during the third quarter compared to the previous year.

The gross margin rate reflects the timing and size of company's price investments compared to a year ago, rising transportation costs, and growth of the specialty pharmacy business, which is a high sales, low margin rate business that generates strong gross profit dollars. Keep in mind that last year in the third quarter, our gross margin rate was higher than our typical run rate.

For the third quarter in 2018, gross margin excluding fuel was actually higher than the second quarter of 2018. These fluctuations illustrate how results in the given quarter can vary based on the cadence of the investments we make in the business. Part of our investments this year support the Our Brands strategy where we continue to offer high quality products at a great value. The improvement in unit movement in the quarter demonstrates these investments are resonating with customers.

We intended to continue investing in price to drive unit growth while also delivering on the bottom line for our shareholders. We are pleased that OG&A cost decreased by 20 basis points as a rate of sales. The significant improvements we're seeing from our focus on reducing store associate turnover is contributing to this positive movement.

We continue to focus on productivity and waste and improvements in our cost to build prescriptions and increased adoption of self scan contributed to this improvement. Our investments in Restock Kroger and redefining the customer experience partnering for customer value and developing talent we pay for by cost of good savings, strong ID sales and productivity gains. This will contribute to generating $400 million in incremental FIFO operating profit through 2020.

Now for an update on our retail fuel performance during the third quarter. Our cents per gallon fuel margin was approximately $0.261 compared to $0.249 in last year's third quarter. The average retail price of fuel was $2.81 compared to $2.46 in the same quarter last year.

We expect our tax rate for 2018 to be approximately 23%, excluding the 2018 adjustment items, Kroger expects its factory to be approximately 21%. These rates reflect a third quarter adjustment related to a regular IRS audit. The IRS audit resulted in a reduction in prior year tax deductions at pretax reform rates and future tax deductions at post tax reform rates.

Our financial strategy is to use free cash flow to drive growth while also maintaining our current investment grade debt rating and returning capital to shareholders. We continually balance the use of cash flow to achieve these goals. Over the last four quarters, we used cash to invest the combined $589 million in Ocado securities and Home Chef contribute an incremental $185 million pretax to a company sponsored pension plan, $467 million to satisfy withdrawal obligations to the central states pension fund, repurchased 91 million common shares for $2.3 billion, which includes $1.2 billion repurchased with after tax proceeds from the sale of Kroger's convenience store business under its accelerated stock repurchase plan.

We paid $435 million in dividends and we invested $3 billion in capital excluding mergers, acquisitions and purchases of lease facilities. At the end of the third quarter, we had approximately $546 million remaining under the current share repurchase authorization.

We remain committed to generating the $6.5 billion of restock free cash flow by 2020 as part of our Restock Kroger plan. We have working capital improvements built into this guidance and off to a great start with $100 million improvement in net operating capital - net operating working capital so far this year.

Kroger's net total debt to Adjusted EBITDA ratio on a 52 week basis is 2.72. Our net total debt to Adjusted EBITDA ratio target is 2.3x to 2.5x and we remain committed to bringing the leverage ratio back into the target range. We are investing an incremental $500 million in our associates, in wages, training and development over the next three years to Restock Kroger. This will be in addition to our continued efforts to rebalance pay and benefits while also focusing on certifications and performance incentives, career opportunities and training.

In March, we also announced investing a portion of our tax savings in our educational assistance program Feed Your Future and an increased 401-k match for non-union associates. The average hourly rate for our store associates is more than $18 per hour when you factor in our comprehensive benefits that many of our competitors don't offer.

We recently ratified a new labor agreement with the UFCW covering more than 13,000 Kroger associates in Columbus, Ohio. The agreement raises starting wages and accelerates wage progressions after one year of service. We are currently negotiating with UFCW for contracts covering store associates at Smith's in Albuquerque and Fred Meyer in Portland.

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 health care, and retirement benefits for our associates. We continue to strive to make our overall benefits package relevant to today's associates.

Our financial results continue to be pressured by inefficient health care and pension costs 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.

Turning now to the guidance for the remainder of 2018. We continue to expect identical sales growth excluding fuel in the second half to be similar to the first half results. We updated our GAAP net earnings guidance to $3.80 to $3.95 per diluted share for 2013 from the previous range of $3.88 to $4.03.

The change in GAAP guidance is due to the third quarter market value adjustment of $0.09 per diluted share for Kroger's investment in Ocado shares and does not reflect any future changes in the market value of those shares because those cannot be predicted.

On an adjusted basis, we maintained our net operating earnings guidance range of $2.00 to $2.15 per diluted share for 2018 and keep in mind that fiscal 2017 included an extra week. We continue to expect capital investments excluding mergers, acquisitions and purchases of lease facilities to be approximately $3 billion for 2018.

And now, I will turn it back to Rodney.

Rodney McMullen

Thanks Mike.

We're not quite through our first year of executing Restock Kroger, and we feel great about where we are. We are laser focused on our customers and fulfilling their needs. We are clear on our vision to serve America through food inspiration and uplift. Our 2018 accomplishments and investments set us up well for 2019, and we are committed to delivering on our Restock Kroger financial targets by the end of 2020. We have a clear path through both redefining the customer experience and growing alternative profit streams.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question today comes from Vincent Sinisi of Morgan Stanley.

Vincent Sinisi

I just wanted to ask a bit further on the alternative revenue streams. Ssince your guy's Investor Day, we on the phone of course, have been getting a lot of questions from investors as well around that. You called out today kind of the Kroger Personal Finance seeing nice results there, but can you just kind of give us a little bit more color on that specifically and just kind of I think as a category alternative revenue streams, kind of what are some of the puts and takes? We know it's one of the more important components of your EBIT guide?

Rodney McMullen

If you look at the October meeting, we went through several different ones. Obviously, today if you look at, we highlighted Kroger Personal Finance in October because we wanted everybody to see that we actually have a great track record of delivering against - identifying new business opportunities and having a growth - grow in a meaningful way that's actually substantial to us.

One of the announcements that we made last year was the Kroger Precision Marketing where we're using the - insights from 8451. All of those things are really based on the traffic from our stores and our digital properties in creating a seamless experience for customers. And all of those things that we're doing will help our customers shop one of our stores easier, and like in the media experience, it will allow our CPG partners and other people to target specific customers through our pipeline.

If you look at over the last four years, the compounded annual growth from a profitability standpoint has been 16%. If you look at our expectations, as you look at '18 through '20, we would expect that to accelerate to 28% growth per year. And certainly, the progress that we're having in '18 would support the 16% that we projected based on the historical 4 years. Mike, anything you want to add?

Mike Schlotman

No, I think we also - Rodney gave some color on the Kroger Precision Marketing. The fact that it's up 150% year-to-date, and I think it's pretty impressive that the boosted search of relatively new product with 700 million product impressions just this third quarter, and when you get click-to-conversion ratios, 2 times to 3 times industry standard, that's the kind of thing that keeps that momentum going and keeps third parties interested in continuing to have that boosted search.

Vincent Sinisi

And then maybe just as a fast followup, just in the press release this morning, just with some of the price investment commentary, is that -- would you say kind of normal cadence nothing out of kind of the ordinary or did you see any particular changes on the competitive front or by category this quarter?

Rodney McMullen

Yes, I would say, just if you look at the overall strategy, it's executing the overall strategy that we started -- what we talked about at the beginning of the year, but we've been embarking upon for several years. So, I wouldn't say anything out of the ordinary as Mike mentioned in his prepared comments, last year's third quarter was higher than trend line.

The other thing, I think it's important just to note is that we did have a couple new warehouses starting up, and a warehouse conversion that also negatively affected the margins in the quarter and those are one time. Well, it will take a couple of quarters for those to get started up in the transition, but that also negatively affected the quarter.

Operator

The next question will come from Karen Short of Barclays.

Karen Short

So I just wanted to ask a question about full year guidance and the implied fourth quarter. So the range is pretty wide for 4Q, getting kind of like $0.38 to $0.53. So I'm wondering, if you could just give a little color on that and the puts and takes to operating margin and then I guess maybe comment on the guidance in light of the fact that gas margins seemed pretty strong in the quarter to date, and I know in the past when that has been the case, you've pulled forward expenses into the fourth quarter or into the quarter whatever the quarter was, were there is strong gas margins, so a little color there would be helpful.

Rodney McMullen

Sure Karen and the wide range, we all agree here at Kroger that the range for the fourth quarter is quite wide keeping it at $0.15 and it's purely driven by what you zeroed in on and that's gasoline margins and where they wind up because they've been very volatile over the last several weeks while a very strong year they can turn pretty quickly both positively and negatively, and if you think about what one margin in gallon means to earnings per share or $0.01 margin per gallon means to earnings per share, it can equate to almost $0.01 a share.

That volatility is what caused us to decide to keep the range fairly wide. It has nothing to do with our view of how the business is going to operate in the fourth quarter. It's purely, will margins continue to be strong? Will they get weak the next - will they get weaker the next five or six weeks or where exactly will they go, and it's really - you're unable to predict where those margins go on a weekly basis, so we just decided to keep it a little wider purely based on where gas margins may wind up in the fourth quarter.

Karen Short

Okay, so is it fair to think though if they remain strong, you will pull expenses into the fourth quarter or it's just impossible to predict?

Rodney McMullen

Yes, I wouldn't necessarily predict pulling expenses into the fourth quarter. If you look at where we are sitting here in early December, our promotional activity and our ads are pretty well set, how we plan to go to market over the holidays coming up and New Years and even as we get into later January, getting ready for the college football playoffs and the Super Bowl, all those big events. Those kinds of plans are pretty well locked and loaded and the supply chain is ready for those kinds of activities to come through.

So to do a lot of other unusual things in the next, call it eight weeks, eight and half weeks would be, I think, we're pretty comfortable with the plans we have in place.

Karen Short

And then just a general question on the alternative revenue streams. I mean, presumably those are high gross margin, and this quarter isn't really the quarter to see the flow through obviously given the comparisons from last year, but gross margins were still a little lower than we're modeling but any color on how to think about how alternate revenue streams will impact reported gross margin ex-fuel going forward?

Rodney McMullen

I wouldn't - longer term, I wouldn't say that we're really to a position to start giving some of the detailed insights. Your hypothesis is absolutely correct in terms of the margins and our alternative profit streams are significantly higher than the core business which is one of the reasons why we want to make sure that we call it out and point it out.

The other thing as you know that's incredibly important in that space, its typically very asset light. So if you look at Kroger Personal Finance, we have an incredibly strong partnership with the bank. The assets that's used to grow that business is reasonably modest. If you look at Kroger Precision Marketing, it's using insights and data to create that revenue stream.

So it's easily scalable as long as you're producing the results for your customers. So it's a piece that's incredibly exciting. In terms of giving some specifics, I just think, it's still a little too early for that.

Operator

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

Edward Kelly

Could we start with just IDs, maybe talk about the cadence of the IDs throughout the quarter, what you're seeing so far in the current quarter and any update on the optimization drag? I think, obviously your guidance implies Q4 will be better, I'm just curious as to whether you're seeing some of that yet?

Rodney McMullen

If you look at the cadence throughout the quarter was fairly consistent throughout the quarter. As you look at so far this quarter, we would be in the same range as where we ended the third quarter. So we've started off at about the same spot. When you look at space optimization and the fact that we're in a holiday season, we've been disciplined to not have stores disrupted during the holiday season.

So we would expect to have those stores start to perform better like we talked about at the Investor Conference. We will start up next year's space ops, we will start some stores in January after the holiday season. When you think about the slide, I showed at the Investor Conference on space op, what we're seeing in ID sales for those stores is not materially different than what I showed back in October.

Edward Kelly

And then I wanted to ask you about SG&A. It was a positive surprise this quarter for sure. Can you talk about your ability to drive 20 basis points of OpEx leverage this quarter. And you've been talking about cost discipline, but is this now starting to inflect into the P&L. And I'm just kind of curious as we think about things going forward, how we should be thinking about this line item, how important is it to your $400 million over time. Just any color there would be good in terms of like what this quarter means is to how we think about modeling going forward?

Mike Schlotman

I think what it means is a lot of what you said and when you look at the areas that I called out in the prepared comments, when you think about retention and our retention getting significantly better than it has, it does multiple things, one, you don't spend the dollars you have to spend to hire somebody just the actual hard cost of getting somebody into the system, whether you do a background check or any kinds of other screenings on the individual, getting them through a training program and then getting them on to the sales floor. At a productivity level lower than someone who has six or nine months experience.

So when you have more and more people who have that six to nine months experience and start to get to the 12 months experience that helps the productivity inside the store. More people then wind up staying particularly the part time work force as they start to understand and appreciate when they're here six months, they start to get the benefit of future where they can get $3,500 a year towards furthering their education. That cost while it sounds expensive, actually will be offset by that person staying for another 12 months or 18 months versus having that person turn a couple of times and having lower productivity and training.

So you kind of create a virtuous cycle and better opening wage rates, more contemporary benefits, helping them with their college education or GED or English as a second language. We have a lot of folks that here work for Kroger in management positions that have decided to go back and get their MBA and other advanced degrees certification. So all of those together help with that.

We continue to see improvements in our cost of filling our pharmacies. Our pharmacy business continues to be very strong piece. Our script count on a 30 day adjusted basis continues to grow nicely and as we leverage that and are able to leverage down our cost to fill prescriptions that certainly helps.

And then the efforts we've had both on our front end transformation that we try to working with space op when possible of reconfiguring the self checkout unit so that it's an easier and more friendly experience for our customers and then the added benefit of the Scan, Bag and Go.

All those help create productivity which is a positive to it. Lot of things I said there. I don't know that I would promise 20 basis points going forward but certainly cost reduction as we've been talking since we announced Restock Kroger in October '17 is a very important part of getting the $400 million of operating profit.

Rodney McMullen

I agree totally with everything that Mike said and I think, the last part that Mike said is the important part, as you look at now through 2020, you should expect to see us reducing costs of - how much cost it takes us to operate our business and Mike gave a bunch of several great examples. But we're really - our operations team is doing a great job working with our stores and our technology team on some innovation ideas to improve processes and take cost out.

So it's really all of those pieces working together but absolutely as you look out through 2020, you should expect us to improve cost and how much it costs us to operate our business.

Operator

And the next question comes from Michael Lasser of UBS.

Michael Lasser

In light of the fact that space optimization disruption should be a little less in the fourth quarter, plus given the reacceleration on your price investment. Should we expect that IDs - they're going to meaningfully accelerate in the subsequent month of your fourth quarter?

Mike Schlotman

Yes, I think the only place I would go on ID sales is our guidance as we expect the second half to be comparable to the first half. Our third quarter was close to the second quarter and our first quarter was a little better than the second quarter.

So we do have a little bit of ground to make up on that guidance but we didn't - we said similar, we didn't say exactly equal to. But we are expecting a little bit better fourth quarter. We are working hard to do that, and I think we have great plans in place.

Michael Lasser

And Mike, what would be the offset to some of those benefits, are there industry factors, consumer pressures what are your thoughts there?

Mike Schlotman

I don't know what do you mean by offsets?

Michael Lasser

Because you're going to see less disruption from space optimization and you should get sales lift from the price investments that you've been making. So I am just wondering if there is some offsetting drags?

Mike Schlotman

Yes, I wouldn't point in any particular offsetting drag as it relates to the top line. Keep in mind, our fuel rewards program continues to be incredibly important to our customers and our associates when they think about the total value that we give them on a day in, day out basis and that $0.10 a gallon they get off, keep in mind, we reduce reported IDs for that, because you have to buy groceries to get the lower fuel discount, not all of our competitors account for that way.

So as that continues to be popular and more and more people engage in that. We're selling more in the stores but it actually slows how quickly ID sales grows just because of the way we do our accounting. So there are always puts and takes on that top line.

Michael Lasser

And my follow up question is on Kroger Personal Finance. Seeing very healthy growth, what's been driving that and how much of that is private label credit card?

Rodney McMullen

It's really all the portfolio of products they offer. So in the last two or three years, we've done a couple of mergers with Roundy's and Harris Teeters. So there's good growth there. There's good growth in the existing business and then the credit card business continues to be an incredible tie in for loyalty for our Kroger customers.

So it's really all pieces of that business continues to grow. Obviously, credit write offs are low as well but that's a pretty small part of the overall impact on the profitability of that business.

Operator

The next question comes from Ken Goldman of JPMorgan.

Ken Goldman

In the past around this time of year, you've provided some initial thoughts about the upcoming fiscal year at least on some occasions. Mike, at the Investor Day, you did say, I think 2019 has to have some - I think the word you used was decent operating profit margin dollars. I just wanted to see if you can elaborate a little bit on that in terms of what you're expecting next year in general for next year, are there any unique tailwinds, headwinds we should be thinking about just opening up that topic if we can?

Rodney McMullen

Yes, I won't go too far on 2019 but it's - if you go all the way back to 2017 and then the first quarter of this year, when we talk about pulling forward some investments from '19 and then the '18, clearly operating profit margin has to grow in 2019 over 2018 and start that march to the $400 million that we're going to generate over the three years of the Restock Kroger plan.

I will say and I knew at some point we will get this question because we were a little - we were pretty more prescriptive this time last year on the call about what we expected for 2018 and a lot of that had to do with the fact that we had a range of estimates out there at that point in time that were as low as in the $1.40s and $1.50s and up to about $2.20 kind of range, it was a massive range.

And what we were trying to do was rein in that range as we guide into the end of the year and knowing that we were going to give guidance in March. We didn't want that wide of a range out there. I think today people are understanding that this is a three year program we're undertaking and as we make - as we pull those investments from '19 into '18, they should start generating a little bit more in '19 and then even more in '20. So it is a three year growth algorithm to get to the $400 million but we continue to see a clear path to the $400 million.

Mike Schlotman

The other point that I would add and we talked about it in October is if you look at digital, our overall digital business continues to be a significant investment for the future of the business. And we would expect for '19 just that to become a less of a headwind than it was in '18 and that is also an important part to remember as well.

Ken Goldman

And then a follow up, if I look at your SG&A dollars and they were down year-on-year, if I exclude the one time pension contribution last year, some extra weeks, it actually was down for the first time and at least 22 years according to my model. So I realize you're gaining efficiencies of store associates, I get that personal finance is a counter SG&A item.

But I'm still not a 100% sure why that decline was so sudden. I mean, your SG&A came in $200 million below where the Street was. So can you help us understand a little bit of what the big dramatic change was in the quarter or maybe I'm just - we're all just modeling it wrong and didn't see something.

Mike Schlotman

From a dollar standpoint, Ken, don't forget that last year would have had the sea stores in our OG&A rate and they are disposed off now - in our dollars.

Ken Goldman

Yes, but last quarter in 2Q, you still were up year-on-year with SG&A. So it's little bit more of a dramatic change. I can follow up offline if it's - I don't want to hold everyone up on the call.

Mike Schlotman

We were up a little bit in the second quarter. I would say the second quarter is probably more a function of in the prior year, we would've had some bonus accrual reductions because of the year - where the year was heading that we didn't enjoy this year.

Operator

The next question will come from Chris Mandeville of Jefferies.

Chris Mandeville

So I have noted, you guys are doing quite well on OG&A but gross margins were a bit lower than what we were all expecting. Mike, can you just maybe help ballpark the impacts on gross margins based on the noted items that you called out and I know, you don't necessarily like to guide to any one line item but just given the particular strength and fuel margins that we're seeing quarter-to-date and how that plays into overall earnings. Can you give us a sense of just how to think about gross margins ex-Q1, Q4?

Mike Schlotman

Yes, if you think about that margin rate in Q4, I'm more comfortable doing that than listing out the effects in any one quarter of some of those things because one quarter is not an indication of where they go long term. The one I did call out is Kroger Specialty Pharmacy, it's a very profitable business. It has a very low margin rate but because of the individual cost of those prescriptions for the patients, it generates very strong gross margin dollars, which is why we're in that business and as that business continues to grow, it will be a headwind. That one alone was a double digit basis point headwind. I won't give the exact amount.

When you think about the fourth quarter, you should probably think about the fourth quarter change in gross margin rate the way we talk about that basis point change being more similar to the second quarter than the third quarter.

Chris Mandeville

And then just my follow up. Over the last couple of week now, we've seen several sizable product recalls and I think some of that was even specific to the Kroger brand in both meat and pet food. So I'm just curious on what Kroger has been doing of late or what they planned to do when it comes to the supply chain and improving sourcing, helping mitigate recall costs.

Rodney McMullen

But, if you look, food safety has been something that Kroger has been incredibly proud of for many, many years and we have a team of folks here that that is their only responsibility is to make sure that products are safe throughout the food channel. We will do routine audits of our suppliers as part of that process.

One of the things that we are incredibly proud of is in the unfortunate situation where there is a recall, we reach out to our customers and let them know that there's a recall on products they've bought. So that we try to get that customer to get the product back to us as quick as possible to make it easy on them and to let them know. It's something that we also review with our board on a regular basis.

If you look at severity of incidence, we've actually over the last five or six years there's been a decline on severe incidents. Now, if you look at overall recalls, that continues to increase just because I think the overall food safety chain in the US continues to improve.

Chris Mandeville

And maybe just two quick housekeeping questions. What was inflation, deflation in the quarter and was there any notable call out from hurricane impacts on the comp or expansion for that matter?

Mike Schlotman

Yes, if you look at the hurricane impacts, it would have been a little bit of a headwind to ID sales. We didn't necessarily call it out primarily because it wasn't that dramatic but it was several basis points of a headwind more than a couple but it's not like it was 20 basis point or 30 basis point, so. But it was meaningful but not directionally going to change the answer. If you look at your question on inflation deflation, I'm looking at my chart here. I have 30-year-olds mega chart for their eyes, not my eye.

So if you look at inflation deflation without fuel and pharmacy on a cost basis, we had about 11 basis points of inflation. If you put pharmacy back into the mix, we had about 22 basis points of inflation. So a very benign environment. It ranges around the categories of who had some inflation and deflation and there were some categories that had a little bit of inflation and others that had a fair amount of deflation.

Operator

And our next question comes from Rupesh Parikh of Oppenheimer.

Rupesh Parikh

So on capital allocation, I was curious how quickly you anticipate being back to that 2.3% to 2.5% leverage ratio and then as we look out to next year, I know, you have $1 billion term loan coming due. So just curious, if you have any initial thoughts in terms of whether you would pay that down or refinance that debt?

Mike Schlotman

So we actually have about $1.1 billion of long term debt that is now classified as current coming due and call it the next 90 day or next 60 days some this month, some next month that we would anticipate refinancing that in the market. We do have forward starting swaps against both of the types of debt we would wind up expecting to issue at very favorable rates. The 30 years that is almost 100 basis points below where the 30 years today and the 10 years hedge not quite that strongly but almost as strongly.

We haven't decided exactly what we'll do with the term loan. It is - some of our banks like the business, some don't like the business but we certainly would have enough capacity with commercial paper to be able to use commercial paper to pay off the term loan if we chose to. We will have - we always have a financial policy committee meeting with our Board in January and we'll discuss our plans of how much flexibility do we want. If we rolled over the term loan and keeps more revolver capacity, so you can handle fluctuations day to day.

Relative to the net total debt to EBITDA range, we are always in contact with the rating agencies. They understand what our program is and we are executing against a program we've described to them relative to them keeping our ratings where they are.

Rodney McMullen

And it's important for us to get back into the range.

Mike Schlotman

Absolutely.

Rupesh Parikh

And then switching topics on price investments, so they clearly accelerated I think the past quarter or two, so just curious in terms of whether the volume uptick so far or thus far is meeting your expectations?

Mike Schlotman

I wouldn't - I don't know if I would be as strong in the comment that they clearly accelerated. If you go back to each of the quarter so far this year, we talked at the end of the first quarter that we started making the pull forward investments in the fourth quarter.

So from that standpoint, what we were pulling forward from '19 into '18, it's a fair assessment that beginning then, we did make those pull forward investments. I wouldn't characterize the third quarter as a big uptick and what our price investments plans were for the year, it's just that we continue to make the price investments throughout the year and it's more a function of how we make price investments last year a little bit choppier than we did this year.

Rupesh Parikh

And are they meeting your volume expectations as far as the volume uptick that you are seeing?

Mike Schlotman

We continue to be happy with what we're seeing from the results of the plan. It's not a single plan, it's not a single investment, so as with anything when you make price investments in a wide range of things, there are those out there that you probably are getting more volume than you expected and some not quite as much, not everyone's perfect but we're constantly stepping back and assessing all the results.

Overall, I would say, we're very happy with what our investments are giving us. I don't want to give the appearance that each and every one of them is perfect because that probably wouldn't be believable. But we are very happy with the collection of them and the ones that are doing well, we do more of them and the ones that aren't quite so well, we try to tweak and see what else might work.

Operator

The next question will come from Judah Frommer of Credit Suisse.

Judah Frommer

Just to follow up on the price investment, first. Can you give us some insight to how internally the decisions are made around seeing better fuel profitability and kind of how quickly you can turn that in to pull forward price investment and then how should we think about that pull forward, does it actually offset investments that you may have made next year or since the environment is so competitive is there just this race to the bottom with everybody?

Mike Schlotman

I wouldn't - it's obvious from some of the questions out there that there's this notion that when fuel profitability is very strong, we invest more in price and that's driving our gross margin down. I actually don't think that's true for this particular calendar year. We had our price program in place as part of Restock Kroger.

We knew what we wanted to invest this year. Washington gave us a Tax Reform Act that lowered our cash taxes, we elected to pull some of our investments from '19 into '18 to get that expense behind us in the first year of the lower taxes start to drive better growth in those categories as we get into '19. I don't - I wouldn't say that we've made any big moves on price as a result of strong fuel margins which is where everything shakes out.

Rodney McMullen

And the other thing I think it's always important to remember when we go to market, our fabulous associates in terms of the great experience they deliver and fresh product is also important. So for us, it's the overall shopping experience that we're trying to create for the customer and we're aggressively investing in the anything, anytime, anywhere, so they can do it anyway they want to whether that's digital, delivery, pickup or physically in the store, and have the same great experience and great fresh product all - and all those together.

Judah Frommer

And then just a quick follow up on the OG&A line. I would say historically, your unionization was sort of - as kind of a knock on the business, and today, I would say that the expansion into online and digital as a needing incremental investment in OG&A but would you say, we're at a point where the unionization may be helping you in some ways given the tightness of the labor environment and is there anything you can do to dispel online grocery necessarily adding meaningfully to SG&A or bringing down the margin there.

Mike Schlotman

I think, when you look at our workforce overall, whether you're unionized or non-unionized. When I look at - because not 100% of Kroger is unionized and when I look at overall results in a unionized market versus a non-unionized market whether it's at the end of the day the OG&A rate and what you pay associates to perform their jobs, when you look at your employee relations, employee satisfaction, there's really not a tremendous difference between those particularly in the wages.

But we offer all of our associates a great health care option and if they're in a union, they're in a more defined benefit plan. If they're not in the union, they would be in - some of them would be in a defined benefit plan but some are in a defined contribution plan.

So it's really a mix of benefits inside those, when I look at some of the home delivery and the online stuff that you refer to. There's a lot of cost in that system that everybody can point to and say, how you're going to do it. It's one of the reasons we joined up with Ocado to build the fulfillment centers that we're going to start building and we announced the first one here in Cincinnati.

While, there are certain costs that will add at a part of the total supply chain for the customer. There are other parts of that cost that will come out of the supply chain, more efficient picking because it's done robotically. It's done significantly faster on a 50 item order compared to how long it takes a 50 item order inside the store. I don't take product from the manufacturer to the warehouse to the store. I take it from the manufacturer to the Ocado warehouse and then it goes right from there to the customer.

So there's different efficiencies which is overall why we think that's going to help offset some of the costs people are worried about.

Operator

And the next question comes from Paul Trussell of Deutsche Bank.

Paul Trussell

Could you speak to any additional color around your digital business. I know you mentioned up 60%. Just kind of what you're seeing out of Kroger Ship versus pickup and Home Chef. In addition, if you can maybe just speak to the new pilot with Walgreens?

Rodney McMullen

There is a whole host of questions there. I'll try to organize it in a way that makes sense. As you mentioned, our digital business, overall grew over 60%. All pieces of the digital business continues to grow. If you look at what was the biggest drivers of the growth, it would certainly be continuing to add locations where customers can pick up and get delivery.

From an online standpoint and the stores that were already had it a year ago their continued growth and then Home Chef as well. Home Chef would be pretty much exactly where we thought it would be from a growth standpoint or where Pat and his team thought they would be and then we were part of it.

If you look at ship and some of the other pieces, it's still pretty early in the process. We would have had a lot more expenses in terms of setting up where all the systems worked versus so much of a sales driver. But obviously, over time, you would expect that to become more of a sales driver but that is very early in the ramp.

The relationship with Walgreens, it's - both of us are very excited about what it can be, but it's one of the things where you really have to start small and learn from it. And that's really the prioritization is let's take baby steps and see if we can identify something that works for a Wallgreens customer and a Kroger customer and some way that both of us can grow our business and make money.

So excited - you know the thing I guess I'm most excited about is when I spent time with our combined teams and their openness and aggressiveness on trying to identify something that's great for our customers, for both of our customers is the thing that's so exciting, but it's pretty early to be able to start giving some more specifics than that.

Paul Trussell

Then just to quickly circle back on inflation or lack thereof is clearly a benign environment in terms of the impact to your third quarter results. I just wanted to just circle back on your outlook, you know, as you think about what's to come over the next few months. Any change in your outlook on inflation deflation impact your results?

Mike Schlotman

Yes, I would say, no. I don't really see a lot out there. I know there's a lot of noise in the marketplace about CPG companies pushing price increases through and the like over time that we will see where that goes and how everybody winds up reacting to it. Keep in mind, when we talk about inflation deflation, it's relative to Kroger and not marketplace forces necessarily.

So it's our cost of goods this year versus our cost of goods last year and as everybody knows a key component of driving the $400 million of operating profit over the next three years is continued improvement in cost of goods So some of that deflation is actually doing things to get better pricing inside Kroger and that may not be something that's replicated at other places.

Rodney McMullen

The other thing, I think, it's always important to remember as I always think it's a dangerous thing for CPGs to raise their cost more than what the economic cost of something increasing and what we find over time when somebody does that, our own brands will pick up a disproportionate amount of share whenever somebody does that. So to me it's a fine balance that we're all doing to try to find what's that optimal price point.

Operator

And that final question comes from Robby Ohmes of Bank of America Merrill Lynch.

Robby Ohmes

Just a couple of quick ones, sorry if I missed this, Mike, can you give us traffic versus ticket in the quarter? And maybe Rodney chime in. I'm just curious the tone of the customer through the quarter, were there any variances there? Are you seeing trade up when you look at what they're doing and then also again - again, sorry if I missed this but loyal households is that - was that still growing in 3Q similar to previous quarters? Thanks.

Mike Schlotman

Yes when you look at overall the basket value grew a little bit in the quarter. And that's primarily a result of mix of what's going inside the basket when you look at transactions in the quarter, when you add in all of the entities that was up - it was up a little bit in the quarter as well.

Rodney McMullen

The tone of the customer they continue to - the economy still feels very good, people continue to buy wine, that - anything that makes their life easier, they will aggressively buy. So wouldn't be anything and then from a household standpoint, we did continue to have slight growth in households as well.

Rodney McMullen

We are incredibly confident about the future of Kroger, especially with Restock Kroger. One of the exciting things about our earnings call is that many of our associates listen in to better understand and gain insights into 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 final comments directed toward them. Last week, we celebrated Giving Tuesday in conjunction with our partner Feeding America, we set a goal to raise enough money to provide 4 million meals to those in need during this holiday season. Together with our customers, we raised enough to serve almost 6 million meals helping us move closer to our Zero Hunger Zero Waste goal of eliminating hunger in our communities.

Last Friday, a major earthquake rattled Alaska. We operate seven Fred Meyer stores that were affected and thankfully all of our associates and customers inside our stores were safe. I'm so proud of the awesome job that Fred Meyer and Kroger team did. Under the leadership of Joe Grieshaber and our teams, everybody work together to get all our stores opened within one day.

Each holiday season, I'm reminded of our privilege to serve more than 9 million customers, who shop with us every day. Every celebration or tradition is as unique as the customer who walks through our door. Among the hustle and bustle of the season, you welcome our customers and help to make their celebrations brighter. We lift our customer spirits and they uplift our spirits as well.

These are just a few examples of what it means to live our purpose to feed the human spirit. It's an amazing thing of what we can do together. Thank you for all you do for our customers, communities and each other.

Merry Christmas, happy holidays and Happy New Year to you and your family and all those listening in. That completes our call today. Thanks for joining.

Operator

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