The Kroger Co. (NYSE:KR) Q3 2017 Earnings Conference Call November 30, 2017 10:00 AM ET

Executives

Kate Ward - Director, IR

Rodney McMullen - Chairman & CEO

Mike Schlotman - EVP & CFO

Analysts

Karen Short - Barclays

John Heinbockel - Guggenheim Securities

Shane Higgins - Deutsche Bank

Edward Kelly - Wells Fargo

Ken Goldman - JP Morgan

Scott Mushkin - Wolfe Research

Operator

Good morning, everyone and welcome to The Kroger Company's Third Quarter Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, today's event is being recorded.

At this time, I'd like to turn the conference call over to Ms. Kate Ward, Director of Investor Relations. Ma'am, please go ahead.

Kate Ward

Thanks, Jamie. Good morning and thank you for joining us.

Before we begin, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions, and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings, but Kroger assumes no obligation to update that information. Both our third quarter press release and our prepared remarks from this conference call will be available on our website at ir.kroger.com.

While there, we encourage you to visit the Events & Presentations page to find the full slide deck outlining Restock Kroger as laid out at our Annual Investor Conference on October 11. Restock Kroger will be the framework we will be using over the next few years to clearly communicate how we plan to serve America through food, inspiration and uplift; and as a result, create shareholder value. 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, Kate, and good morning, everyone, and thank you for joining us today. With me to review Kroger's third quarter 2017 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

I'd like to thank you for joining us at our 2017 Investor Conference in New York last month where we outlined Restock Kroger, our plan to create shareholder value by redefining how America eats. Food retailing is more exciting than ever, more Americans identify as foodies and customers have more food choices than ever before. In the past, we've defined our market as share of untraditional grocery stores; today we've redefined our market as shared stomach, this sharpens our focus when we look at our industry and our customers. We see anyone who sells food as competitors which doubles the size of our market to $1.5 trillion.

If you're eating, we want to serve you that meal. The fact that Kroger is trusted by more than 60 million households is an incredible competitive advantage. Kroger has competed in an ever-changing retail landscape for 134 years because our touchstone has always been the customer. We price the customer at the center of everything we do, and because of our relentless focus on serving customers, Kroger is uniquely positioned to be the partner they turn to for meals. Restock Kroger has four main drivers; redefine the grocery customer experience, expand partnerships to create customer value, develop talent and live our purpose. These pillars combined will create shareholder value.

Going forward, I plan to highlight an item or two each quarter that we've made headway on. This quarter I'd like to begin by talking about how we're creating a seamless environment where our customers can choose how they engage with us in store and online. Our efforts are all about making things easier for our customers and providing personalized, affordable and exclusive options that fit their needs. Seamless will play a major role in redefining the grocery customer experience. Our hypothesis has always been that our customers will want to have options on how they engage with us. This hypothesis shaped our strategy and we've been executing that strategy by accelerating Kroger's digital and e-commerce efforts for the last several years.

We know that our customers have already decided they love ClickList, which is why we continue to rapidly expand that offering. By years end, we will be serving customers at more than a thousand click and collect locations. Our third quarter digital revenue growth was 109% driven by ClickList. We also know that some customers desire home delivery. We've gone from zero to more than 300 locations offering home delivery in a spend of little over a year by partnering with service providers including Strip, Roadie, Uber and others. We'll continue to build on our home delivery offering in 2018 with these partners, as well as Instacart, who we are developing a unique relationship with. We have initially launched a partnership with them in Southern California.

We'll continue to use our data and customer insights to make it really easy for our customers to navigate across the channels they choose when shopping with us, and we'll continue leveraging our physical proximity to our customers as a competitive differentiator. To do all this requires the investment we outlined in Restock Kroger. Everything we're seeing in our data and in customer behavior tells us Kroger's transition to seamless is working. Today households that engage in our seamless offerings, engaging digitally and with our physical stores spend more per week than households that do not. The future looks even more promising. We'll continue to add even more services, expand our available product selection and more effectively use our insights to create a personalized experience that every customer will love.

Winning in a seamless world also means optimizing space and ensuring our brick-and-mortar experience is curated to deliver exactly what customers are looking for. We firmly believe that customers are the future, we'll continue to frequent physical stores will compelling offers and experiences. A very recent example of this, is Kroger had our best ever Black Friday results for general merchandise led by record sales at our Fred Myer [ph] division. Another focused area on redefining the grocery customer experience is winning with our brands. It's no surprise that America's most beloved grocery store has some of America's most beloved brands, which as a portfolio we will continue to champion for growth. In fact, our brands as a standalone company would be in the top third of the Fortune 500.

In the third quarter, our brands continue to deliver strong performance making up 28.2% of unit sales and 25.6% of sales dollars excluding fuel and pharmacy. Simple Truth continues to resonate in a big way with our customers with sales growing 19% in the third quarter. Another important

Restock Kroger area is focused on accelerating cost of goods savings and sales leverage.

We will continue to work on controlling cost to invest in areas that matter most to customers. For example, we are leveraging our relationship with suppliers to drive costs and inefficiencies out of our various businesses. These processes have successfully driven significant savings in cost of goods which allow us to invest in price for our customers, at the same time this helps our supplier generate volume growth. Our use of data and science creates opportunities and efficiencies that both parties benefit from. Across the Board, customers are recognizing our efforts to redefine the customer experience; and they are rewarding us with their loyalty. This in turn creates value for our shareholders, that's exactly what Restock Kroger is designed to do. We will create shareholder value by generating incremental margin dollars and free cash flow over the next three years.

As our business continues to improve, we remain committed to delivering on our 2017 earnings guidance. We are also confident we have the ability to grow identical supermarket sales and market share in 2018.

Now, here is Mike to share more details on our third quarter results and discuss our fourth quarter and fiscal 2017 and 2018 guidance. Mike?

Mike Schlotman

Thanks, Rodney. Good morning, everyone. Our core business was strong in the third quarter. We're very pleased with our ID sales exceeding 1% in the third quarter. We were especially happy to see the very strong performance on our fresh departments; the results in produce and meat were terrific, and we continue to see double-digit growth in natural foods.

Our ID sales results were driven by both, higher spend per unit and strong growth and the number of households. Total visits continue to grow throughout the quarter, and our market share was up. Our businesses gained momentum and our customers are recognizing the investments we are making. We noted at our Investor Conference that over the next three years, Restock Kroger will be fuelled by $9 billion in capital investments, cost savings and free cash flow. We recognized that in order for -- in order to be there for our customers today, and more importantly, to be where they are going in the future we need to make investments more aggressively and faster than ever before.

We've already prioritized the way we invest capital by both reducing the amount we spend and optimizing our capital allocation process. We now look first for sales driving and cost savings opportunities through both brick-and-mortar and digital platforms; second, we will continue to make sure our logistics and technology platforms keep pace with and scale to those demands that were created through these investments. Then finally, we will allocate capital to storing activity; this process has allowed us to use less free cash flow for capital investments.

As Rodney said earlier, we are aggressively managing OG&A costs and implementing new programs to reduce our cost of goods sold. One example is our recent decision to require on-time and in-fold delivery from suppliers. We're implementing penalties when scheduled deliveries are missed within a designated window. Overtime, this will help keep cost standby on sharing more predictable operations, but more importantly, it won't share that we have the products on our shelves that our customers want and when they want them. We expect Restock Kroger to generate $400 million in incremental operating profit margin over to three years from 2018 to 2020. We also expect to generate more than $4 billion of free cash flow after dividends over the next three years. Our goal is to continue generating shareholder value even as we make strategic investments to grow our business.

Fuel performance was also outstanding in the quarter. Our cents per gallon fuel margin was approximately $0.249 compared to $0.179 in the same quarter last year. The average retail price of fuel was $2.46 versus $2.17 in the same quarter last year. This along with our strong core business results demonstrates the diversity of our earnings. The fuel performance in the quarter also created the opportunity for us to make an incremental, a $111 million contribution into our USC consolidated pension plan. Funding these obligations proactively overtime demonstrates our ability to meet our commitment to protect employee pensions while simultaneously delivering value for shareholders.

As you know, we announced last month our intention to explore strategic alternatives for our convenience store business, including a potential sale. This was the result of review of assets that are potentially of more value outside the company that is part of Kroger; this process is ongoing and there has been a high level of interest. As we stressed last month, our convenience store management and associates are an important part of our success; we value what they do and thank them for continuing to put our customer first everyday as we conduct this evaluation. Over the last four quarters we used cash to contribute an incremental $1.1 billion to company-sponsored pension plans, repurchase 59 million common shares for $1.7 billion, take $446 million in dividends and invest $2.9 billion in capital.

Our financial strategy is to use our financial flexibility to drive growth while also returning capital to shareholders and maintaining our current investment grade debt rating. We continually balance the use of cash flow to achieve these goals. As of the end of the third quarter, our current share repurchase authorization had approximately $590 million remaining. In return on invested capital for the third quarter on a rolling four quarter basis was 12.31%.

Now I'm going to spend a lot more time talking about pensions this quarter than I normally would. This is driven by not only what we've done this quarter but also what we've been doing over the past several years. About a decade ago we identified a great amount of exposure on pension plans and recognized then we would need to begin addressing that exposure like we would any big endeavor, one step at a time. Our efforts begin in earnest in 2011 when we negotiated and created the UFCW consolidated pension plan.

The keys for us were capping prior service costs, negotiating a new benefit accrual going forward, consolidating four plans into one and sharing both, professional and more efficient management of the assets going forward. We agreed to fund the plan over five years but elected to fund it in January of 2012; this arrangement reduced Kroger's annual multi-employer pension expense and secured the pension benefits for tens of thousands of Kroger associates. Including this agreement, we have since made more than $2.3 billion in payments and funding commitments with two objectives in mind; one, to address the underfunding and the company sponsored pension plans, and two, to address the liabilities of various troubled multi-employer pension plans. We have adopted this approach in a low interest rate environment to provide greater stability for the pension benefits earned by thousands of Kroger associates and retirees, and to manage these liability proactively or frankly, to avoid kicking the can down the road.

We have said for some time that we expect our net total debt to adjusted EBITDA ratio to grow, this is because we're bringing an off-balance sheet item on your balance sheet, we're funding an obligation already on our balance sheet. As a result, we are updating our target range for this ratio to 2.2 to 2.4 times. These obligations whether recorded on or off Kroger's balance sheet have generally been considered when our credit profile has been reviewed but since they weren't funded, did not get picked up at our net total debt to adjusted EBITDA ratio. Our current result of 2.57 times is above this range. We expect to use free cash flow and potential proceeds from the sale of assets to get us back in the range.

Protecting associates and retiree pensions is one significant way that we take care of our associates. Another is hiring and job creation, Kroger is currently hiring total 14,000 part-time and seasonal jobs, this is in addition to the nearly 10,000 permanent jobs we've already created in 2017. Through Restock Kroger we plan to invest an incremental $500 million in human capital in wages, training and development over the next three years. 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.

On the labor relations front, we recently ratified an agreement with the UFCW for store associates in Charleston, West Virginia, and we're currently negotiating an agreement with the team stores [ph] for the master agreement. 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.

Our financial results continue to be pressured by inefficient healthcare 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. The importance of growing our business and growing it profitably which will help us create more jobs and career opportunities and enhance job security for our associates.

Turning now for our guidance for the fourth quarter of '17 and all of '17, we expect fuel margins to moderate in the fourth quarter and we're already seeing that quarter-to-date. We expect fourth quarter identical supermarket sales growth exceeding -- excluding fuel to exceed 1.1%. We confirmed our 2017 net earnings guidance for 53 weeks of $1.74 to $1.79 per diluted share and our adjusted net earnings guidance range of $2 to $2.05 a share. Both our GAAP and adjusted net earnings per diluted share guidance includes the effect of the hurricanes. The low end of this range is $0.04 above where industry analyst consensus forecast has been demonstrating Kroger's ability to deliver shareholder value in a dynamic transition year.

Our LIFO expectation has been lower to $60 million from $80 million and we expect capital investments excluding mergers, acquisitions and purchases of leased facilities to be approximately $3 billion for 2017.

Before I turn it back to Rodney, I want to note that in the 8-K we filed earlier today, we reconfirmed our early thoughts on 2018. Rodney?

Rodney McMullen

Thanks, Mike. We are pleased with the third quarter results and the fourth quarter is off to a solid start. Our associates who are providing friendly and fresh service to our customers in a seamless way. In addition to Restock Kroger, we outlined our investment thesis at the Investor Day last month, and I'd like to share it with you again today because I -- we feel like it really highlights our strengths.

As Americas growth, we are growing in a fragmented market, progress more data than any of our competitors leading to deep customer knowledge and unparallel personalization. We have incredibly convenient locations and platforms for pickup and delivery, within 1 to 2 miles of our customers. We have a leadership team that combines deep experience with creative new talent. We have the scale to win worth more than 60 million households shopping with us annually. In fact, Kroger has been named Americas most loved grocery store several times. We connect personally with our associates, customers and community to uplift and improve life. We have a proven track record of consistently returning capital to shareholders through an increasing dividend and share buyback program.

And with Restock Kroger in place, we are confident in our ability to continue winning the customers, growing our business and creating shareholder value.

Now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question today comes from Karen Short from Barclays. Please go ahead with your question.

Karen Short

I just try to understand gross margins a little bit better, Mike so you just said in the prepared remarks that you expect margins to moderate in fourth quarter and obviously everyone was very surprise by the 3 basis points up gross margins this quarter; so I guess I'm wondering if you could just share a little more light on what might have been transitory this quarter.

Mike Schlotman

What I talked about as far as moderation and margins in the fourth quarter was we expect our few margins to moderate in the fourth quarter and we've already been seeing that. What happened with gross margins this quarter, the 30 basis points without the fuel modern health and LIFO charge that we talked about in the earnings release, we have become significantly more diligent on lowering our cost of goods and negotiations with our vendors. Our sales mix was very strong in the quarter relative to more natural foods and more our brands which helps drive our margin rate up and those did also continued price investments, our costs -- our inflation [ph] cost is still above our inflation at retail, if you go back to the chart I used at the investor conference but they are beginning to converge and both of them are now in positive territory. I don't want anybody to think we did invest in price in the quarter because we certainly did in a very big way and it's really the factors I talked about.

Karen Short

So is it fair to say then this dynamic in terms of the -- being better at lowering the cost of goods is something we should expect at least for the next three quarters; and then, if any way you could just give what cost inflation was versus retail inflation?

Mike Schlotman

I walk-in to the habit of revisiting that chart that were both over zero; so we did have cost inflation, as well as retail price inflation that got past on but we didn't pass all of it. I also walk-in into the habit of predicting where gross margins may go on a quarter-to-quarter basis because you never know exactly what negotiations or what benefits may fall on a particular quarter but we do feel good about the results we posted.

Karen Short

Okay. And just on the expenses, could you did talk about multi-employer credit but -- any color on how to think about multi and clear expenses next year versus this year just directionally?

Mike Schlotman

As I sit here today, so there is two components of multi-employer expenses; there is one that we may got a sense per hour basis is part of our contracts to third-party plans that we don't manage, maybe trusting on those. So those will be whatever the hours we work in the contractual rate per hour; my guess is that you would see a slight increase -- some increase in that number. I think as you think about contributions to our multi-employer, to the UFCW plan that I talked about we created five years ago, as I sit here today I would expect that to be slightly less next year than this year given the contribution we just made, plus they are having a very nice year from a return on asset basis.

Operator

Our next question comes from Michael Laser [ph].

Unidentified Analyst

So even the rate of gross margin that you saw in this quarter continues, we choose that as an opportunity to accelerate and deepen your price investments, and what are you seeing on the competitive environment as far as pricing at this point?

Rodney McMullen

Well, one of the things that you've heard us say for a long time is, we will not lose on price and we'll continue to use our data and insights to understand where we should be priced on a basket of goods and individual items. So we will continue using that data to influence and cause us to invest in pricing going forward. As you know at our Investor Day, Mike outlined that looking over the next three years we would view over the next three years will aggressively continue to invest in price and we'll use the savings from all the things that Mike outlined to pay for those renewed investments for our customers. Mike, you want to add anything?

Mike Schlotman

No, I mean you hit the nail in the head. We have been and we'll continue to invest in price and we have a lot of plans in place to figure out what is to pay for that.

Unidentified Analyst

And then my follow-up question is, if we to get tax reform and your tax rate go down significantly, how would you look to deploy that benefit to your P&L? Would you just let it flow to shareholders or would you look subsidized investments you might make with that savings?

Rodney McMullen

The one thing that -- first of all, we're very excited about where the tax reform is headed, we're especially excited about the house version because it starts almost immediately where the Senate is the later year. We believe it will also influence for us to continue to invest in our business which will grow jobs and I think what will end up happening is you will see us do a balance of everything together, some of it our shareholders will benefit from, some of it our associates will benefit from and our customers will benefit from it as well because we really view that all the together is what drives the sustainable business that continues improving overtime. And as you know, that's been our strategy for a long period of time and would really look at this as an opportunity to continue to drive growing our business, creating jobs, been able to share some of that with our associates and customers as well.

Operator

Our next question comes from John Heinbockel from Guggenheim Securities. Please go ahead with your question.

John Heinbockel

So let me start Rodney, Mike; the -- I know it's harder to manage this balance than we think right between comps and margin improvement; how would you characterize the balance right now? Are you happy with the balance between the two? And then, I know you said you wouldn't lose on price, do certain competitors out there, has that message gotten through such that some selective irrationality has dissipated or was that still going on?

Rodney McMullen

For us I felt really good about the balance for the quarter but I would broaden it a little broader than your example because I would also include cost controls; we're making some improvement on shrinking some other piece, elements as well. So when I look at the overall balance, I felt good about what we were able to accomplish, at the same time focusing on investing some entry level rates for our associates in several markets as well. The other thing that I liked about the balance for the quarter is that it sets us up well going into the fourth quarter as well. On pricing, I remember years ago, Joe Pickler [ph] told me on economous [ph], all short statements are wrong; and on the -- if you tell me what you want me to find, I think I can probably find it on pricing across the market.

So we would not view that the market is any different today than it was two months ago, five months ago or whatever; it's really anymore, it's almost store specific, it's not even market specific in many cases. I was in a competitor the other day and they are three miles apart; the note price and egg prices were over $1 per unit different.

John Heinbockel

And then what I was going to say, secondly on ClickList, right; you haven't said how many are going to open next year? What was your thinking in terms of how fast you want to go, obviously if it's not with incremental customers, it's not that dilutive; does that incline you to go faster if the organization can handle it? And then is there anything differently you're going to do operationally next year with ClickList? I know at some point you may think about where the demand is and how you handle that longer term but do you do anything different operationally, in terms of how you pick; how you consolidate orders or pretty much it is what it is for '18?

Rodney McMullen

Well, for '18 we haven't given a specific number and I can tell you internally, we're actually still working on it as you look at the second half of the year obviously in the first quarter and second quarter we have those lined up. We would continue to get ClickList in every store that we can do that and make sense, we use our insights to understand in some places it just wouldn't make sense. There are some stores where we would like to have it but we just don't have the physical space, so you're -- one of the things you're trying to do is find the physical space. Operationally, today we continue to see progress in our operational metrics as it matures and as we use technology to make it easier for our store teams.

At the current volume, I don't see huge changes in approach but that's one of the things that we're so excited about our online approach is at a certain point, it's by far the most effective way of doing it is in-store but as the volume becomes high enough, it's very easy to transition that over to dark stores and just tied into our existing infrastructure. So we feel really good about where we are and we feel good about as the volume changes, we can adjust the model to continue to connect. I don't know Mike, do you want to…

Mike Schlotman

No, I agree with you. And we obviously, announced our relationship with Instacart that we in Southern California which will be a prime example of what Rodney said we're on average smaller stores and smaller parking lots and this is a great solution for a market like that where it's just over the customers want but the physical assets we have wouldn't support it.

Operator

Our next question comes from Shane Higgins from Deutsche Bank. Please go ahead with your question.

Shane Higgins

I just wanted to follow-up a little bit on the ClickList; I mean you guys had over 500 stores I believe this time last year. What color can you give us just in terms of how those stores have kind of ramped and performed over the last few quarters? And just in terms of any contribution to the comp and how that's impacted margins? Thanks.

Rodney McMullen

It helps comps; from an expense standpoint it's continuing to invest in the future and as everybody has heard me talk about it before, everything that we have learned and seen on ClickList, it takes three to five years before we're really indifferent on a financial perspective of whether somebody comes into the store and shops or somebody shops on ClickList, and obviously that's the labor that the customer provides on picking the groceries versus us picking it for them. But overtime, we continue to grow the business and we get better operationally from an expense standpoint.

So if you look at the quarter and if you look at year-on-year, it continues to be incrementally more an investment from a P&L standpoint, it helps identical all the maturity that we're seeing on some of the early locations continues to feel -- have us feel comfortable that in a three to five year period for a store, you're really indifferent and just becomes one more offer for the customer. And that's really what we're focused on and we pay a lot of attention as I mentioned in the prepared remarks, we think it's incredibly critical to provide a seamless experience because the customer does come -- still can't continue to come inside our stores.

Shane Higgins

And are you seeing this disprogression -- does it look similar to what you've seen at the Harris Teeter Stores where I believe you guys have offered this prior to your acquisition of the company; they'd offered it for a number of years?

Mike Schlotman

That's very, very much so and as you know, when we merged with Harris Teeter and we solved their insights, it's what caused us to aggressively start doing ClickList and the only changes we made was asking the Harris Teeter team if you had to do it over again, what would you do differently, those things we have done but the patterns that we're seeing would be very similar to what we saw -- what Harris Teeter saw before we merged and what Harris Teeter continues to see.

Shane Higgins

And just a housekeeping question on cost inflation; Mike, I might have missed this; did you actually give a number for the cost inflation during the third quarter?

Mike Schlotman

50 basis points.

Shane Higgins

50?

Mike Schlotman

Yes, sir. 50.

Operator

Our next question comes from Edward Kelly from Wells Fargo. Please go ahead with your question.

Edward Kelly

Rodney, could we just start with on the IDs, could you just sort of walk us through the cadence of the IDs through the quarter and what you're seeing so far in Q4, I mean your commentary around a better number than the 1.1 suggested you're higher than that now but just -- your thoughts there would be good.

Rodney McMullen

If you look at it during the quarter, it was very balanced across the quarter, nothing that would jump out one way or the other; we had traffic growth throughout the quarter. If you look at the household growth and things like that, it was pretty consistent and we continue to see that so far in the fourth quarter. It's a nice, steady balance moving in the right direction.

Edward Kelly

So in Q4, so far are you above the 1.1, is that why you got it that way?

Rodney McMullen

Well, as you look day to day, it's hard to see but we would be very similar to that. It certainly supports the guidance we gave.

Edward Kelly

And then Mike, just a question on you on leverage ratio. So when you bring that math under funding on balance sheet, the rating industry obviously already know all this information and they've thought about this when they have looked at you in the past and determine rating. So does what you're doing at all have any impact on the way you're thinking about allocating cash flow overtime?

Mike Schlotman

It really doesn't, as we have more opportunities and negotiate more opportunities; if I could get all of these union contracts if I wouldn't want to do it [indiscernible], like I said in my prepared remarks, it's one step at a time on big endeavor like this; I would prefer to bring them all in balance sheet, manage the assets myself, get rid of a lot of friction cost. One of the funds we consolidated, it was unbelievable, the management fees that were aimed, because their assets were so low. And as you get a bigger pool of assets going after the same goal, you obviously get better fees, so there is lots of ways it reduced our cost and generally speaking, the rating agencies do get it and understand it; it's -- I think I'll allow this for a second and everybody in the room just kind of looked at me like -- but we've actually talked, should we start talking about the leverage ratio closer to exactly how the rating agencies do it, so there isn't this disconnect between the two and we just put everything after the way we believe they look at it, they don't tell you everything but -- and then it's not; it's volatile as it seems when we add something, so that's something we're kicking around just to take some of the -- what seems like a growth in our leverage when it's just moving it from one part to another.

Edward Kelly

And just lastly for you Mike, how do you see the allocation of the proceeds from the C-store sale sort of playing out related to repo or debt reduction?

Mike Schlotman

I think I would just go back to what our strategy is and we would allocate our -- those proceeds to support all the pillars of our financial strategy, keeping in mind the contribution to the bottom line at those stores to generate; as well as the need to get our leverage ratio down.

Rodney McMullen

It will be a balance between…

Operator

Our next question comes from Rupesh Parikh from Oppenheimer. Please go ahead with your question.

Unidentified Analyst

Good morning, this is actually Erika [ph] on for Rupesh, thanks for taking our question. So I actually had a question on pharmacy; so there has been a lot of speculation lately with the new player potentially entering in the pharmacy space and other, such as CBS discussing plans to offer next day delivery; so just curious whether pharmacy delivery is something your customers are requesting? And, you know, your ability to potentially offer this convenience down the road, and just the competitive dynamics to surrounding kind of this speculation?

Rodney McMullen

In terms of delivery, we -- in some places we already offer delivery to the customer request is enough. Going forward, if it becomes something that's more important, we'll be able to leverage it on the infrastructure that we're putting in place for ClickList on delivery. The -- for us one of the things that we like, the pharmacy business continues to improve and grow because we're able to help people eat healthier as well, and your 84.51 in our pharmacy teams are really working hard or health and wellness team, it's really working hard on how do we help customers eat healthier on their terms because we know the flavor propels people like, and we're actually doing some things now and testing what our associates -- and once our associates give us feedback, then we'll expand and provide that to the customer as well. So we really feel good about the opportunity going forward by leveraging all the insights that we have.

Unidentified Analyst

And then just switching gears to the hurricanes during the quarter, are you able to quantify the complex view [ph] on the quarter and any impact to earnings that you saw from the hurricanes?

Mike Schlotman

Well, the expense that we incurred do not penetrate our insurance deductible, so it was contained at less than the $26 million I spoke off last quarter. It was in the $20 million to $25 million range. And when you think about where the hurricane sit and where we have stores, while it certainly helped the Houston division sales, the overall effect on the total company, given we have 20 to 100 stores and a 100 or so affected in Texas by the storm was relatively negligible to the overall number.

Operator

Our next question comes from Ken Goldman from JP Morgan. Please go ahead with your question.

Ken Goldman

Mike, you said you were significantly more diligent if I'm quoting you right and lowering cost with vendors and I have a couple of questions about this. First, I'm just curious can you provide some color on what this means on practical purposes? What have you done in terms of your negotiations with vendors that's working for you and I'm talking prices, not just really fill rates? And then second, the food at home industry, the manufacturers have much higher margins than the grocers, and usually in any supply chain as higher margin players have the leverage but you and some of your competitors are doing things lately, you're pressing on prices, you're asking for better delivery times, you're demanding it, right; that kind of suggests your leverage is a little bit stronger than what I might have thought but it was I guess your vendors would just say no, we won't pay these fees, we won't lower our prices.

So, forgive the long question but does it imply that maybe because of more private label or whatever else you're doing to distinguish yourselves, that's sort of power tied and shifting a little bit in favor of the retailers or is that…

Mike Schlotman

We've never really tried to look at it as a power struggle and we really appreciate the partnerships we've had with our CBG suppliers. Relative to the find for the late trucks, it doesn't do us any good to have folks around our warehouse expecting trucks to show up and the truck doesn't show up or that we have orders in for products from our stores and we get a truck from a supplier that doesn't have all of the goods on it we expected it to have on it. And not only are we incurring the cost at the warehouse for those ideal workers, it also winds up affecting sales when we can't fulfill the orders that our stores have asked for and then we can wind up with out-of-stocks or low stocks inside the store. And it's really just trying to strengthen that relationship if it's supposed to get here today and it's supposed to be a full truckload, we'll get it to us today and make it a full truckload.

You know, this isn't within minutes of a window, this is a relatively wide window at this point and I would say the biggest thing on cost of goods is, we've always at the category manager level done a really good job of negotiating cost of goods. There have been times when they've made decisions historically that somewhere up the chain in the company we may have overturn the decision they made which causes them to think somebody doesn't have my back when I negotiate really diligently and get us a better cost of goods on our product. I can tell you today, the category manager negotiates a price or a product in our store, not in our store; that decision stands there because they are the ones with all the data and information about how that decision is made.

It's all those decisions are made, we don't just do this, give us the best price or you're out of the store. It's all made with a powerful data waiting for 51 behind it to understand consumer preferences and substitute ability and things like that. So it's a pretty broadbased approach and I would say those two generally are the highlights.

Rodney McMullen

And we really do try to work with our partners on taking cost out of both of our systems and then giving that to the customer. We're very transparent in terms of the way we're negotiating and why we negotiate what we do; and the data as Mike mentioned, is incredibly important to understand how the customer view each item and what's the substitute-ability across items and that's how we use what we do but we do it in a very transparent way.

Operator

Our next question comes from Scott Mushkin from Wolfe Research. Please go ahead with your question.

Scott Mushkin

I just wanted to talk about the fourth quarter and general merchandise, a little off topic here but just wondering, if I was going to go and buy a TV or something from Fred [ph] buyer up in Seattle, can I get that delivered; in other words, can I buy it online and have it shipped to my home? I was on the website, didn't seem like that ability was there and I was just wanting to see if it is and I'm missing it; just wanted a clarity.

Mike Schlotman

Our ship-to-home is an evolving process Scott and you know, as we've said in our conference call in the prepared remarks, we had a record Black Friday and Fred [ph] had a record Black Friday. And when you talk about TVs, that's a record Black Friday relative to a few years ago where electronics would have been a huge part of their Black Fridays. And it's -- not every customer wants things delivered to their house, there is still a joy and excitement of going out and shopping for things and we'll continue to offer and overtime offer more opportunities and options for our customers on how they want products delivered but when you think about this year's Black Friday being a record year, I think folks I brick-and-mortar [indiscernible] everything is going to get shipped at home or little bit ahead of themselves.

Rodney McMullen

The other thing as we mentioned last month at the investor meeting, you have a certain amount of resources and we're doubling down on food and making sure that we're doing everything we can on food. We will start addressing things beyond just food but first of all, we just wanted to make sure that we've got food positioned appropriately.

Scott Mushkin

Like you said, that is a good transition to my next comment because obviously the store traffic for general merchandise is down quite a bit last holiday, it could be down quite a bit this holiday if some of the early numbers are verified. So I guess, you guys called out the 1.1 comp and I guess from an analyst perspective, and we just had Cosco [ph] put up adjusting for a calendership of 7 -- some of your largest competitor, Wal-Mart I think told us that their food comps are best at seaming years and above their 2.7 that they reported. So I guess I'm just trying to understand, especially with the gross margins being up so much in the quarter, why your sales seem to be lagging in an economy that's just racing?

And how you guys want to frame -- would frame it? I mean, clearly, again some traditional suite marks you're doing okay but net-net on the entire economy it doesn't look good at all and I was just wondering if you had any thoughts on that?

Rodney McMullen

As we've mentioned in our call, overall in identicals we felt good about the progress we continue to make. We continue to focus on improving that, tonnage improved more than the number; as you know, as customers switch to our own brands, the retail price of that item is less as well. So there are some of those things that's within the numbers. Now with that said, we are not satisfied with where our identicals are and we continue to push to improve our identicals from where we are and see a lot of exciting opportunities to do that.

Scott Mushkin

Rodney, do you worry -- I know the CEO of HighV [ph] was talking about maybe -- these big stores don't work, they've stopped going to Minneapolis with their 90,000 to 105,000 and they are building actually two fulfillment centers, e-commerce fulfillment centers. Would you worry a little bit about the asset and that the center of the stores are going to transition more and more online? And then I'll yield, thanks for taking my questions.

Rodney McMullen

Yes, it's kind of fascinating. So far if you look at our big stores, they continue to perform very, very well and our customers tell us they like them. Now one of the things that's incredibly important is, what do you put inside as a store and then how long does it take to shop for the store and things like that. And what we have found is actually the flexibility of the store actually allows you to change it a lot, so if you look at how we use the inside of the space, we significantly allocate additional space for fresh departments today versus what we would have two or three or four years ago. It's -- in terms of you sorted out your question, you worry about everything but what we're seeing is the customer continues to connect well with that format and what is really important for the customer is the ability to shop inside of a store when they want the ability to pick up when they want, and in some cases get a delivery; so it's really all those things together that's what our customers are telling us and showing us.

And you know, in certain parts of the store in the middle is declining but I can tell you pet [ph] and some of those categories are continuing to have great growth; so you don't use the space the same as what you used to it either.

Operator

Our next question comes from Chris [ph] from Goldman Sachs. Please go ahead with your question.

Unidentified Analyst

Can you provide any more details as to how space optimization at the initial stores is progressing and maybe specifically, how do you think about the sales elasticity of promotions in center store relative to perishables today versus maybe 3, 4 or 5 years ago and does that factor into your space optimization efforts and how you think about utilizing vendor allowances and price investments by category going forward?

Rodney McMullen

The space optimization so far continues to make good progress. If you went to a store that's been changed, if you talk to our store teams, they would give you a whole list of things that they were surprised about what was done and they would also tell you after they got used to it and the customer got used to it, they actually liked the changes and there is as many things that's operationally focused as helping to have better variety of staying [ph] stocks, some of those things for our customers. The allowances that a vendor would give us would not be something that would cause us to affect space optimization but what -- then obviously, we look at profitability by vendor profitability by item, and whether you carry an item and things like that would be things that you would certainly be in negotiation as well.

On pricing elasticity, it really depends -- every store would actually have different pricing elasticity, every customer behaves differently and it's one of the reasons why we think the 84.51 insights are so important and critical; it's being able to connect with that customer one on one versus a group.

Unidentified Analyst

And then, maybe just a follow-up to Scott's question; can you give any further details as to how you envision your store footprint, both the size of the box and maybe the number longer term, particularly given your greater focus on share of stomach as opposed to traditional food at home, as well as online. Does the look of Kroger restore evolve overtime?

Rodney McMullen

Well, the look of a Kroger store always evolves overtime and like -- I know the other day I was in one of our marketplace stores that -- I think the stores 4 or 5 years old and we just took a lot of this work from space optimization and put it into the stores. So the store wasn't very old but we made a lot of changes to it. So going forward, I would totally expect that it continued to be the case. I believe when you look at going forward, you will see a broader range of physical stores but the customer -- I think you will continue to have all of the above because if you look at stores where we have a very developed ClickList, there are certain times where our customers typically shop more than one of our stores, sometimes they will shop a big store, sometimes they will shop a small store and it really depends on their mission and they will use ClickList as well. So we would continue to believe that it's very important to have multiple size stores going forward.

Unidentified Analyst

And then just one housekeeping if I could; I may have missed it in the 8-K but as part of your fiscal '18 outlook, did you -- do you expect full year LIFO operating margin ex-fuel to be up or down?

Rodney McMullen

Didn't go there.

Unidentified Analyst

Got it.

Rodney McMullen

We have time for one more question.

Operator

And our final question comes from Chris [ph] from Jefferies. Please go ahead with your question.

Unidentified Analyst

Rodney, just thinking about some of the newer initiatives that were referenced in the press release, programs like dinning [ph], private label flowers and apparels, I know they are not needle movers by any mean but I'm wondering if you could kind of take us through your thought process and why you've decided to allocate capital to these little areas as opposed to maybe partner out more -- acquire your way into some of these businesses, established brands? And then, I guess adversely, I'm sure the capital demand is quite different but why do you choose to partner on delivery when we know that controlling that relationship with the end customer is so important?

Rodney McMullen

For us on delivery the way that we've partnered, we still have the relationship with the customer and we decide which third-party to deliver because the point that you made is the reason that we always want to make sure that the relationship stays with us versus a third-party. In terms of -- on some of the other things why we did it on our own versus partnering with somebody, we would always -- when we decide to do something, evaluate and look at whether we should partner with someone or not, it's -- a lot of times it's finding the right person to partner with and that's usually just as hard as anything else because you have to have somebody that really believes that 2 plus 2 will equal 5 or 10 or something; and that you share accordingly, that's always hard to do. So we're always open and we will seek to partner with somebody when they will accelerate what we're doing. So if you think about some of the delivery things, those relationships; the reason we did it is it accelerated what we were able to do. So we're very open to third-party relationships but it really has to be something that works for both.

Unidentified Analyst

And then just lastly, I know you aren't willing to necessarily go there at the Analyst Day but are you willing to disclose online sales in total at this point? It's nice to see the percentage gains but they don't really tell us all that much. And then Rodney, you used the phrase, a unique relationship with Instacart, not sure from reading into that at all but did you mean anything by that in terms of you having a different relationship with them versus other retailers?

Rodney McMullen

In terms of our overall digital business at this point, we would not break out the dollars, it is becoming something that's reasonable in size but -- and at some point in the future, we will be willing to break it out but today we just think -- don't think it's that helpful. In terms of the reason I said a unique relationship, it really was a relationship that we felt that worked for us and worked for Instacart and it allows both of us to grow our business. I don't know enough about their relationships with other retailers to be able to compare them but for us the thing that was really important was something that leveraged their experience and technology and people but leveraged their assets and we kept our relationship with the customer. So that was what we did and it was -- it's unique in terms of -- we really view that it will help both of us to continue to grow our business.

Unidentified Analyst

All right. Thank you very much.

Rodney McMullen

Before we end today's call, as you know I always like to share some additional thoughts with our associates listening on.

To live our purpose towards Restock Kroger is what make -- what you make possible every day. By uplifting each other, our customers and our communities, Kroger zero-hunger-zero ways planned is our vision to end hunger in the communities we call home, and eliminate ways to cross the company by 2025. Last week, the day before Thanksgiving, I had the good fortune to celebrate friends giving with our roundies team in Wisconsin. I also had the chance to personally visit a couple of local food pantries plus our really cool innovative mobile market and the mobile market is a former NASCAR trailer converted into a fresh grocery store that goes to twice a day to underserved neighborhoods around Milwaukee, really cool stuff, really cool partnership.

And that's just one example. And you know, as I have the opportunity to be with our team and seeing how much we do in just one division for so many people, that's their need. It really takes my personal gratitude to a whole new level. I also happen to know the Kroger Foundation just donated a brand new truck to Feeding America Southwest Virginia Food Bank and our Mid-Atlantic region. It actually came complete with a big red bow for the holidays. I was equally impressed to learn that in only 24 hours on giving Tuesday, our associates and customers helped us donate over 1 million meals through Social Media. The generosity of our associates and customers never ceases to amaze me and inspire me, it's just simply wonderful. This is what it really means to live our purpose, to feed the human spirit.

Thank you for all you do each and every day. I wish you and your family a Merry Christmas and Happy Holidays. That completes our call today. Thanks for joining.

Operator

Ladies and gentlemen, the conference call has now concluded. We do thank you for attending today's presentation. You may now disconnect your lines.