Kroger Company (NYSE:KR) Q3 2010 Earnings Call December 2, 2010 10:00 AM ET

Executives

David Dillon – Chairman, Chief Executive Officer

Rodney McMullen – President, Chief Operating Officer

Michael Schlotman – Senior Vice President, Chief Financial Officer

Carin Fike – Director, Investor Relations

Analysts

Susan Anderson – Citigroup

Scott Mushkin – Jefferies & Company

Karen Short – BMO Capital Markets

Robert Ohmes – Bank of America Merrill Lynch

Edward Kelly – Credit Suisse

Charles Cerankosky – Northcoast Research

John Feeney – Janney Capital Markets

Neil Currie - UBS

Operator

Good day ladies and gentlemen and welcome to the Third Quarter 2010 The Kroger Company Earnings conference call. At this time all participants are in a listen-only mode. Later we will conduct a question and answer session. If at any time during the call you require audio assistance, please press star followed by zero and we will happy to assist you. As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the call over to your host, Carin Fike, Director of Investor Relations. Please go ahead.

Carin Fike

Good morning and thank you for joining us. First I'd like to take a moment to express our thanks to those who came to our investor conference in Cincinnati. It was great to see you there and we hope you enjoyed our meeting, including a presentation by Clive Humby. If you weren't there, you missed a lot.

Before we begin today, 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 www.kroger.com. After our prepared remarks, we look forward to taking your questions.

Just as a reminder, 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 topic with one question and one follow-up question, if necessary. Thank you.

Now I will turn the call over to David Dillon, Kroger's Chairman and Chief Executive Officer.

David Dillon

Thank you, Carin, and good morning everyone. Thank you for joining us today. With me to review Kroger's third quarter 2010 results are Rodney McMullen, Kroger's President and Chief Operating Officer, and Mike Schlotman, Senior Vice President and Chief Financial Officer.

We were pleased with Kroger's third quarter results and believe they demonstrate the continued success of our Customer First strategy. Increases in identical sales, tonnage, and loyal household count show our core grocery business is strong and resilient. We also met our commitment to strike an appropriate balance between sales growth and margin investment, and we achieved operating margin leverage through sales growth and ongoing operating efficiencies.

I'm very pleased that Kroger increased both earnings and earnings per share for our investors in the third quarter. These results reflect our progress towards building a flexible customer-focused business model that can create shareholder value through sustainable earnings growth and strong cash flow.

Kroger's identical supermarket sales for the quarter increased 2.4% excluding fuel. Our associates produced these positive results in an environment that continues to be challenging for both retailers and customers. Some say the great recession is technically over. For Kroger, it's not over until our customers say it is, and many of our customers continue to be cautious in their spending. At a time when many retailers are struggling to turn around negative identical sales trends, Kroger continues its exceptional identical sales record, now 28 consecutive quarters of positive identical supermarket sales growth excluding fuel.

By listening closely to our customers, Kroger has created a variety of competitive advantages that collectively are very difficult for other retailers to replicate. The strength of Kroger's identical sales results relative to many of our competitors trends strongly suggest we continue to gain market share.

Our positive identical sales growth continues to be broad-based across the store and nearly all markets. All departments experienced positive identical sales growth in the third quarter with the strongest increases in our nutrition, produce and deli bakery departments. Sixteen of our 18 supermarket divisions produced positive identical sales growth excluding fuel during the quarter. Of the two remaining divisions, one was essentially flat and the other experienced a slight decline.

In a few minutes, Rodney will share some additional sales insights with you, including loyal household trends, tonnage growth, and performance of our exclusive store brands. First I'd like to update you, though, on the four major factors we told you at the beginning of the year would influence Kroger's fiscal 2010 financial results. These factors are the economy and its effect on customer spending, food costs, competition, and fluctuating fuel margins. Mike will talk about the performance of our retail fuel operations in a few minutes. I'll briefly discuss the trends we've seen in the other three areas.

Overall, the economic recovery is slower and weaker than we anticipated it would be at this point in the year. Job growth remains elusive and fuel prices have risen. These factors affect consumer confidence and their grocery budgets, and many of our customers remain cautious in their discretionary spending. We continue to manage our business with the expectation that this economic environment will persist through the end of this fiscal year and throughout next year.

Although the economy is sluggish, some food costs are rising. We've seen inflation in our meat, dairy and produce departments; however, our grocery department continues to experience deflation. Rodney will address this further in his remarks.

The competitive environment remains challenging. Our unique competitive advantages, including our Customer First strategy, positioned Kroger to compete and win in this environment. While price is important, it is not the only factor that determines where customers spend their grocery dollars.

They tell us the entire customer experience matters. That's why we continue to invest in all four areas of our strategy to strengthen their loyalty to Kroger and our family of stores.

This morning Kroger narrowed its identical sales guidance to a range of 2.5% to 3% for the year excluding fuel. The previous range was 2 to 3%. Three weeks into the fourth quarter, our identical sales are tracking a little above the upper end of this guidance; but it's still early. For earnings, we have narrowed our guidance to a range of $1.65 to $1.78 per diluted share. We are striving for a result in the upper upper half of this range. This guidance reflects the fact that our customers remain cautious. We are off to a good start in the fourth quarter, but volatility from week to week remains high which makes predicting a narrower range difficult. While the competitive environment hasn't worsened, competition remains intense.

As always, the holidays are Kroger's time to shine and our associates are focused on having our store stocked and ready for many holiday temptations and treats to meet the needs of every shopper, no matter how modest their budget. Rodney will now offer some more insight regarding our business trends during the third quarter. Rodney?

Rodney McMullen

Thank you, Dave, and good morning everyone. We are very pleased with the results our Kroger team has achieved in a very challenging retail environment. I will provide some additional color behind our solid third quarter sales results, specifically on tonnage growth, food costs, customer shopping behavior, and labor relations.

As Dave mentioned, Kroger's third quarter identical sales rose 2.4% excluding fuel. This result was primarily driven by solid unit growth without much help from retail price inflation. Our stores sold more product units compared to the same period last year, a low single-digit increase. Keep in mind that this is on top of a very strong tonnage growth in the third quarter last year in the high single digits.

In the grocery department, the increase was driven by positive growth in national brands. Corporate brand units in the grocery department declined slightly compared to very strong tonnage growth in the same period last year. We remain very confident in the outlook for strong future growth in this important part of our business.

Corporate brands represented approximately 34% of grocery department units sold in the third quarter compared to roughly 35% in the same period last year. Corporate brands represented approximately 26% of grocery department sales, about flat versus third quarter 2009. Kroger's corporate brands portfolio is best in class among U.S. retailers, and we believe this is a unique competitive advantage. Our goal is to continue building this portfolio and increase sales and increase sales of national brands. We do not view these objectives as mutually exclusive. Kroger's unique portfolio of more than 20,000 corporate brand items combined with our strong partnership with national consumer goods companies helps us offer the variety and value our diverse customer base seeks.

In the third quarter, we launched our new branding campaign for banner brand products with fresh packaging to appeal to shoppers. We added new items to our store brand line-up including Kroger Wholesome at Home meals for busy families. We also continued to reinvent our exclusive Private Selection line of premium foods. Just in time for the holidays, we added new seasonal ice cream flavors like New York Style Pumpkin Cheesecake and Strawberry Peppercorn. Yes, that's Strawberry Peppercorn. It's a wonderful, unexpected flavor and I strongly recommend you try it.

It's not just our customers who have noticed the enhancements we've made. The Private Label Manufacturers Association recently recognized Kroger as Retailer Innovator of the Year for winning entries in all four award categories – product development, packaging design, consumer marketing, and in-store merchandising. Congratulations to our corporate brands team for this honor.

Now I will move on to food costs. We are seeing inflation in some of our perishable departments, as Dave mentioned, particularly meat and produce. De-inflation is persisting in our grocery department largely due to increased promotional spending by national brand suppliers. This promotional spending masks some of the list price increases we have received. The level of deflation is about 50 basis points if you exclude milk. Grocery represents about half of our supermarket business so this level of deflation has a meaningful impact on our total company results. Inflation in grocery has been slow to develop, but we still believe it's coming.

Many of you ask about Kroger's ability to pass along product cost increases to customers, particularly at a time when shoppers are spending cautiously. We believe it depends on the product. We are passing on product cost increases from national brand suppliers in the grocery department today, and we will continue to do so.

Inflation in the perishable departments affects our business differently. In these areas, product costs are typically driven by short-term factors such as seasonality and product supplies, so product costs can vary from quarter to quarter.

I'd like to give you an update on our customer shopping behavior trends. In the third quarter, the total number of households we served continued to grow. In fact, more customers across all segments from value to upscale visited our stores compared to a year ago. This tell us that Kroger's shopping experience and value proposition is striking a chord across a broad spectrum of shoppers.

While total household growth is important, we focused more attention and energy on increasing our number of loyal households. Kroger has been steadily increasing its number of loyal households for several years. In the third quarter, Kroger added loyal households at a faster rate than total households. The number of visits per loyal household remained about the same as a year ago, but the amount our loyal customers spend with us on a monthly basis continues to increase. This drives the solid identical sales results that Dave shared with you earlier.

Kroger's partnership with dunnhumby continues to help us make sense of our huge amount of customer data. We use this information to offer more compelling ads and weekly specials, and to offer the right product selection in our stores. Kroger has more insight in our customer behavior than most retailers today, and we use this data to reward them for shopping with us with special offers, coupon mailers, recall alerts, for example. Listening to our customer feedback and acting on what they tell us is a big part of our strategy. Every quarter we survey more than 50,000 households to find out what they like and don't like.

Once again, we made steady progress in each of our four key areas in the third quarter. Our people, our prices, the products and services we offer, and the overall shopping experience in our stores.

Now I'd like to give a brief update on labor. We also have good progress to report in labor relations. We successfully achieved agreements that offered solutions for associates and the Company while managing rising healthcare costs and stabilizing pensions. Most recently, our associates have ratified new agreements in Houston, Toledo, Cincinnati, and New Mexico. Logistics associates in southern California and non-food clerks in Portland, Oregon also ratified new contracts.

Finally, we reached an agreement with unions in Seattle and associates there are expected to ratify that agreement this week.

Now Mike will offer more details on the quarter and Kroger's financial strategy. Mike?

Michael Schlotman

Thanks, Rodney, and good morning everyone. Earlier today, Kroger reported solid third quarter financial results that are consistent with the fiscal 2010 forecast we shared with investors in March. We believe these results demonstrate that we are managing our business well in an economic environment that hasn't improved as we expected.

Kroger's third quarter net earnings were 202 million, or $0.32 per diluted share. This compares to $176.7 million or $0.27 per diluted share. In making that comparison, I am adjusting last year's third quarter results for the non-cash asset impairment charges totaling $1.05 billion after tax that primarily resulted from a goodwill write-down.

Turning now to some details behind our third quarter earnings, FIFO gross margin excluding our retail fuel operations decreased 10 basis points. Supermarket selling gross margin excluding fuel declined 13 basis points. Recall that Kroger's third quarter supermarket selling gross margin excluding fuel declined 109 basis points last year. An average of the two-year decline reflects a more normalized investment level for our business model.

Delivering value to our customers through lower prices is an ongoing part of Kroger's strategy. We are committed to improving Kroger's price position relative to our competitive set. We believe this approach helps us grow market share and brings incremental profitable business to our enterprise. At the same time, we remain mindful of striking an appropriate balance between investments in all four keys of our Customer First strategy and near-term financial results.

Excluding the impairment charges in fiscal 2009, Kroger's third quarter non-fuel OG&A rate was 14 basis points lower than the same period last year, even as we continue to face the challenge of rising credit card fees, healthcare, and pension costs. Positive identical sales growth, good cost control, and our ongoing implementation of operating efficiencies produced this result. Identifying and executing sustainable operating cost reductions remains a critical element of our Customer First strategy. We will use these savings to improve our customer shopping experience and further grow our business.

Kroger's third quarter operating margin rose 6 basis points as a rate of sales excluding our retail fuel operations and adjusting for the 2009 impairment charges. This reflects the gross margin in OG&A performance that I just described plus approximately 4 basis points of additional sales leverage over rent and depreciation expense. Kroger's non-fuel operating margin performance is consistent with the expectations we shared with you last quarter. It reflects sequential improvement in this measure as we transition back to a more normalized operating environment than we faced in the back half of fiscal 2009.

Kroger's third quarter tax rate was 31.7% this year compared to 35.9% for the same period last year when you adjust for the impairment charges in our prior year results. Our tax rate was lower this year primarily due to the resolution of certain tax issues during the quarter. This benefit added about a penny and a half to our third quarter earnings per diluted share. We now anticipate a full-year effective tax rate slightly below 35%. This rate includes the second and third quarter tax benefits.

Dave has already commented on three of the four factors that are affecting our 2010 financial results. Fuel margins are the fourth factor, and so far these have been slightly stronger than we anticipated for the year. In the third quarter, our retail fuel operations benefited our total Company results by about a penny per share on a year-over-year basis. The cents per gallon fuel margin for the fourth quarter was approximately $0.127 compared to $0.119 for the same period last year. On a rolling four-quarter basis, the cents per gallon fuel margin was $0.121 compared with $0.107 in the comparable prior period.

Our decades of experience in this business have taught us that fuel prices and margins are unpredictable, so we manage this business by focusing on gas gallons sold. On this measure, our retail fuel operations had another outstanding quarter. Both our supermarket fuel centers and C-stores produced solid identical gallon growth as customers continued to engage strongly in this component of Kroger's overall value proposition.

Moving on to the Company's financial strategy, Kroger's operations generated strong free cash flow, and we believe it is important to allocate that cash flow among various priorities balanced in a manner to benefit our shareholders. Capital investment is one of those priorities. We firmly believe it is critical to invest in our business through new technology as well as other store improvements to ensure that we are the grocery retailer of choice. We now anticipate investing 1.8 to $2 billion in capital projects during the current fiscal year. This compares to our previous guidance of 1.9 to 2.1 billion.

Our free cash flow allocation remains balanced across debt management, share repurchases, and dividends. We are firmly committed to Kroger's investment-grade credit rating and manage the Company's debt levels accordingly. At the end of the third quarter, we had reduced Kroger's net total debt by almost $490 million compared to a year ago. On a rolling four-quarter basis, Kroger's net total debt to EBITDA ratio adjusted for the impairment charges in 2009 was 1.93, which is consistent with the same period last year.

Just after our third quarter ended, we closed on a new $2 billion, 3.5-year revolving credit facility. This speaks to the strength of our balance sheet and the success of Kroger's business strategy.

While we believe our debt-management strategy creates long-term shareholder value, we remain committed to delivering near-term value to shareholders through our share buyback program. During the quarter, we invested $64 million of free cash flow to buy back 2.9 million shares at an average price of $21.72 per share. Kroger began its regular program of share buyback activity in January of 2000. Since then, we have invested $6.2 billion to repurchase 285 million shares of stock at an average price of $21.65 per share. That represents over 30% of the Company. I believe this track record demonstrates our commitment to the buyback.

Kroger's quarterly dividend is also an important part of our stock's value proposition for investors, adding about 1.5 to 2% to total shareholder return. Since Kroger's dividend program was initiated in March of 2006, a little over four years ago, our Board has increased the dividend four times. Our most recent increase was reflected in the dividend payment made to shareholders yesterday. It remains the Board's objective to further increase the dividend over time with consideration given to the needs of the business, the interest of our shareholders, cash flow trends, and other factors.

Now Dave would like to make a few remarks before we take your questions. Dave?

David Dillon

Kroger's third quarter results demonstrate that our team continues to perform well in a tough environment. If we step back and look at our results in the broad context of our Customer First strategy and our journey to create sustainable value for shareholders, I think we've accomplished a great deal. Our associates have weathered significant change in economic conditions and delivered steady results throughout. We firmly believe that taking care of our customers is the best way to create value for our shareholders. Whenever we delight our customers and exceed their expectations with lower prices, a faster and friendly checkout, or an amazing floral arrangement for a special occasion, we're building loyalty and investing in the future growth of our business.

At the same time, we're focused on creating a sustainable business model that rewards shareholders through solid near-term and future earnings growth, share repurchases, debt reduction, and dividends. Kroger continues to deliver value today while investing thoughtfully in our future. This is how we can ensure long-term success for our company and our shareholders.

We now look forward to your questions.

Question and Answer Session

Operator

Ladies and gentlemen, if you would like to ask a question, please press star followed by one on your touchtone telephone. If your question has been answered or you would like to withdraw your question, please press star followed by two. Once again, that is star, one for questions.

Your first question comes from the line of Deborah Weinswig of Citi. Please go ahead.

Susan Anderson – Citigroup

Good morning everyone. It's Susan Anderson on the line for Deb.

David Dillon

Hi, Susan.

Susan Anderson – Citigroup

Hi. I'm wondering if you can talk about what's behind, maybe—I know they only decelerated a little bit sequentially, but the ID sales trends going from 27 to 24, particularly given that deflation has eased a little bit.

David Dillon

Sure, be happy to. First, let me give you a perspective. If you look at the year, we went from a 24 this last quarter, 27 the quarter before and 24 in the first quarter. The 27 in that quarter, second quarter, included the Memorial Day holiday that was not in the preceding year, so it's a little bit overstated. The way we look at it is we think we've had steady identical sales really through the year and I put it in the context of the four factors we talked about today and that we talked about the beginning of the year – that with the environment that we're operating in, we did expect to have some caution in where those sales might be. But what we actually feel we've done is come out about the middle of the range we guided to, all the way to the present time.

Now if you look at just the last few weeks, that might be helpful to you also. We indicated in the earlier comments that so far in our fourth quarter, in the first three and a half weeks or so in the fourth quarter, our current IDs without fuel are a little bit above the range we've given for the whole year, so that means we're above the 3%. You've heard recently some other retailers describe some of their holiday sales just recently, and so to give you some context for us, our October business was better really than the average for the third quarter, so we were picking up at the end of the quarter. And the November business, which would include the last week of our third quarter and these first three and a half weeks that I've described, we're better yet than October. So we're seeing much the same kind of a pattern that's been described by the retailers. Now, you wouldn't see quite the high variability in a grocery food operator than you would in a non-food operator, but we've still seen that same general pattern.

The caution that we have is that we've seen some variability among consumer spending really through the year where there are individual weeks or individual periods of time that can only be explained by consumers thinking they want to spend and then changing their mind and becoming a little more cautious; and we don't see anything in the environment that causes us to change what that picture might look like.

Susan Anderson – Citigroup

Great, thanks. That's really helpful. And then just one follow-up, I guess, based on the improving ID sales trends. If you look at the two-year stack on the earnings growth, it looks like that is also decelerating in the third quarter and then again in the fourth quarter. I guess, what's behind the thoughts that, you know, if ID sales are improving and getting better, that earnings would not be improving.

David Dillon

Again, I would back way up and look at the year as a whole and look at those four factors we talked about and the variability in those, the cautious customers. And if you had told me at the beginning of the year that of the four factors, that we'd have significant headwind on three of the four, and all but fuel really has been a headwind rather than a tailwind, I actually would have suggested guiding more to the bottom half of our guidance instead of the top half of our guidance. But as it's turned out, even though we've had that headwind, I think our associates and our organization and our Customer First strategy have proven to be very resilient and have shown good, solid performance.

Now I think the comparison to last year is a little bit difficult because we had some erratic numbers—differences from one quarter to the other last year, but on the whole I'm actually pleased with the directional position we're in.

I'm pleased at the results that we achieved in the quarter, and I look at it as a more favorable outcome given the environment that all of us are operating in.

Susan Anderson – Citigroup

Great. Thanks a lot. Good quarter you guys.

David Dillon

Thank you.

Operator

Your next question comes from the line of Scott Mushkin of Jefferies & Company. Please go ahead.

Scott Mushkin – Jefferies & Company

Hey guys. I wanted to kind of follow on some of those questions that were just asked. The midpoint—if I look at the midpoint of the guidance, it's implying a pretty sharp deceleration in earnings growth from the third quarter and it sounds like you actually are pretty encouraged by the way things are going so far in the fourth quarter; and of course, last year's fourth quarter was pretty awful. So I was just wondering, are you being just very, very cautious here or is this $0.13 variability we have in earnings as we're almost four weeks in—is there that much unsure about the fourth quarter?

David Dillon

I guess I'd answer it basically the same way I did, although maybe with this additional point. Think about the high variability that we've seen in customer behavior, not in any—typically in any given week or month, but from one month to the next. Even in the third quarter, we had a few weeks in the middle of the quarter and nearer to the beginning of the quarter that were unexplainably low. And so we think that the range of possible outcomes is wider than you might normally expect. That's why you saw us try to give you the range of where we could see. We could imagine some cases that could get you to at least some of that range. Certainly, our mindset is to the top half of that range and we are working to achieve the highest possible result in the setting; but we think that there are going to be points in the quarter, despite the fact that we and other retailers have had an uptick in November sales, we think there are going to be moments in the quarter that are unexplainably difficult and are really because the customers are being more cautious in today's environment.

Scott Mushkin – Jefferies & Company

Okay. So getting back to the third quarter, I was a little surprised to see both a declining selling gross margin and a fairly sharp deceleration to your stacked comp. I guess, how do I square that? And then just going more into the selling gross margin which is flat, I think, sequentially, but actually deteriorated quite a bit on a two-year stack basis, I guess that surprised me as well because we are cycling some pretty insane milk promos from last year, so maybe you can give us a little insight into that selling gross margin. You know, did you take a step back because the competitive environment was a little tougher in the third quarter, and should we see that break positive in the fourth?

David Dillon

The competitive environment hasn't gotten worse but it still remains intense, and we expect that will be true in the fourth quarter. It certainly was true in the third. I'd be surprised if it's any different even next year. And so I don't think that helps you in what you're trying to describe. I tend to look at, from quarter to quarter, how are we seeing the business go and that flow; and at first glance, I could see where you could see the drop in our identical sales in the third quarter and conclude, well, that drop was driven by less of an investment in gross margin in the particular quarter, certainly compared to last year.

But I don't actually think that that's it. As I've indicated, I think the 24 is really more representative of what the year has been. We're about 25 so far through that time period. So I think really we've been steady through the year with high variability being from month to month, occasional months have been down. The last two months have been reasonably strong. So I don't think that it's a case of reducing our investment and killing our sales. I actually think the sales have stayed strong and I think we've been careful to try to balance that investment so that we didn't overspend; and I think we came out about where we had hoped to be in that regard.

Scott Mushkin – Jefferies & Company

And Dave, the sequential—you know, the stack selling gross margin actually deteriorating quite a bit. You know, we were going against, I think, a 109 or something last year where your selling gross margin had come down. I mean, what's our thought of the fourth quarter? Are we going to actually finally see that at least on a one-year basis break positive?

David Dillon

Well, I'll let Mike comment about the fourth quarter but what I think you should look at—first, you should look at the two years together. That's a better way to think about it. But if you look at the way we've tried to build our business, we have for the last six or seven years invested more in gross margin. At first we invested a lot more and it came straight out of our operating profit margin, and other than the anomaly years, I think we are—certainly have an effort to slightly improve that operating profit margin. But our intent is to still invest and we invest by saving money, reducing our costs as a percent of sales and then reinvesting that, sometimes in price, sometimes in other areas. But that remains to be our intent, so it shouldn't you surprise you at all that we had a slight decline in selling gross and we had a similar reduction in OG&A, and then we picked up some leverage on rent and depreciation. So that combination actually works pretty well. That's pretty much what we're trying to do.

Mike, you want to comment about the fourth quarter?

Michael Schlotman

Yeah, I won't get very specific on what we expect in the fourth quarter. I won't predict if it's going to be up or down. We did give guidance in our 8-K that we filed today for operating margin for the full year, and we actually expect the operating margin to be similar for the full year to where it is for the year-to-date. If you think about three quarters in, all but three periods, it takes a pretty big change in the fourth quarter either up or down to change the year-to-date third quarter results, and that's where we would expect.

Scott, when you look at the two-year stacks, you're correct that in the second quarter our two-year stack was about 101 basis points or so of investment in selling gross margin, and our two-year stack now is about 122 basis points. Keep in mind, we did say in our prepared remarks that the two-year—if you look at the average of the two years in the third quarter, that is within the range that we would expect to see on an annual kind of basis. What we have to do a better job at year-in, year-out is to not have 122—or 109 one quarter and 13 the next quarter, but to make it more ratable each and every year and each and every quarter so that you don't see the fluctuations.

Rodney McMullen

The other thing that I would add on top of that, if you look at the third quarter – and Dave mentioned it – is really balancing reduction in selling gross with our reduction in OG&A. And that's really what we're trying to do and get the leverage on rent and depreciation where we do have a slight expansion in operating margin which drives the earnings growth. But the other thing that Dave mentioned earlier is the volatility that we have from week to week is still significantly more than what we would have had in the past, and we're really trying to make sure that we deal with those appropriately as we have those swings that are really based on what the customer is doing, not changing in competitive situation with the market. It's really customer-based changes.

Scott Mushkin – Jefferies & Company

Okay, thanks for taking my questions.

David Dillon

Thanks, Scott.

Operator

Your next question comes from the line of Karen Short of BMO Capital. Please go ahead.

Karen Short – BMO Capital Markets

Hey, thanks for taking my question. Sorry to go back to the selling gross for a second. Can you maybe talk a little bit about the cadence of the selling gross margin investment throughout the quarter? Did you get more promotional as the quarter progressed or was it pretty steady state?

Michael Schlotman

Yeah, I don't know—my view, Karen, is everybody always wants –and I'll let Rodney give a little more color to this, but one of the things everybody has to keep in mind is a selling gross reduction doesn't indicate a level of promotional activity. We're trying to be very cognizant of how we go to market from a promotional standpoint. Our selling gross is intended to be permanent investments we make in giving our customers a better price day in, day out; and it's driven as much by that as any particular promotional activity that we're reacting to. What Rodney just said – our investments aren't reflective of reacting to something that happens in the market. It's our commitment to continuing to give our customers a better price day in, day out over time.

Rodney McMullen

If you look at it within the quarter, it would be pretty consistent. The other thing that you always have to factor in is changes in mix. Obviously there are some products that we sell that have higher gross margins than others, which would also affect it; but if you look at the 13 basis points overall, it's pretty consistent with where we expect it to be, and it was pretty consistent across the quarters. It would not have been driven by just promotional activity.

Karen Short – BMO Capital Markets

Okay, so looking at as you started the quarter, did you maybe have expectations that the environment would ease in the quarter and that you would be able to have a slightly less of a reduction in the selling gross; or, I mean, was this something that was in plan—in place well ahead of the quarter? I'm just trying to get a gauge.

Rodney McMullen

Yeah, I would say the plan is really more tied to what we were hoping and expecting for reducing costs by, and that's really how we're factoring in how much we think we can afford to spend from a gross standpoint. So it's really looking at selling gross and cost reductions together in terms of where we anticipate those to be, and trying to make sure those two are in balance.

Michael Schlotman

Our goal was to start growing operating margin again in the third quarter, which is what we in fact did because of the OG&A reductions and leverage on rent and depreciation that we had.

Karen Short – BMO Capital Markets

Right. And so it's fair to say, then, the quarter did more or less shake out in line with your internal expectations?

Rodney McMullen

Certainly if you look at it relative to as we started out the third quarter. Now, if you looked at it when we set out our objectives for the whole year in 2010, we were expecting in the second half of the year to have a little more inflation than what we're seeing, a little more job growth than what we're seeing, and an economy that was improving rather than just really staying kind of flat and stagnant. So when you look at it in March when we set out the original goals and objectives for 2010, we would have expected the second half of the year to look better than what it was in the third quarter, what it looks like the fourth quarter will be.

Karen Short – BMO Capital Markets

Right, that’s fair. Okay. And then just wondering if you could comment on the comp. Could you just decompose it a little bit between traffic and basket; and then in terms of what you are now seeing in the fourth quarter – where is the improvement coming from? Thanks.

David Dillon

Yes, we have a slight increase in the average sale, that is the total sales divided by customer so you get an idea of what each person buys. The increase, it’s just slight. It’s like three quarters of 1%. And our transaction count, which is just the raw count of transactions going through the register, was up over 2% for the quarter, so you can see it was driven much more by that. If you look at our dunnhumby data, it’s the same thing – our results, our identical sales were driven by increasing number of loyal households and increasing number of total households. Now, it’ also a good sign, we think, that our loyal households grew at a faster pace than our total households grew, and that’s always good news in our mind; but that was driven by a growing number of people who were shopping with Kroger.

Rodney McMullen

And it’s customers that are loyal to Kroger, and they’re more loyal to us this quarter than they were second quarter and the third quarter of last year. So we think that’s really important because obviously those are customers that aren’t cherry-pickers. They’re buying more than just what you have on promotion. They’re really experiencing the whole Kroger experience. And what we’re finding is once we get those customers to us, over time they continue to increase their spending.

Karen Short – BMO Capital Markets

And that’s the same thing for the trends so far in the fourth quarter? It was loyal household customer driven?

David Dillon

I don’t have that in front of me, and I’m not sure we’re going to want to add comments to that, unless you want to add anything.

Rodney McMullen

Well, let’s just say we wouldn’t have that level of detail yet relative to the last three weeks. That’s stuff that really comes out on a four-week cycle, so we really don’t have that level of detail. If you look at the raw numbers that Dave referenced initially, the mix would still continue to be strong both between what people are spending, the number of visits, and spending per visit. So so far, a nice balance.

Karen Short – BMO Capital Markets

Great. Thanks for taking my questions.

David Dillon

Thanks, Karen.

Operator

Your next question comes from Robbie Ohmes from Bank of America Merrill Lynch. Please go ahead.

Robert Ohmes – Bank of America Merrill Lynch

Thanks. Hi David. I was hoping you could comment or give color on the sort of spread between pricing of the national brands when you include promos versus your corporate brands, and if that affected the relative momentum of corporate brands in the quarter? And then maybe speak to—you know, into the fourth quarter or even into next year, when you factor in your expected promo outlook for the corporate brands—sorry, for the national brands, what you think—how you think that all is going to play out? Thanks.

David Dillon

I'll give you just a—kind of a top line overview, which you've heard some of already, and then I'll ask Rodney to add some color that he might want to add here. But as we said, during the quarter we saw the national brand tonnage units were up reasonably well, and that our Kroger brand units were actually slightly down, and we think that's in part because of the comparison against last year when Kroger brand units were real strong. We also think it's in part because of the investment in promotional money that the national brands have made, which Rodney also referenced. That has tended to encourage additional national brand sales.

I also think it's a partial indication of some of the customer base seeing that the world around them has improved. I wouldn't read too much into that, but I think there is a little bit of that that is naturally going to happen as some individuals see their world improving. It's just that we're seeing high variability among our customers in terms of that impression of improvement.

Rodney, you want to add some color?

Rodney McMullen

Yeah. Robbie, the only thing I would add—a couple things I would add on Dave's comments. If you remember a year ago, corporate brands was picking up huge share. The national brand folks were increasing prices or not reducing prices as some of the deflation that was happening out there, and we thought they were really probably making more profit than they deserved. I think customers reacted by buying a lot more corporate brands, and the rate of growth in corporate brands was significantly more than anything we would have historically expected or experienced. So I think part of it is the national brand folks got tired of losing share and they're getting more aggressive on some of the promotional activities that I mentioned before.

The other thing that I would add on the corporate brands is a big chunk of corporate brand tonnage is dairy, especially milk, and milk is significantly higher this year than a year ago. And whenever you have that kind of increase, you'll always have tonnage declines because people will go back to drinking soft drinks or whatever else versus milk when milk is much higher. So a lot of that was driven by the changes in the milk category.

Robert Ohmes – Bank of America Merrill Lynch

Got it. And just a quick follow-up – as you look to next year and the national brands would obviously be looking to get their prices up, how does the mechanism for that work in terms of less promos versus list prices? And then also, how do you execute that with your loyal households, or how is the response of your loyal households to sort of migrating prices up with national brands versus your average customers?

David Dillon

Well, I hear—part of your question seems to me is to what extent do we think we can pass through costs as they are passed to us by our national brand vendors. Is that the essence of what you're asking?

Robert Ohmes – Bank of America Merrill Lynch

Yeah, I guess I was trying to ask that in a sneaky way, but maybe just some color on how you do that in loyal versus—

David Dillon

Well I'd be happy—I mean, I'll give the answer to that straight up, is that when it comes to grocery-branded products, it's fairly clear what we're doing and how we're approaching this is that as we have cost increases to us, whether it's list cost or reduction of promotional spending, we are passing that through to our customers as the vendors give it to us. And therefore, in my opinion, what the consumer does with that is purely in the hands of the national vendors. So some items you will see when, if you raise prices, you will end up with less tonnage; and the vendors who raise those prices are going to have to deal with what happens with lower tonnage. I think the dynamics of whether they will spend more in promotional money or not will be almost an audible call on the field at the time by the vendors on what do they see in movement and what do they think they need to do. And some, I think, will respond by adding money to promotional spending, and some will respond by saying I guess I'll take my lumps with the lower tonnage and just get through it.

But all of that spells the same picture, is that we view those choices as in the vendors' hands. We push back where we think it's appropriate to push back, but remember, we sell lots of other products; so when somebody raises a price on something and we pass it on to the customer, if that tonnage goes down, the customer most likely will switch to something else that we sell. Sometimes it's Kroger brand, sometimes it's a competing national brand; but in each case, our view is that the decision of retail price in that regard is up to them—up to the vendor, and we think we're going to be able to pass through those and have so far shown success in doing that.

Rodney McMullen

I would just add one other comment to Dave's, and you've heard us talk about this before, but we think it's one of the really important parts of having such a strong corporate brand program overall. Any time a vendor puts a cost through that is not tied to the true economic costing changes, our private label always gains share; and it's a lot harder for the national brand to get it back once somebody's tried the corporate brand item. So for us, we believe that's a huge advantage for us by having such a strong corporate brand program really across all categories, because whenever there is a cost increase that's not tied to the true economics, over time it shows up in market share change.

David Dillon

That's why really we're happy to be selling more national brands and selling more Kroger brands. We like both of those sales.

Rodney McMullen

It's our customers' choice what they buy.

David Dillon

Right.

Robert Ohmes – Bank of America Merrill Lynch

And just the loyal household response to times where prices are going up versus the non-loyal customer response – is there any big variance?

Rodney McMullen

I wouldn't say that you see much change in behavior in that regard, no.

Robert Ohmes – Bank of America Merrill Lynch

Great. Thanks a lot.

Rodney McMullen

Mm-hmm. Thank you.

David Dillon

Thanks, Robbie.

Operator

Your next question comes from the line of Edward Kelly of Credit Suisse. Please go ahead.

Edward Kelly – Credit Suisse

Yeah, hi. Good morning guys.

David Dillon

Good morning, Ed.

Edward Kelly – Credit Suisse

You know, we've beat up this selling gross margin question pretty good, but I do have some follow-ups. Mike, I think you said something about the two-year stack selling gross margin of what we're running at right now – this, I don't know, call it 100, 120 basis points. It's kind of what you target longer term. I don't know if I heard that right. The reason I'm asking this is because I don't think that was the case back in '07 and '08. I mean, that number was more like 50 basis points, so could you just clarify that?

Michael Schlotman

Sure. If you look at the two-year stack and average that on an annual basis, it's in the 50 to 60 basis point range, and that is what we would desire to be able to reduce selling gross margin on an annual basis by and not have it be lumpy and have it 109 like it was last year's third quarter and 13 like it is this year's quarter, but have that be more in the 50, 60 basis points on a more regular basis. If you look at '08, we had quarters as low as 9 and as high as 59; and if you look at '07, we had one quarter were it actually went up and another quarter with a 48 basis point investment. So it has been erratic, but if you look at it—the way we try to look at it is to be in that kind of a range on an average annual basis each quarter.

Rodney McMullen

Yeah, but I wouldn't just look at selling gross by itself. One of the things we're really trying to strive to do is be more consistent in terms of from quarter to quarter so we don't have the volatility as much; and making sure that we're really tying changes in selling gross to changes in taking costs out of our business. And that's the reason why we think it's so important looking at the operating margin; and when you look at the operating margin, that we do strive to have slightly increasing over time because that really that will flow through and create good value in earnings growth for our shareholders.

Edward Kelly – Credit Suisse

Yeah, I guess that's the longer term strategy, but I guess what I'm confused about is that, again, if I do go back to '07 and '08 – and Mike, you're right. I mean, obviously it was volatile. Your two-year stack in both of those years was around 50 basis points which would imply that the selling is down 25 a year; and now you're saying that the two-year stack is closer to 100, which is 50 basis points a year. So is there a fundamental shift in how much you plan on investing going forward, or am I just not looking at this right?

Michael Schlotman

Yeah, you also have—I wouldn't say it's a fundamental shift. That's kind of our desire, and as Rodney said, our overall desire is to grow the operating margin; and we won't manage the business to be in the 50 to 60 basis point range if we can't find cost savings to pay for that. There is the desire and then how we'll manage the business over time, and our goal is to grow the operating margin over time.

Rodney McMullen

Yeah, when we first started this whole process, we didn't really put a governor on it, but the governor on it today is what do we find in costs. And while that not be quarter to quarter - we're looking at a little longer term than that – on an annual basis, that's our effort. That's our focus, is to try to balance us out a little bit better.

Edward Kelly – Credit Suisse

All right. So regardless of what we're investing in selling gross margin next year, you're basically saying that the goal here is to get the operating margin up.

Rodney McMullen

Yes. Up slightly.

Edward Kelly – Credit Suisse

All right. Up slightly. Okay. And then also Q4, I know Thanksgiving was pretty much a mess last year. How did that go this year – your thinking about this?

Rodney McMullen

I think it would really tie into the comments that Dave made before. So far we've been pleased with where we are. It wouldn't have been nearly as messy this year as last year, but it's still early in the quarter. We still have eight and a half weeks left, and the volatility that we see from week to week and day to day continues to be high, so so far we're happy with where we are. It wasn't the mess that it was a year ago, but it's still too early to declare success, I would say.

Edward Kelly – Credit Suisse

And when we say it wasn't the mess it was a year ago, that's also a reflection of the margin as well, right?

Rodney McMullen

All of the above.

Edward Kelly – Credit Suisse

Okay. And the holiday season last year – you know, Christmas, New Year's – was that a mess last year as well?

Rodney McMullen

No. If you remember a year ago, we talked about Thanksgiving was really tough and was the most difficult part of the quarter. The balance of the quarter was actually better, so it was really around the Thanksgiving period that would have been the worst. The other two holidays were pretty normal.

Edward Kelly – Credit Suisse

Right. And then last question for you is back on this inflation topic. I think there's a lot of debate in the market about whether supermarkets can or cannot pass it through, and I think what investors are doing is looking at the last year or so and saying we saw inflation in some categories and you had trouble passing it through. But I think what I've heard from you today was that that was in the perishable section where there is volatility, and maybe it is more difficult to pass prices through versus dry grocery center of the store where it's a little bit easier to pass it through. And if we think about 2011, it's really about re-inflation in dry grocery. So should we feel more comfortable with your ability to pass through prices next year than where we've been?

David Dillon

I think that you've correctly identified the two thought processes. If the categories you're talking about are the perishable categories, and in that I would include fluid milk, you're talking about something that varies regularly, sometimes daily, on prices; highly competitive, changes the tonnage rather quickly when you change your retail prices, and those get balanced out however they get balanced out through the year. Sometimes you end up worse off because of the competitive pressure; sometimes you end up better off, but whatever it is, that ends up being how it works out.

The other category are the dry grocery or the branded products, and on those products I think you should think of that as a category almost unto itself. And the reason I describe it differently is because when you're talking about being able to pass through prices, generally you're really talking about – or should be talking about, I think – about when a vendor is giving us a cost increase that they've chosen to make, sometimes it's driven by underlying commodity costs, sometimes not. And in those cases, I think it behaves very predictably, and that's the inflation that we were referring to at the beginning of the year that we thought we'd see a little bit of as opposed to not seeing inflation.

I actually separate the perishables and, while I don't ignore it, for purposes of whether we passed it through or not, I do. And so I think you've got to look at it that way, and I think that picture will roll out the same next year. We don't know whether we'll see the inflation or not. That's a high variable for next year, but we definitely think that that's a question that will have to be answered as we go through the year.

Edward Kelly – Credit Suisse

If the brands in grocery raise prices, does your private label prices go up as well? I mean, you're seeing the cost pressures, right?

David Dillon

It compares on the cost pressures.

Michael Schlotman

Usually we would see cost pressures faster in corporate brands than we do national brands because we're actually procuring the raw materials.

David Dillon

Yeah. So where there's cost pressures, you would see that, yes.

Michael Schlotman

And we see the other side too when it goes down.

Edward Kelly – Credit Suisse

Okay, thank you.

David Dillon

Thanks, Ed.

Operator

Your next question comes from the line of Chuck Cerankosky of Northcoast Research. Please go ahead.

Charles Cerankosky – Northcoast Research

Good morning, everyone.

David Dillon

Hi Chuck.

Charles Cerankosky – Northcoast Research

David, you're talking about the economy recovering somewhat slower than you expected at the beginning of this year. How is that showing up in things like basket size, the customers' item selection, various store departments, and even some of your geographies?

David Dillon

We're seeing a lot of variability among our customers. Some customers have—for their world, things have improved, and the picture we described last quarter is the same picture I would describe today. Boars head meats have improved their sales; high-end wines have improved their sales, as examples. Nutrition, we already identified that as improving. Starbucks have increased their identical sales within our stores. All of those are examples of for some individuals, at least for those purchases, they see their world has changed a little because all those categories had suffered during the beginning of the recession. At the same time, though, we're still seeing increases from the year before in food stamps used to purchase groceries. The percent of our business done on food stamps on the whole has continued to rise. It's at an all-time high and roughly double—a little bit more than double, actually, where it was just a short three years ago or so. And those customers obviously are still suffering and having a difficult time making ends meet. So we're customers all across the board in lots of different ways.

Now across geography, as we mentioned, 16 of our 18 divisions had positive identical sales results, and of course there was some variability among those too. Of the two remaining, one was essentially flat and the other was just slightly down, and in some of those markets anyway I can see some economic headwind in the local markets that could help explain some of that result. So I don't know if that helps give you a little more color, but that's how we see the picture today.

Rodney McMullen

The only thing I'd add that makes things a little more complicated – if you think about some of the areas that Dave talked about improving, on boars head and some of those areas, some of that is also driven by people brown-bagging or taking their lunch to work, because you go to a Kroger's store, pick up everything you need for lunch for $1 or $2 and have a very good lunch versus spending $4 or $5 if you go out somewhere, maybe $6. So some of that growth, I think, is because people are brown-bagging more, some of those kind of things too.

David Dillon

Yeah, definitely.

Charles Cerankosky – Northcoast Research

Dave, would you care to give a—among your 18 divisions, care to give a range of comps from bottom to best?

David Dillon

No, thank you.

Charles Cerankosky – Northcoast Research

All right.

David Dillon

Can't blame you for asking, but no thank you.

Charles Cerankosky – Northcoast Research

If we look at the food inflation issue, do you see any sign of the CBGs reducing promotional spending as a way of reflecting higher input costs in a number of commodity areas?

David Dillon

We can give you examples of CBG companies that are doing every behavior that you can describe, so yeah, there are some that are doing what you're suggesting. On the whole, you could say that what we're seeing is some additional spending, but we do continue to see list costs by many of the vendors going up and we continue to hear the comments and the sort of chatter in the outfield is that they believe, given some of the commodity cost increases they've experienced, that they need to pass some of that through. It's just that we haven't seen it yet. But that's the same exact picture we've been hearing now for a couple of quarters, and I walked in today, I had the same conversation this morning here just to make sure that I had current information. And we have every reason to believe that CBG vendors want to increase their costs but very few of them really are actually doing it.

Charles Cerankosky – Northcoast Research

All right. Thank you very much.

David Dillon

Thank you, Chuck.

Operator

Your next question comes from the line of John Feeney of Janney Capital Markets. Please go ahead.

John Feeney – Janney Capital Markets

Thank you very much. I just wanted to dig in on the difference between—you know, it seems like the single biggest promotional lever, competitive lever is discounting in perishables, and when you talk about the competitive environment over the course of the year, David, could you parse for me—both over the course of the year and recently as we've gone from a tough quarter to starting off this quarter better, has there been much change at the margin in terms of promotional behavior in perishables specifically, and therefore margins in perishables specifically, and within that dairy particularly, which seems to be the biggest single lever we see?

David Dillon

I wouldn't characterize promotional spending in perishables as being the single biggest lever. It's one lever, just as in branded goods is another and Kroger brand packaged goods is another too. I would characterize all of those—the difference really between the perishable and the non-perishable is the perishable works on a little shorter time frame because those costs change abruptly sometimes based on weather and so forth, and you'll see that—it's more of a gunfight because it's quicker reaction, quicker changes, wherein branded products often we'll plan those things out months ahead of time and have—because they want to plan production, they'll have those plans already nailed down, and sometimes those will change but generally they don't. So I don't know that I can characterize the difference that you're seeking.

Rodney, you want to add any color to that?

Rodney McMullen

No. I mean, the volatility would be a little bit more in perishables but at the end of the day, the profitability really doesn't change that much. But the weekly volatility would be more.

David Dillon

Right.

John Feeney – Janney Capital Markets

Yes, but I mean—I guess—I think that's a totally fair comment, David, about how things should be and how things have been and will be over the long run. But over the near term, we think about some of this aggressive promotional activity by—you know, when people get a little bit panicked and want to, say, grocers that are not comping positively want to try to get some customers. I mean, that's one thing you can reach for. I guess at the margin, has there been any change in that activity over the—just, say, the past three months? Have you seen less promotion in, like—

David Dillon

I don't think it's been materially different than it had been before. I think that's why we described the competitive environment as continuing to be intense, but not worse. But it's certainly not better either. I don't think there's much difference.

John Feeney – Janney Capital Markets

Okay, that's fair. Thank you, Dave.

David Dillon

Mm-hmm, you're welcome. Thank you. We have time for one more question.

Operator

Your next question comes from the line of Neil Currie of UBS. Please go ahead.

Neil Currie – UBS

Thanks for taking my question. I don't want to flog the dead horse of selling gross margin again, so I'll ask the question in a different way if I can and talk about more general strategy. You always mention the word balanced about your approach to balancing shareholder and customer concerns, and obviously this time last year the balance went very much in favor of the customer where you admitted that you overinvested in pricing activity and your operating margin declined quite rapidly. Our worries at the time was that that margin was just going to be lost and it was never really going to be recovered, and whilst there has been some improvement in operating margin this year, given what happened to the selling gross margins, given what—you know, you're still way below two years ago and third quarter margins previously. Can we safely assume that that overinvestment really is somewhat lost because you don't seem to be—you don't seem to have the appetite to recover that lost margin.

David Dillon

Well it sounds like from your question, Neil, that you're defining recovery as a return to the previous gross margin percent.

Neil Currie – UBS

No, operating margin, because two years ago the operating margin was 2.9%.

David Dillon

Okay, operating margin. I believe, though, the way I would see recovery is in what happens with our sales over time and then what happens with our margin over time, not just the year to year. But look at the recession we've just gone through and think about the results of many of our competitors that had some rather serious declines from where they had been running in profit and operating profit. We didn't have such—we had declines but not as serious of a decline, and as things begin to recover, that means our recovery, at least back to the par, isn't going to snap back quite as abruptly. But our potential for the future, I think, is much greater because we have something to work with. We've got identical sales to work with, we've got customers who are rather permanently loyal customers at Kroger that continue to grow, and that gives us something to work with to which you can apply that operating profit margin. So I think it's a combination of the improved operating profit margin, which we've seen some of, which we expect to see gradually more of over time, and the improvement in our customer traffic, customer behavior. Those two working together actually does give you the recovery that we're seeking.

Neil Currie – UBS

Okay, and then just allied to that question, clearly you have got what I consider to be a much better business model than your competitors who are struggling, because you have lower prices and your margin structure reflects that. But in terms of, again, trying to get that balance right, if you take out the tax benefit—you know, the lower tax rate that you had this year, your EPS growth was 11% which is I think what you'd probably be targeting in a normal year, but you have a very easy comparison. My question is going to be basically in future years when you maybe don't have the same OG&A declines that you saw this quarter, tougher compares on last year in terms of margin, can you continue to get that sales and margin balance right because your ID sales didn't grow as fast as they have in the last couple of quarters. The two-year stack has deteriorated. I mean, can you—is this as good as it gets, really, is what I'm asking.

Rodney McMullen

Yeah, Neil, I think over time we would continue to expect to get the operating cost savings to pay for the investments and to be able to have the identical food store sales to leverage the numbers. Your correct that in the back half of last year, it's really the back half of last year that's causing the two-year stack deterioration; and as Dave said earlier, I think the trend in idents this year when you move Memorial Day and equalize the first quarter and second quarter, we're actually quite consistent on identical food store sales this year.

One thing I do want to point out on the earnings per share where you take out the tax and it grew 11%, there were some unusual items in the OG&A as well. If you notice in the quarter, rent on the income statement went up this year versus a trend where it had been going down. We booked about $5 million of expense for some stores in northern California when Ralphs exited northern California or the subtenant defaulted on it, so that's in the quarter as well; and there were some reserves put up for certain litigation issues as well. Just those two items entirely offset the benefit of the tax benefit, so that's one of the reasons we were happy with the overall results in the quarter.

Now, it was an 18% increase and you shouldn't expect an 18% increase over time, but we think fundamentally it was a strong quarter in earnings per share growth, particularly given an environment where three of the four factors that we laid out at the beginning of the year could cause us to be at the low end of the range, and in fact we've narrowed our range and have continued to target above the midpoint of the original range. We think we've balanced it quite well in this environment, and—

Neil Currie – UBS

So another $0.02 of one times in there.

Rodney McMullen

Well, it's almost—it's about a penny and a half, and the tax benefit was about a penny and a half, just those items. We don't go into those details on our releases or our call because the way we look at it, we're a big company. The tax is volatile; you can't predict it; and there's other things that happen positively and negatively over time, and we don't like to talk about them but those two did offset the tax benefit and I don't want all the headlines to be we only made the quarter because of the tax benefit because there were some offsetting things in there. But it's always like that.

Dave, I don't know if you have anything else to.

Neil Currie – UBS

One of the things worth mentioning that's good to know, the other thing I'll ask about the tax rate is what do you expect for the fourth quarter? What's in the guidance?

Michael Schlotman

Well, it's—the guidance for the year is basically where we are year-to-date, slightly under 35%. It's—again, you never know if there's a tax contingency going to go for you or against you on a quarterly basis. It's up to folks other than us.

Neil Currie – UBS

Sure, but should we assume 37% for the fourth quarter?

Michael Schlotman

About 36 is what I would assume.

Neil Currie – UBS

Okay. Okay. Thanks a lot.

David Dillon

Thank you, Neil, and before we end the call though today, I do have a special message for all our associates who we encourage and invite to listen in. First, I'd like to recognize Paul Scutt, Senior Vice President of Retail Operations for his leadership and contributions to Kroger. Paul recently announced his plans to retire in February after a distinguished 45-year career with our company. He's been a driving force behind Kroger's safety, productivity and cost control improvements through the years, and we're grateful for his influence on our business. We wish Paul and his wife Carol all the best and we'll miss seeing him on a daily basis.

I also want to thank all our associates for delivering on our Customer First strategy once again. Each of you play a unique part in achieving the positive results we announced today. The changing economy has affected each of us in some way and it has affected some of our customers more than others. We remain committed to serving all our customers, those who continue to shop on a tight budget, those who feel more confident in their spending, and everyone in between. Thank you for your special efforts every day to give each customer a warm welcome and a fantastic shopping experience.

With two months remaining in our fiscal year, we need all of your individual efforts to finish strong in the fourth quarter. No matter where you work – in our supermarkets, our manufacturing plants, our warehouses, convenience stores, jewelry stores, fuel centers, or even the offices – you help make the holidays special for our customers. So I hope each of you have a wonderful and safe holiday season with family and friends. Merry Christmas and happy holidays.

Thank you all for joining us.

Operator

Ladies and gentlemen, this concludes the presentation. Thank you for your participation. You may now disconnect. Have a great day.