The Kroger Co. (NYSE:KR) Q2 2015 Earnings Conference Call September 11, 2015 10:00 AM ET

Executives

Cindy Holmes – Director of Investor Relations

Rodney McMullen – Chief Executive Officer

Michael Schlotman – EVP and Chief Financial Officer

Analysts

Karen Short – Deutsche Bank

Rupesh Parikh – Oppenheimer

John Heinbockel – Guggenheim Securities

Ed Kelly - Credit Suisse

Vincent Sinisi – Morgan Stanley

Ken Goldman – JPMorgan

William Kirk – RBC

Kelly Bania – BMO Capital Markets

Robert Ohmes – Bank of America Merrill Lynch

Alvin Caezar Concepcion – Citi

Mark Wiltamuth – Jefferies

Andrew Wolf – BB&T Capital markets

Brian Cullinane - Wolfe Research

Operator

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

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

Cindy Holmes

Thank you, Laura [ph]. 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 second quarter press release and our prepared remarks from this conference call will be available on our website at ir.kroger.com. After our prepared remarks we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question and one follow-up question if necessary.

Please save the date for our 2015 investor conference, which we will hold at the New York Stock Exchange on October 27. Details will be coming soon and we hope you can join us.

I will now turn the call over to Kroger's Chairman and Chief Executive Officer, Rodney McMullen.

Rodney McMullen

Thank you, Cindy. Good morning, everyone, and thank you for joining us today. With me to review Kroger's second quarter 2015 results is Mike Schlotman, Executive Vice President and Chief Financial Officer. And the next time you see Mike, please congratulate him on his well-deserved and well-earned promotion.

We are pleased with our second quarter results. Our 5.3% identical supermarket sales growth without fuel allowed us to continue investing in our business and delivering on our aggressive growth plan. Strong fuel margins toward the end of the quarter allowed us to deliver results that exceeded our original expectations. During the second quarter we achieved our 47th consecutive quarter of positive identical supermarket sales growth. We exceeded our goal to slightly expand FIFO operating margin without fuel on a rolling four-quarter basis.

We kept costs down, which together with identical supermarket sales growth, allowed Kroger to leverage operating expenses at a rate of sales and we continued to grow market share by improving our connection with customers, which fueled both our top and bottom lines, and enables strategic Customer 1st investment. These consistently remarkable financial results are possible quarter after quarter because our business is built on the belief that serving customers is serving shareholders.

Based on the strength of our second quarter results, we are raising our net earnings per diluted share and identical supermarket sales growth guidance for the year. While customers continue to feel optimistic about the economy throughout the second quarter, they also continue to tell us they want to spend less. More and more, they want retailers to help them save money with sales and coupons. We are well positioned with our everyday low prices and our weekly sales and digital offers to solve this for our customers.

As you know, the food retail business is in a constant state of change. Part of what makes our Customer 1st strategy is so powerful is it provides Kroger a firm foundation from which to approach new opportunities in the right way to benefit our customers, associates and shareholders. While there are many examples for our businesses is rapidly involving I'd like to highlight three key areas of innovation and investment today: Technology, food and people. And how the steps we are taking in each of these areas are broadening our competitive advantage for the future.

We are actively expanding our use of technology in ways we believe will make a difference for customers and associates. This summer we expanded our online ordering pilot in Cincinnati to three additional divisions. We are now offering our order online, pickup at the store solution in select Kroger stores in Louisville and Indianapolis and Fred Meyer stores in the Portland area. This is, of course, in addition to the Harris Teeter's successful express lane service.

When you think about digital opportunities, we do not limit our focus to e-commerce. Digital for Kroger includes a broad range of efforts to interact with customers in increasingly relevant and meaningful ways whether online or through our mobile app. A key metric is our measure of digital and household engagement. And during the second quarter, we continued to gain household engagement at record numbers.

Our Kroger technology team continues to earn recognition for leading edge initiatives to establish the Internet of Things in our stores. Earlier this summer, Kroger's electronic temperature monitoring project was named a winner of the CIO 100 Award by CIO Magazine. And as we shared with you in June, the talented team at 84.51 is helping us grow and evolve even faster due to their closer daily involvement in our business. 84.51's specialty, helping us make data-driven decisions that truly put the customer first is a significant competitive advantage for Kroger.

Our multi-tiered Corporate Brands portfolio has always been a powerful differentiator for Kroger. Simple Truth continues to see explosive growth. Private selection remains a vibrant billion dollar brand that is growing in the double digits and developing unique offerings in many categories. I'm pleased to share with you that later this month we will launch an entirely new brand called HEMISFARES. HEMISFARES brings only the best food finds from around the globe to our food curious customers for an amazing authentic eating experience. It's a guide tour of the best tastes on the earth.

Imagine landing in a country known for its incredible food and experiencing the finest examples of its region's most famous and delectable eats. Every HEMISFARES product is curated from the source and imported directly to our stores. The most exciting part is that no one else has a brand like this. HEMISFARES is a great example of what makes our Corporate Brands unique and we think will appeal to millennials, foodies and ultimately all cuts of our customers. And by the way I've tried a lot of the products and its outstanding. It's not just great and I think you're going to love it when you get a chance to try it.

Our reputation for consistently – consistent execution rests squarely on the shoulders of our 400,000 associates who make it all happen in our stores, distribution centers, manufacturing facilities, and offices. Our work force is expanding rapidly to support our growth strategy. Last year, we created 25,000 new jobs and right now we are hiring to fill an estimated 20,000 new and permanent positions in our stores. We are looking for people who want to be part of a team, take pride in everything they do and want to grow with us.

One important and untapped resource for new associates is our country's military veterans. Since 2009, more than 29,000 veterans have joined our ranks, and hundreds of current associates continue to actively serve in the military. Over the past several years Kroger has formalized our military hiring initiatives. We joined the 100,000 Jobs Mission, a coalition of companies with the common goal of hiring transitioning service members and military veterans, and we have increased our presence at military recruiting events.

Next week we are hosting our first ever Honoring Our Heroes hiring event during which we will hold open interviews at every one of our supermarket locations on Tuesday, September 15 for all veterans and their family members. The fact that nearly 70% of our store managers started out as hourly associates or stocking shelves or bagging groceries speaks to Kroger's opportunity culture, which we believe is a differentiator for us today and will continue to be so in the future.

Before I turn it over to Mike, I'd like to comment on our announcement yesterday of a new organizational structure for our senior leadership team. We take a team approach to leadership and this new structure is designed to better align resources to our company's goals. It also streamlines decision-making and accelerates progress on our growth strategy. As I said in our announcement yesterday, Kroger is incredibly fortunate to have such an exceptional strong group of leaders across our company, and our senior leadership team has unmatched depth and experience to continue delivering for our customers, associates and shareholders.

Now Mike Schlotman will offer more detail on Kroger's second quarter results, provide you an update on labor relations and update our guidance for 2015. Mike?

Michael Schlotman

Thanks, Rodney, and good morning, everyone. First, I'd like to spend a few minutes discussing our results for the quarter in each of the key performance target areas for our long-term growth plan.

Our first metric is identical supermarket sales without fuel. Our identical supermarket sales growth of 5.3% in the second quarter demonstrates the strength of our core business. Our identical supermarket sales growth was driven by a combination of strong tonnage growth and an increase in the number of households shopping with us in the second quarter. We also met our goal to grow the number of loyal households at an even faster rate than total household growth during the quarter.

All geographies and supermarket departments had positive identical supermarket sales excluding fuel during the quarter. We continue to see outstanding double-digit identical sales growth in our natural foods department. Our meat, deli, and pharmacy departments also posted strong sales.

Rolling four-quarters FIFO operating margin excluding fuel, the 2014 and 2013 adjustment items and the contributions to the pension and foundation in the third and fourth quarters of 2014 – I hope you got all that – increased by 20 basis points. This exceeded our commitment to grow the rate slightly over time on the rolling four quarters basis.

Return on invested capital on a rolling four quarters basis was 14.24%. We're now presenting a comparative number this quarter because the last year's second quarter calculation does not include a full year of Harris Teeter assets and results. We continue to expect our return on invested capital for fiscal 2015 to increase slightly from fiscal 2014 results. This is an important metric as we continue to increase our capital investment to drive our future growth.

Before I share our second quarter results in more detail, I'd like to discuss how we are successfully managing through the current operating environment which has more volatility than normal, especially as it relates to fuel margins and inflation. We benefited from higher fuel margins late in the second quarter. As Rodney said, our nonfuel results were right in line with where we expected them to be. We expect fuel volatility to continue for the remainder of the year.

Another factor that we are actively managing is product costs. While inflation continued at a lower rate during the second quarter, which we estimate was approximately 1.4% without fuel, some commodities had high inflation and others had deflation. Seafood and milk were deflationary. Produce prices were less deflationary in the quarter and we continue to see inflation in generic pharmaceuticals. It bears repeating and if you look back over the past several years, we have had periods of high and low inflation and we've shown that regardless of the environment we will deliver greater value and convenience for our customers.

Now I'll share our second quarter 2015 results in more detail. As you know, we don't provide guidance for total sales because of the unpredictable impact that fuel has on our overall results. Total sales in the second quarter were impacted by the lower retail price of fuel, much like the first quarter. The average price of retail fuel during our second quarter was $2.67 compared to $3.54 last year. Total sales in the second quarter increased 0.9% to $25.5 billion compared to $25.3 billion in the same period last year. Excluding fuel, total sales increased to 5.7% for the second quarter compared to the same period last year. In the second quarter, our net earnings totaled $433 million or $0.44 per diluted share. Net earnings in the same period last year were $347 million or $0.35 per diluted share.

Kroger reported a $21 million LIFO charge during the quarter compared to a $26 million LIFO charge in the same quarter last year. FIFO gross margin excluding retail fuel operations decreased 7 basis points from the same period last year. Strong identical supermarket sales growth and cost controls allowed Kroger to leverage operating expenses as a rate of sales in the second quarter. Total operating expenses excluding retail fuel operations decreased 35 basis points as a percent of sales compared to last year. Second quarter FIFO operating profit excluding fuel increased approximately $93 million over the prior year.

Now for retail fuel operations. In the second quarter, our cents per gallon fuel margin was approximately $0.19 compared to $0.183 in the same quarter last year. We expect fuel margins to continue to be volatile during the second half of the year. Kroger brand's performance during the second quarter was solid, representing approximately 26.4% of total units sold and 25.1% of sales dollars, excluding fuel and pharmacy.

I will provide a brief update on labor relations. We recently agreed to new contracts in Columbus and Memphis and have ratified all of the local agreements associated with the master agreement with the Teamsters covering several distribution and manufacturing facilities. We are currently negotiating contracts with the UFCW store associates in Denver and Portland and with the Teamsters covering our Southern California distribution centers. Our objective in every negotiation is to find a fair and reasonable balance between competitive cost and compensation packages that provide solid wages, good quality, affordable healthcare and a retirement benefit for our associates. Kroger's financial results continue to be don't be pressured by rising healthcare and pension costs which some of our competitors do not face. Kroger and the local unions which represent many of our associates should have a shared objective: growing Kroger's business and profitability, which help us create more jobs and career opportunities and enhance job security for our associates.

Our long-term financial strategy continues to be to repurchase shares, give an increasing dividend, fund increasing capital investments and to maintain our current investment-grade debt rating. Our strong financial position has allowed us to return $1 billion to shareholders through buy-backs and dividends over the last four quarters. During the second quarter, Kroger repurchased 1.1 million common shares for a total investment of $43 million. Capital investments, excluding mergers and acquisitions and purchases of lease facilities, totaled $812 million for the second quarter compared to $672 million for the same period last year.

We expect capital investments, excluding mergers, acquisitions and purchases of lease facilities, to be at the high end of the $3 billion to $3.3 billion range for the year. We're turning towards the high end because we see a strong pipeline of high quality projects and we continue to be encouraged by the results from our new stores. In order to have a steady flow of projects and increase the total number of store projects we are spending on stores scheduled to open in 2016 to make sure they are ready to meet our target dates. Additionally, we continue to reduce the amount of time it takes to complete projects.

The company's net total debt-to-adjusted EBITDA ratio decreased to 2.02 compared to 2.32 during the same period last year. Kroger's net total debt is $11.3 billion compared to $11.1 billion during the same period last year. Again this year, or again this quarter, we have essentially maintained our absolute debt level while returning $1 billion to shareholders through share buybacks and dividends over the last four quarters, investing $3.1 billion in capital on a rolling four-quarter's basis, plus an additional $426 million on mergers, acquisitions, and purchases of leased facilities. In other words, we are keeping our commitments to our bondholders and shareholders while delivering value to our customers and increasing opportunities for our associates.

Now I'd like to update our growth objectives for 2015. Based on our strong year-to-date performance, we raised our identical supermarket sales growth guidance excluding fuel to a range of 4% to 5% for 2015. The prior guidance was 3.5% to 4.5%. We also raised our net earnings per diluted share guidance to a range of $1.92 to $1.98 for fiscal 2015. The previous guidance was $1.90 to $1.95 per diluted share. This range exceeds the company's net earnings per diluted share growth rate guidance of 8% to 11%. Shareholder return will be further enhanced by a dividend expected to increase over time. We continue to expect the third quarter to be at the high end of our long-term growth range and the fourth quarter to be below the range. Our second quarter results demonstrate that our base business is performing very well. The volatility of fuel in the back half of the year will determine where we end up within that range.

Now I'll return it back to Rodney.

Rodney McMullen

Thanks, Mike. Kroger's business is strong. Our team of associates continues to derive our Customer 1st strategy by taking care of our customers in big and small ways, offering fresh foods and keeping costs down so that we can reinvest those savings in our associates, store experience, products and prices. As a result, we continue to earn customer loyalty and gain market share. We are investing to grow our business for the future while delivering on our promises today. Our stores are hiring to fill 20,000 new permanent jobs. We are expanding our digital and e-commerce offerings. Our confidence in Kroger has never been stronger.

Now we look forward to your questions.

Question-and-Answer Session

Operator

Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question will come from Karen Short of Deutsche Bank.

Karen Short

Hi. Congratulations on a great quarter.

Michael Schlotman

Thank you.

Rodney McMullen

Good morning.

Karen Short

Good morning. I don't want to sound negative here but I guess what I'm wondering in terms of your ID guidance for the year, it definitely reflects a slowdown in the two-year comp in the third quarter and fourth quarter, even though it looks like inflation is maybe getting a little bit better, maybe less of a headwind. So I guess any color there? Are you of being conservative? Any color you could give would be helpful.

Rodney McMullen

The guidance is always one of the hardest things to come up with what's the right estimate. As you know, we've always expected inflation to continue to slow down during the year and we would expect that to continue. Now, we're working hard, as always, to make sure that we're at the good side of that. If you look at where we are so far this quarter, we continue to track within the guidance and kind of similar to where we were in the second quarter. So we feel good about where we are. And we see exciting opportunity. I don't know, Mike, did you want to?

Michael Schlotman

Yeah, Karen, another thing to keep in mind is if you look at real growth, if you look at our current ID sales trend and even what we would be projecting and take away the relatively benign inflationary environment today, it's actually as strong a real growth as we've had in quite some time, really going all the way back to three or four years, actually four or five years. You really don't see a trend as strong as we have today when you look at it on an inflation-adjusted basis. Our tonnage growth is quite strong. And from our standpoint, as long as we continue to have the tonnage growth in many of the departments that we have, we'll be just fine because that's the ultimate demonstration of the strength of your businesses is how many items are the customers buying on a weekly and monthly basis.

Karen Short

Okay. That's helpful. And then I guess also, just on your guidance. I just was wondering on your updated pension guidance, you have some changes in both the company and the multi-employer. It's unclear to me on the multi-employer if your prior guidance just didn't include the $16 million that was previously accrued, but you definitely also increased the company-sponsored, so obviously, you're raising your guidance, even with those two headwinds?

Michael Schlotman

Yeah, the $16 million would have been accrued and expensed when it was accrued. Keep in mind, on the multi-employer plans, when you have a contractual obligation or actually put dollars in, you expense it versus the company plan, we could put money in and it may not translate into a current expense. So they're quite different in how you account for the two calculations. I don't – it's not a dramatic change in our expectations between the two plans, although somewhat.

Karen Short

More of a headwind. Okay. I'll get back in the queue. Thanks very much.

Michael Schlotman

It would be – I mean, it would be a slight headwind compared to where we were earlier in the year, but nothing dramatic.

Karen Short

Right. Okay. Thanks.

Rodney McMullen

Thanks, Karen.

Operator

Our next question comes from Rupesh Parikh of Oppenheimer.

Rupesh Parikh

Good morning, and congrats on a really nice quarter.

Michael Schlotman

Thanks.

Rodney McMullen

Thank you.

Rupesh Parikh

I want to just touch on your pharmacy business. We've seen some of your competitors call out some headwinds within their pharmacy business on the margin line. I just want to get a sense of whether you guys are also seeing some headwinds within your pharmacy business as well on the margin line.

Rodney McMullen

As you know, one of the things that's so important for us is our total portfolio of businesses. And when you look, there's almost every year you'll have something stronger and something else weaker. And if you look at the pharmacy business, what we would be experiencing would be pretty similar to what some of our competitors would talk about. We continue to have very strong growth on the number of scripts filled, and that has been true for a long period of time and our pharmacy teams continue to do a great job on taking care of our customers. But in terms of financial, it would be very similar to what some of the others have talked about. But it is – the nice thing and the great thing about having a portfolio of businesses where some pieces are obviously growing well in excess of the total.

Rupesh Parikh

Okay. Great. And then switching topics to maybe expenses, the leverage this quarter is much better than what we saw last quarter. Besides sales leverage, was there anything else that may have contributed to the better leverage this period?

Michael Schlotman

No, I think it's really across-the-board, good cost controls in many facets of the business. As we often say here at Kroger, sales are a beautiful thing, and when you can have north of 5% IDs, the sales leverage on the expense line becomes quite enormous, and particularly if your ID sales start to exceed where your own expectations were it gets a little tough to add hours as fast as the sales start to come and it takes a while to catch up to that. There could have been a bit of that as well. But I wouldn't say there was any one particular area that would stand out. It's really pretty strong across-the-board cost controls from many locations.

Rodney McMullen

One of the other things that we mentioned on the first quarter, we were pretty aggressive on incrementally investing hours in some places. Some of that you begin to get the flow of it and you understand where does it make sense and where doesn't it make sense as well.

Rupesh Parikh

Thank you for all the color, and good luck for the half back.

Rodney McMullen

Thank you. Appreciate it.

Operator

And next we have a question from John Heinbockel of Guggenheim Securities.

John Heinbockel

So, guys, two things. Do you think – when you look at the momentum the business has and the things you have to invest in, have we gotten to a point where it's really hard to keep ex-fuel EBIT margin to just up slightly, right, without making investments that you don't think have a return? Or do you think we're just in a period here where timing of investments have been slower and that's partly why you're getting the 20 basis points?

Rodney McMullen

When you look at the business overall, I would still feel that slightly improving is where – is the right thing long-term for the business and what creates the most sustainable long-term value for the business and obviously, then flow-through to our shareholders. It's never as easy to be exactly precise every quarter in terms of where you invest and how does the margins flow through, and so I feel good about where we are, but I certainly don't believe as I look forward to cause us to do anything to adjust the guidance we've provided. I don't know, Mike, any additional…?

Michael Schlotman

Yeah, and one of the things to keep in mind, John, as you know we have a portfolio of things we want to invest in over time. And these aren't promotional activities, to your point we aren't going to go out and have crazy promotional activity that's not going to be sustainable and drive long-term growth but we have a portfolio of things we want to continue to invest in and you know frankly some of the strength we're experiencing today is on the backs of some of the investments we made in the third and fourth quarter of last year. And you make a little bit of an investment and then several months later you start to see the fruits of that investment. And that's one of the things that's leading to the strong IDs we've had in the first half. And we've tried to get into this rhythm where we're more diligent about when we invest, how we invest balanced up against consistent results. And I think we're doing as good a job as we've ever done and we still have that portfolio of areas where we would like to invest in.

John Heinbockel

And then, Rodney, you talked about the organizational structure which is quite different than you've had as far back as I can remember. You said sort of right for this time. Maybe more specifically, what do you think the structure gives you benefit-wise and then it does sound like a lot of the guys will have more direct reports than they did before? What do you have to do if anything different in how you run the business tactically to account for that? The people be overseeing more than they had previously.

Rodney McMullen

Well, a big part of that is just the growth that the team has had. I feel very comfortable that the growth they've had as leaders will allow them to have a little broader span of control than they've had before. As you know we're incredibly fortunate to have such a great depth of people and we're incredibly fortunate that they've been at Kroger for a long time so they really know our business well and understand what we're trying to get done.

For me it really does eliminate one layer of decision-making and it really does streamline our ability to make decisions. And the team is working together so well as a team. And I'm just really excited about going forward. I think it will just make it a lot smoother in terms of how we operate on a day-to-day basis.

John Heinbockel

Okay. Thank you.

Rodney McMullen

Thanks, John.

Operator

And the next question is from Stephanie Chang of Credit Suisse.

Ed Kelly

Hey, guys. It's actually Ed Kelly here asking a question for Stephanie.

Rodney McMullen

Hey, Stephanie.

Ed Kelly

So I guess my first question for you, well, my one question.

Rodney McMullen

Your one question. Very good.

Ed Kelly

I have a follow up. So just related to IDs. I mean, your IDs are clearly exceeding expectations. You're raising the full year guidance for the ID again this quarter. I would guess that the level of inflation is less than what you probably thought coming in to the year. And Mike you talked about it with tonnage right being the strongest that it's been in some time. Could you just maybe help us understand how you're driving such strong growth in the business and maybe even what's surprising you as you look at the top line performance today?

Rodney McMullen

It's a great question. And to me, the thing that is so important about what Kroger has been doing for a long period of time, not just in this quarter is really focusing on multiple aspects of connecting with their customers and associates. So it's really we continue to improve the products that our customers have. We – our merchandisers continue to find new ideas and new products. Our operators continue to improve execution and figuring out ways to take costs out of the business and we continue to take that and invest in what the customers tell us is important.

So it's really all of those things working together. The thing that you never know is how will competitors react to what you're doing? And how – customers continually change and how do you make sure that you're staying out in front of those changes? So far this year, we're incredibly delighted with how we've identified how the customers evolving and changing. And connecting with those customers on a deeper, deeper way. Our customers tell us from the way that our associates serve them the products we deliver, the prices that we've continued to improve what we're doing, and it's really the combination of all those things working together.

Ed Kelly

Maybe just a quick follow up here on inflation. I think I heard you guys say that you continue to expect inflation to slow throughout the rest of the year. We have I think heard from one of your smaller competitors yesterday about particularly produce and maybe produce bottoming and getting better. So could you maybe provide a little color on some of the categories and how you see that progressing throughout the rest of the year?

Rodney McMullen

Yeah, Ed, as I said in my prepared comments the produce picture, actually, the deflation slowed. And actually if you were to look at the very end of the quarter was a slight bit of inflation in the last several weeks. Nothing to write home about. But it was deflationary for the quarter but got less and actually turned a bit towards the end of the quarter. You continue to see other categories out there that have a mixed bag. Grocery is still let's call it just north of flat. Just a little bit of inflation and that's a big driving factor in it. The other one to keep out, to keep in mind as you think about inflation is pharmacy is a big inflationary area that I spoke of as well. The generic costs continue to go up. It's the earlier question on the headwind from gross margin in pharmacy it's one of the reasons why that headwind exists because you can't pass that on as quickly as the cost of the underlying pills go up.

So it continues to be a mixed bag. You're seeing some of the meat complex get less inflationary. And in fact deflationary in some areas but still some slight inflation in other areas. Seafood's a little deflationary right now. But it continues to be a little bit all over the board.

Ed Kelly

Okay. Thanks, guys, and congratulations, Mike, by the way.

Rodney McMullen

Thanks.

Operator

The next question is from Vincent Sinisi of Morgan Stanley.

Vincent Sinisi

Hey. Great. Thanks very much for taking my question and congratulations as well. Wanted to ask on the digital initiatives. You guys had said that a few more divisions now have the pickup at store capabilities. Can you give us a little bit more color as to what you're seeing in terms of traction usage there? What may be in the basket and then maybe kind of some thoughts going forward for further rollout?

Rodney McMullen

Well, they give you some insights. It's what we find is some customers enjoy shopping that and in addition to still buying stuff in the store. So it's – and you've heard us talk a long time about on digital we really do believe it's an "and" and not an "or." And all it is trying to offer one more way of a customer engaging with us so that they get engaged with us the way they want to versus the way they have to.

And what we find is the customer feedback has been very positive for some customers. But it's not all customers. And the learnings that we were able to get from Harris Teeter is they were able to accelerate teaching us how to do it and then our store associates are doing a great job of executing against that.

In terms of specifics on going forward, the only thing really I would say is that it continues to be something that we test and we'll kind of – the pace in which we go will really be driven by how fast the customers engage with us. And one of the things that we're trying to do as a company is pace things based on our ability to execute against it. And the customers' connection with it. So I wouldn't be able to give you specifics right now because we really don't have specifics yet.

Vincent Sinisi

Okay. No, that is helpful. Thank you. And maybe just as a follow-up I'll stick with the digital initiatives. And I know you guys had said you're continuing to see really nice growth in the loyal households. Have been there any changes on your end? Since the exclusivity with what was done humvie [ph] you know over the past couple of quarters has changed. Has there been any change in your approach to getting to know those loyal customers and who else maybe you are working with or not going forward?

Rodney McMullen

I wouldn't say there's been change. The thing that's probably the biggest difference is the leadership team at 84.51 is involved in every meeting now. And it's things when you're trying to make a decision on what you do, the folks who are around the table and they have great insights so you really having those insights as part of the decision at the front end rather than at the back end of the conversation. So the biggest thing is just the quality. To say that we get additional insights I wouldn't say there's additional insight so far. I would say there's a lot of additional projects that we're working on that should help us going forward that I feel very confident in, that it just makes it easier to get those things done rather than having to negotiate with the third party.

Vincent Sinisi

Right. Okay. That's helpful. Thanks very much, and good luck.

Rodney McMullen

Thank you. Appreciate it.

Operator

The next question is from Ken Goldman of JPMorgan.

Ken Goldman

Hi. Good morning, everyone.

Rodney McMullen

Good morning.

Ken Goldman

There's been so much change in Southern California amongst some of your larger peers. And I realize it's not easy, maybe it's impossible to quantify, but can you give us a sense for how much those changes have either benefited you or created a more challenging competitive environment? Just thinking about some of the issues that Haggen has had, some of the changes Albertson's has put into place. If you can address that at all, I'd be appreciative.

Rodney McMullen

That's one of those where obviously it's a good question but hard to answer. When you look at our business in total in Southern California, we're very happy with where we are. But the thing – the biggest thing that we think is driving it is our associates are doing a great job and our leadership team there in terms of improving how we serve our customers. Now, whether it's things customers do or competitors are doing that cause our customers to like what we're doing better, that I don't know. I think it's always important to remember that in Southern California, Costco is actually one of our biggest competitors. Whole Foods would be a huge competitor there. You have a ton of really high quality independents there. So the competition there is very diverse and more than just the Safeway and Albertson's and their merger and Haggens.

So I really – it's hard to say. A certain part is because of whatever somebody is doing. And we're really much more focused on how are the customers telling us we're delivering against what they're asking for. Mike, anything you would want to add to that?

Michael Schlotman

No, I agree. When there's any kind of disruption in the market, we look at it as an opportunity from a positive standpoint, not a woe is me or what's going to happen? How are we going to deal with this? And when names change on banners, when people may go to market differently, the opportunity always exists that folks may look for a different place to shop that didn't do that in the past. We want to make sure that Dawn and her team continue to do what they're doing to excite our customers and associates in Southern California.

Ken Goldman

Thank you. And then my follow-up, I just wanted to confirm that I heard correctly. You did say I think 3Q QTV ID sales x-fuel sometime what we saw in 2Q, right? So far anyway?

Michael Schlotman

What I said is quarter-to-date it's pretty similar where we are in quarter two.

Ken Goldman

Right. Right. Thanks very much, guys.

Rodney McMullen

Thanks. Take care, Ken.

Operator

And our next question is from William Kirk of RBC.

William Kirk

Thank you. I have a question on Simple Truth. I think it's in some of your convenience stores now. I was just wondering how the brand's performing in that channel and how many C-stores it is in, I guess.

Rodney McMullen

I'm looking at C-stores for two days and I already got it in there. Honestly, I don't know the answer to that question. How many it's in or how broad the...

Michael Schlotman

On a few select items, it's in pretty broad in a lot of our convenience stores but it's pretty narrow. It's early in the process. And we're really trying to learn how broad can the brand go and who all connects with it? As you know, historically, convenience stores isn't a place you go to for healthy offerings and we are trying to make sure that the customer, if that's what they want, they can find what they want. So it's early in the process but we are trying to learn how far the Simple Truth brand can go.

William Kirk

Okay. Thank you. And then on the M&A opportunity environment, we saw repurchases come down in the quarter. Leverage is back to where it was pre Harris Teeter. How are you feeling about the M&A environment and opportunities out there?

Rodney McMullen

I would say our M&A appetite is the same as it's always been. If the right opportunity comes along and it's the right set of stores, right set of assets, and right management team, we would think about it. There's not a lot that happens in the space that doesn't come across our desk. I wouldn't read anything into the share buyback coming down in the quarter to signal something on M&A activity. We were pretty up-front that we expected to front-end load our share repurchase program, and really what you're seeing in the second quarter is the use of stock option proceeds and the tax benefit from that to repurchase shares to offset that dilution. And we're comfortable with our leverage where it is and it allows us a lot of flexibility. And keep in mind, we are increasing capital which consumes some cash as well.

William Kirk

Okay. That's perfect. Thank you.

Rodney McMullen

Thank you.

Operator

The next question is from Kelly Bania of BMO Capital Markets.

Kelly Bania

Hi. Good morning.

Rodney McMullen

Good morning.

Kelly Bania

Thanks for taking my questions. I was curious if you could talk a little bit more about the HEMISFARES' rollout. It sounds like that would be a premium quality, premium price point category. And just curious, in exactly which categories are you going to be launching that? How many stores? And really just stepping back and thinking about how does that come to fruition at Kroger? What's the idea process in terms of bringing that to market? Was that borne out of an 8451 kind of data science project? Or just any color on how that comes to market.

Rodney McMullen

Well, the biggest thing is it's really our Corporate Brands team would use the insights from 8451 plus other research they've done. We find customers are increasingly becoming foodies. And it's really trying to figure out how do you find great products that will satisfy that foodie need experience they want in a way that is actually a very affordable price. And if you look at the quality of this product, if you would go to a restaurant and eat food – eat something of this quality, it would cost four or five times as much as what it costs with us. So customers get to experience something that's very unique that's outstanding quality. And it's really the team searching across the world finding items that are very, very unique and very regionally based. The initial items – I actually don't know how broad it is. I can tell you the ones I've tried would be more pasta and sauce-based and olive oil and balsamic vinaigrette. Those types of items are the ones that I've tried. So the things I've tried are more based from Italy, but I'm sure there's others. It's just that's the ones I'm familiar with.

Michael Schlotman

And the whole idea of HEMISFARES is to allow our customers to take a journey of food experience around the globe without having to leave home. And it will be very specific on the packaging where the product's from. The folks at our Corporate Brands who have procured this actually have met with and have visited with and helped with the folks who manufacture this product or produce the product on-site in their home country. And some of this product it's the first time that anybody's gone through the trouble of importing the product with some of the items in into the U.S. that we have. So they've done a phenomenal job with this and we're really excited about yet another great offering for our customers in the stores.

Rodney McMullen

Yeah, we would expect it to be in almost all of our stores. We think most customers will want to engage with it. On some of the items, there is a limited amount of production. So it's – it's not something that you can just go out and produce twice as much if it sells twice as much.

Kelly Bania

That's very helpful. And then just wanted to ask another question on deflation and some of the categories. I think you mentioned that all departments was still comped positive even though you had some deflation in dairy and produce and maybe seafood for the quarter. So I was just curious how you manage that. Do you do some incremental promotions in those categories in order to drive volume and increase the comps there when you experience deflation or how do you manage that so stably?

Rodney McMullen

Well, a lot of times it depends on what's driving the deflation. In some categories, you have deflation when the product is at its peak and tastes great. If you look at like, produce, usually if there's deflation that means there's tons of product available, and it's really great product so you end up selling more. In other areas, when you have deflation you're able to give such a great value for the customer for the item, so you end up promoting it more and the volume grows. So it's – we would drive our promotions based on what our insights tell us that customers like and at what point they like versus trying to just make sure we have every department positive. But fortunately, every department was positive identicals. And I know Mike you were looking up some of the specific numbers?

Michael Schlotman

No, I was just looking – when you look across the departments, the strength of whether you look at the – just the IDs or the inflation adjusted ID sales, it's really pretty remarkable how broadbased the strength of that – of the momentum is in various departments. I mean we had some departments that even on inflation adjusted basis were still double-digit ID sales inside their department. And I'm excluding fuel and pharmacy from that. So it's –

at the end of the day it's really fundamental that I spoke of it earlier why we're so cognizant of what volume we're driving from a unit basis because that's at the end of the day what drives your business.

Kelly Bania

Great. Thank you.

Michael Schlotman

Thanks, Kelly.

Operator

And next we have a question from Robert Ohmes of Bank of America Merrill Lynch.

Robert Ohmes

Oh, thanks for taking my question, and, Mike, congrats on the promo.

Rodney McMullen

Thanks.

Robert Ohmes

Just actually two kind of quick ones. You know, Mike, I think you were alluding somewhat to the wage pressures. Can you walk us through is the wage pressures a lot more than normal for Kroger right now and is that sort of a broader economic thing? And then maybe tie into that so maybe more commentary on any changes you're seeing in your overall customer – HEMISFARES sounds like more upscale private label launch are you seeing change in amount of trade-up going on or any changes in different levels of your customers' behavior would be helpful. Thanks.

Michael Schlotman

Yeah, the comments I made earlier weren't directly related to any wage pressures. It was actually the – our own decision and Rodney mentioned it as well, of certain departments where we invested some incremental hours in those departments to drive a better customer experience. And it also happens to be departments where some of our tonnage has been very strong as well. So those hours would have ultimately been in the stores anyway but it was in advance of that.

The wage pressures I would say aren't really any different than what we spoke of in the first quarter. There continues to be some out there. We're cognizant of trying to deliver the right overall package to our associates from a solid wage, a good healthcare package and a retirement plan as well. And we're a little different than a lot of our competitors where we're balancing all three of those for all of our associates.

As it relates to HEMISFARES, I would put that in the category of the private selection and Simple Truth range where it is more of an upscale product. And very high quality product. And it's – but it does wind up having fairly broad appeal to a lot of folks because when you really step back and dissect a lot of customers, there are many customers who on some items are a budget shopper, on other items they wind up splurging on particular items. And these can be the kinds of items those folks wind up splurging on while in other departments they're perfectly happy with an entry level price point or a banner brand that's a lower price point for them. I would say that the HEMISFARES as it develops in private selection and Simple Truth as that mix shifts towards those it is actually one of the things that is helping to drive our mix to be a little bit different than it has been historically as well.

Rodney McMullen

Yeah, the thing that's so hard to tell I don't think it's so much economy based as customers clearly want high quality food. So if you look at the area's natural and organic, Boar's Head, Starbucks, sushi all those areas all have strong nice growth. So it's really – it really appears to be much different than just economy based. When you talk to customers they are definitely interested in saving money. There is no doubt about that.

Robert Ohmes

Got it. Thanks very much.

Rodney McMullen

Thanks.

Robert Ohmes

Thanks.

Michael Schlotman

Take care.

Operator

And our next question comes from Alvin Concepcion of Citi.

Alvin Concepcion

Hi. Good morning.

Rodney McMullen

Morning.

Alvin Concepcion

And thanks for taking my question. Congrats on a great quarter.

Rodney McMullen

Thanks.

Alvin Concepcion

I'll keep it to one question. Just wondering if you can talk about changes in the competitive promotional environment for both the overall business and the natural and organic part of the portfolio? Are you seeing anything different as the second quarter progressed? And even third quarter to date?

Rodney McMullen

Yeah, as you know, when we look at competition we always assume that competition's going get more aggressive going forward than it's been in the past. And we always find that if that doesn't happen then life's easier. It's just the way we've years ago learned to do our business plan. We wouldn't see anything that would be major in changes. There's always a certain promotion or you'll see things that different competitors do. And you'll see it even within weeks changing. So there isn't anything that I would say is a huge change in second quarter versus first quarter.

Alvin Concepcion

Thank you very much.

Rodney McMullen

Thanks.

Michael Schlotman

Take care, Alvin.

Operator

The next question comes from Mark Wiltamuth of Jefferies.

Mark Wiltamuth

Hi. Good morning. Certainly had a nice bounce the fuel margins here in recent months. If some of this persists, would you anticipate reinvesting that back into the business? Or do you think that would – you'd let that flow through to the bottom line?

Rodney McMullen

It's obviously a good question. It's one where I don't think I would really be able to answer it at this point because it really depends what's going on in the marketplace and what we think is the best use of that. So at this point I really wouldn't think it would be appropriate to answer it.

Mark Wiltamuth

Okay. And then just curious on your click and collect experience in those newer markets. Are the customers signing up for some of those longer term fees like the monthly or annual fees? Or are they gravitating more to the pay per visit approach?

Rodney McMullen

You actually have customers doing all three. I would say the most customers are on the two extremes. They do the yearly approach or the per order approach. But it's not one of those things where you see 80% of the customers going one way or the other.

Mark Wiltamuth

Can you tell if it's incremental in those new markets?

Rodney McMullen

Some of the basket would be incremental but it's still so early that it's – the answer I gave you is what we're seeing but I wouldn't use a whole lot of basis off of it because the sample size is still too small.

Michael Schlotman

It's a data point not a trend.

Rodney McMullen

Yeah.

Mark Wiltamuth

Okay. Thank you, and congrats a good quarter.

Rodney McMullen

Thanks, Mark.

Michael Schlotman

Thanks, Mark. Take care.

Operator

The next question comes from Andrew Wolf of BB&T Capital markets.

Andrew Wolf

Thanks, and good morning. I want to follow up on the volatility that you cited in the product costs. First on pharmacy inflation with generics, can you quantify or even specifically or directionally how much that affected gross margin?

Rodney McMullen

Yeah, I wouldn't talk about a direct effect on gross margin but I will tell you that pharmacy inflation in the quarter continued to be above 90%.

Andrew Wolf

Okay. And again, that wasn't pass through due to the contracts and so forth?

Rodney McMullen

Well, you have contracts out there that you have to wait until you can pass it through. But also keep in mind as generic inflation happens, we have $4 30-day supply and $10 90-day supply and we haven't changed those price points either.

Andrew Wolf

Okay. Thanks. That's helpful. And when you talked about managing inflation and deflation, you had a good follow-up I thought on the pricing versus market share. Let me ask you about just on the inventory side. Does Kroger try to either go long commodities or inflating or be a little short those are deflating? Or is it when you talk about managing, is it much more about being sharp on pricing and managing it between – using price to lever either market share or profitability?

Rodney McMullen

We do some things for consumption in own manufacturing plants when we look at supply of products and the supply chain that is out there. We don't go overboard on hedges and we really don't use hedges so much. It would be cash purchase contracts to lock in a price for a period of time. We typically don't get too excited about doing those things unless the current prices and projected prices are trending below a five-year rolling average because it's – if you talk to people in the oil industry today, oil's only going do one thing and that's go down. When oil prices are going up and you talk to somebody in the oil industry, they're only going do one thing and that's go up forever. And I would say most people in the commodities world have that view.

So we're very careful about how we do it. The amount we consume is actually pretty large so we try not to be – I use the term a lot internally: I'd rather be approximately correct than precisely wrong. And if I make too big a bet one way or the other, I'd probably be precisely wrong.

Andrew Wolf

Last thing. So that – what you just described is only for the vertically integrated part of the business, the manufacturing? It doesn't permeate to retail at all, or does it?

Michael Schlotman

Yeah, so for example, I wouldn't go out if I see something happen in produce and try to hedge the apple crop this fall. You probably can't effectively do that anyway, but we do things with growers, trying to lock up fields and things like that, but that's more to make sure we have the exact product we want, not necessarily – we do that regardless of the inflationary environment.

Andrew Wolf

Okay. Thank you.

Rodney McMullen

Thanks, Andrew – Andy. One more question. We have time.

Operator

Yes. And that last question will come from Scott Mushkin of Wolfe Research.

Brian Cullinane

Hi. This is actually Brian Cullinane on for Scott. Thanks for taking the question. Just wanted to talk broadly – your business model is clearly unique and advantaged with the data technology that you guys have. I just wanted to touch on how you guys think about expanding and whether it's through square footage growth and acquisitions or building more stores, getting your store and you're offering to more consumers kind of in areas that you're not currently in?

Rodney McMullen

Well, if you look in terms of going to territories that we are not in at all, as you know, historically, we've done that through mergers, and we're always, as Mike mentioned earlier, looking out for the right one to do something with. We're finding incredible opportunity on fill-ins and most of the incremental capital that Mike talked about is what we're finding is incremental project opportunities for great projects in existing markets. And right now, that's the highest focus. Now, that doesn't mean that we wouldn't go into a new territory, de novo, at some point.

Brian Cullinane

Great. And any thought to – you're spending more on capital, but to accelerate any of that with the success that you're having with some of the new stores and new projects?

Rodney McMullen

Well, we feel like we already are. If you look at the incremental capital that we're spending, and we continue to push that. So you're always looking for opportunities to grow, but grow and make sure you execute, and we feel like we have started picking up that pace.

Michael Schlotman

Yeah, I prefer an environment where I have a bunch of division presidents upset with me that they have great projects that we haven't been able to fund because of our capital, what they would call capital constraints, and spending $3.3 billion this year doesn't sound real constrained to me. So if they weren't clamoring for more dollars, I'd be nervous about our opportunities, but as long as they're clamoring, I feel good about where we are.

Brian Cullinane

That's great. Thanks very much.

Rodney McMullen

Thanks, Brian.

Rodney McMullen

Before we end today's call, I'd like to take a moment to acknowledge that this morning is the 14th anniversary of the attacks of September 11. I know that many on the call today were personally affected by those events. We continue to mourn those we lost on that horrific day and to honor their memory through our support for police, fire fighters and other first responders, as well as the military and their families. At the 9/11 – I recently had a chance to go to the 9/11 Memorial and Museum and it's incredibly touching, and I'm sure most people on the call have, but if you haven't, it's well worth seeing and it really does make you appreciate all the things that the police, fire fighters and other first responders did on that morning.

Finally, I'd like to share some additional thoughts with our associates listening in today. One of the most exciting things about working for a growing and expanding company is the additional opportunities it creates for associates. Many of you would agree that Kroger is a place where you can come for a job and stay for a career. When I ask associates and managers why they've stayed, most tell me they fell in love with working with people, our customers and associates, or they found a deep passion for food. Often, it's both. As I mentioned earlier, nearly 70% of our store managers started as hourly associates. I believe there are many young people working for us today who will become our future leaders and will be having Mike's role and other senior leaders' roles, and mine.

Our associates are people who care who want to connect with something bigger and make a difference in our communities every day. We ask candidates to imagine you at Kroger, because whether you're looking for a flexible part-time job or for a lasting and rewarding career, you can find it here. And we're looking for friendly bright people who want opportunities to learn and grow. This is such an exciting time to be at Kroger. Together, we do make a difference.

That completes our call for today. Thanks for joining.

Operator

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