The Kroger (NYSE:KR) Q3 2011 Earnings Call December 1, 2011 10:00 AM ET

Executives

David B. Dillon - Chairman, Chief Executive Officer and Member of Proxy Committee

J. Michael Schlotman - Chief Financial Officer and Senior Vice President

W. Rodney McMullen - President, Chief Operating Officer and Director

Cindy Holmes - Director of Investor Relations

Analysts

Jonathan P. Feeney - Janney Montgomery Scott LLC, Research Division

John Heinbockel - Guggenheim Securities, LLC, Research Division

Charles Edward Cerankosky - Northcoast Research

Karen F. Short - BMO Capital Markets U.S.

Mike Otway - Jefferies & Company, Inc., Research Division

Alton K. Stump - Longbow Research LLC

Meredith Adler - Barclays Capital, Research Division

Deborah L. Weinswig - Citigroup Inc, Research Division

Andrew P. Wolf - BB&T Capital Markets, Research Division

Todd Duvick - BofA Merrill Lynch, Research Division

Edward J. Kelly - Crédit Suisse AG, Research Division

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2011 Kroger Co. Earnings Conference Call. My name is Stacy, and I'll be your conference moderator for today. [Operator Instructions] As a reminder, this conference call is being recorded for replay purposes. I would now like to turn the presentation over to your host for today, to Ms. Cindy Holmes, Director of Investor Relations. Please proceed.

Cindy Holmes

Thank you, Stacy. Good morning, and thank you for joining us.

Before we begin, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions, and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings, but Kroger assumes no obligation to update that information.

Both our third quarter press release and our prepared remarks from this conference call will be available on our website at www.thekrogerco.com. After our prepared remarks, we look forward to taking your questions. [Operator Instructions]

Thank you. I will now turn the call over to Dave Dillon, Chairman and Chief Executive Officer of Kroger.

David B. Dillon

Thank you, Cindy, and good morning, everyone. Thank you for joining us today. With me to review Kroger's third quarter 2011 results are Rodney McMullen, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

Kroger associates delivered on our Customer 1st strategy in the third quarter. We had strong sales and earnings per share growth. This is exactly the positive momentum we strive for as we enter the holiday season, our most exciting time of the year, and we are very pleased.

Keep in mind that a year ago, third quarter earnings were helped by a $0.02 tax benefit and a $50 million lower LIFO charge. In that context, this was an outstanding quarter.

Based on the consistency of our results over the course of this year, we have the confidence to raise our earnings and sales guidance for the year. Identical supermarket sales increased 5% without fuel for the quarter. This continues Kroger's industry-leading trend of positive identical sales growth for 32 consecutive quarters. Consistent identical sales growth lets us know that our Customer 1st strategy is connecting with customers in a meaningful way.

Our focus on 4 keys, our people, products, prices and shopping experience is how we grow customer loyalty each shopping trip. Positive identical store sales also drive earnings growth as illustrated by our results so far this year.

Our third quarter performance was broad-based across the company. Each of our 18 retail divisions had positive identical sales, excluding fuel. Every department achieved positive identical sales as well, led by growth in natural foods, deli and produce.

I would like to especially recognize our associates for their excellent work to control costs this quarter.

Kroger's financial results are solid, dependable and predictable, especially on a rolling 4-quarter basis. They reflect the balance that we seek between cost savings and investments to consistently grow our business and deliver a value both for our customers and our shareholders.

In a few minutes, Rodney will share some additional customer insights with you, including loyal household and tonnage trends, along with the performance of Kroger's exclusive corporate brands.

First, I'd like to touch on the 2 themes that we told you at the beginning of the year would influence Kroger's fiscal 2011 financial results. The first is our commitment to the Customer 1st strategy that we just discussed. We want to reduce the overall cost of running our business in ways that do not negatively affect our customers, and then reinvest those savings in our customers to drive higher sales. Higher sales, in turn, produce higher earnings.

The second theme includes the external factors that are influencing Kroger's business this year. The pace of the economic recovery, the impact of food and fuel prices on customer spending, the competitive environment, higher pension and healthcare costs and retail fuel margins.

Inflation and the economy have had a more negative effect on the overall operating environment than we had originally expected. We have successfully navigated these influences by following our business strategy and making tactical adjustments as needed over the course of the year.

Rodney will now offer some more insight into the business for the third quarter. Rodney?

W. Rodney McMullen

Thank you, Dave, and good morning, everyone. We are very pleased with the results our Kroger team has achieved in the third quarter. As Dave mentioned, our associates have done an incredible job serving our customers by controlling expenses and cutting costs. We are investing those savings in ways that enhance the shopping experience and help our customers save even as in food inflation persists at high levels. Executing our Customer 1st strategy enables us to deliver value today while continuing to invest for the future.

I would like to begin by discussing how our customers are navigating this challenging consumer environment and how that is impacting our business. Despite the consumer caution and rising food prices, Kroger continued to add both loyal and total households in the third quarter, adding loyal households at a faster rate. The combination of growing loyal households and an increase in shopping trips resulted in more units sold to those customers.

We are seeing increasing stress on certain customers, both in terms of what they tell us is happening to them and how they are behaving. Smaller baskets are the norm across all customer segments, in line with trends we began detecting in June. Customers are shifting what and how they are buying groceries and consumables. For example, we saw significant growth in sales in our corporate brand items. Some customers are buying smaller pack sizes for items in certain categories.

These changes are a result of customer reaction to the combination of food inflation and a poor economy. When you consider that household income has remained stagnant for the past year, in fact, for the last several number of years, some shifting in purchasing behavior is understandable. This is one of the reasons we embarked upon the strategy we did several years ago.

Even though our estimated product cost inflation excluding fuel was approximately 6% for the quarter, we were able to increase our penny profit per item in the grocery category. Mike will say more about how food inflation impacted our gross margins for the quarter. I do want to note that not every single retailer calculates product cost inflation in the same way. Kroger's calculation is weighted to take product movement into account so we can get a better measure of what the true effect on the consumer is over time.

We believe 6% accurately reflects what the consumer is in fact, experiencing. Using a calculation that measures inflation at a particular point in time would result in an inflation estimate different than the one we actually calculate.

In looking at unit sales, we have seen a continued slowing of the rate of growth of unit movement throughout the year. When considering different promotional activity and changes in pack sizes some customers are buying, we believe our tonnage is essentially flat.

We will continue to pass along product cost increases from suppliers. At the same time, we will confidently invest for the future in pricing, people, products and the customer shopping experience. We estimate that we have lowered our customer shopping bill by $2.2 billion per year, and our weekly promotions and personalized rewards to loyal households continue to grow customer loyalty in a difficult economic environment.

In the third quarter, more customers chose our exclusive items, which grew Kroger's corporate brand share and sales more than national brands. Corporate brands represented approximately 27% of grocery department sales dollars and 35% of the grocery department units sold. These figures compare with 26% and 34%, respectively, for the third quarter of last year.

Considering the consistent share growth of Kroger's corporate brand products for several years, it is obvious that once after customers try them for the first time, they continue to choose them for their great value, both in terms of quality and low price points.

Our corporate brand team continues to develop innovative product lines to address unmet customer needs. During the quarter, we launched some great new products for customers looking to change their eating habits, including a 99% natural, zero-calorie baking sweetener that measures cup for cup like sugar.

In our bakery department, Kroger's new no sugar added pies, available in apple, cherry, pumpkin and other delicious flavors, are a great option for those on low or no-sugar diet.

We also have good progress to report in labor relations. Several previously unsettled labor negotiations have resulted in contracts that have been ratified, including those in Southern California, southeastern Ohio and Charleston West Virginia, along with the Teamsters at one of our distribution centers in Washington State. I'd like to thank our associates and division leadership for their work to reach mutually acceptable agreements.

We are in discussions with the UFCW for Memphis area stores and with the Teamsters for some distribution centers and dairies in the Midwest. These contracts are in extension while negotiations continue. As you know, our objective in every negotiation is to find a fair and reasonable balance between competitive cost and compensation packages that provide good wages, high-quality affordable healthcare and retirement benefits for our associates.

Now Mike will discuss our third quarter results and Kroger's financial strategy in detail. Mike?

J. Michael Schlotman

Thanks, Rodney, and good morning, everyone. As we reported earlier today, net earnings for the third quarter totaled $195.9 million, or $0.33 per diluted share. Net earnings in the same period last year were $202 million, or $0.32 per diluted share.

FIFO gross margin, excluding retail fuel operations, decreased 34 basis points. Food inflation accounted for most of this decrease. The FIFO gross margin decline was more than offset by a 29-basis point improvement in our OG&A rate excluding fuel, and improvements in rent and depreciation of 19 basis points also excluding fuel.

We look at operating margin on a rolling 4 quarters basis because tactical adjustments to the strategy can have a positive or negative impact from one quarter to the next. On this basis, excluding fuel, the operating margin expanded by 5 basis points. This is the third consecutive rolling 4-quarter period with an expanded operating margin.

This calculation of operating profit is on a LIFO basis, meaning that the calculation includes the LIFO charge. During the quarter, our estimate of this year's LIFO charge increased $35 million, from $150 million to $185 million.

To get LIFO caught up year-to-date, we had an incremental $27 million charge over what we had budgeted in the third quarter. Excluding the LIFO charge from the calculation, our rolling 4 quarters operating profit increased 21 basis points.

Due to the increase in our LIFO estimate, we expect the operating profit margin on a LIFO basis to show a slight decline for the year. But on a FIFO basis, it will show a slight increase.

The reduction of 29 basis points in OG&A without fuel demonstrates the leverage of our strong identical food store sales and cost control efforts in the face of rising debit and credit card fees, pension and healthcare expenses. Also as a result of current expected operating performance for the year, our incentive plans are estimated to pay off at a higher rate than last year. Collectively, debit and credit card fees, pension, healthcare and incentive plans have increased 45 basis points, with incentive plans being the largest of these.

Kroger's retail fuel operations in the third quarter earned approximately $0.137 per gallon compared to $0.127 per gallon in the same quarter last year. For the last quarter of the year, we expect margins of approximately $0.115 per gallon.

Given the trend in higher credit and debit card fees, earnings from fuel were essentially flat compared to last year. And the cents per gallon margin after debit and credit card fees was also essentially flat.

I'll now update you on our long-term financial strategy. We are very focused on allocating the substantial cash flow of Kroger's business to reward our shareholders, both today and in the future. Over the last 4 quarters, Kroger has returned over $1.8 billion to shareholders through share buybacks and dividends. During 2011, Kroger is using cash flow from operations and cash-on-hand to repurchase shares, pay dividends to shareholders, fund capital expenditures and maintain our current debt rating.

During the quarter, we leveraged Kroger's strong cash flow to invest $471.2 million to repurchase 21 million shares of stock at an average price of $22.39. At the end of the third quarter, approximately $721 million -- $721.6 million remain under the $1 billion stock repurchase program announced in September of 2011.

Capital investment, excluding acquisitions and purchases of leased facilities, totaled $497 million for the third quarter compared with $484 million in the same period last year. We expect capital investment for the year to be slightly above $1.9 billion, excluding acquisitions and purchases of leased facilities.

We also saw a strong improvement in the EBITDA return on net operating assets, or ERONOA, of 19.68%, an increase of 108 basis points from a year ago.

Net total debt was $7.7 billion, an increase of $476.6 million from a year ago. On a rolling 4 quarters basis, Kroger's net total debt-to-EBITDA ratio adjusted for the impairment charges in 2010 was 1.89 compared with 1.93 during the same period last year.

As we reported earlier this morning, Kroger's increased its fiscal 2011 guidance. We now expect identical supermarket sales growth, excluding fuel, of 4.5% to 5% for the year. Previously identical supermarket sales were expected to range from 4% to 5%.

We are also increasing the range of our net earnings guidance to $1.95 to $2 per share -- diluted share for the year. Previously, we expected net earnings in the $1.85 to $1.95 range.

We are in the middle of our business planning process. Based on what we're seeing today, we expect to reach 8% to 10% annual earnings per share growth in 2012, plus a dividend of 1.5% to 2%. This does not factor in the 53rd week in fiscal 2012.

As you know, our long-term growth model was to generate 6% to 8% annual earnings per share growth over a rolling 3- to 5-year time horizon. We will provide full guidance in March but thought it would be helpful for you to know how we currently see 2012 shaping up.

Now I'll turn it back to Dave.

David B. Dillon

Thanks, Mike. I'd like to conclude by reflecting that when we began our Customer 1st strategy, we had to make investments in price and other areas of the shopping experience. Those choices were an imperative. And while we still see opportunity to continue these investments, today we have the flexibility to pick and choose how and when to do so.

I mentioned at the start of the call that our financial results are solid, dependable and predictable, especially on a rolling 4-quarter basis. Looking at Kroger's operating margin on that longer time horizon demonstrates this powerful positioning. A rolling 4-quarter view is important because we are constantly making tactical decisions about these investments.

Our margin in any one quarter may fluctuate depending on our decision to accelerate or decelerate investments. But if you look under the hood at our operating margin over the course of a year, you'll see that the results reflect the strategic balance we seek between cost savings and investment that we believe are necessary to consistently deliver value to our customers and our shareholders.

I'm very proud of this year. I'm personally proud of what our associates have achieved. Kroger is winning in the marketplace and delivering value for our customers, associates and shareholders. We have a great strategy that has worked well in a variety of economic environments. That gives us the confidence to be bullish on the rest of this year and 2012.

Now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from the line of Deborah Weinswig with Kroger (sic) [Citigroup].

Deborah L. Weinswig - Citigroup Inc, Research Division

Actually with Citigroup. So David, you talked about the inflation the economy have had a more negative impact than expected and that you've made tactical adjustments. I don't know if you could maybe enlighten us and expand on those?

David B. Dillon

Well, the point really is to look at what's happening with our customers. And we knew all along in the year that the real issue would be how does the world -- the operating world that our customers find themselves in, the macroenvironment that affects everyone, how will that affect us. And what has happened is that the intersection of inflation, which means higher prices for the customer, and a poor economy, which means the customer doesn't have as much money in their pocket. Those 2 factors together have caused at Kroger and I think elsewhere and many of the CPG companies, as retail prices have gone up, tonnage, the growth in tonnage, has declined a bit to where, as we've said now, as our tonnage last quarter was essentially flat. And we think that's essentially a sign of our times. And it's because when customers have to spend more money to get the groceries they need, they don't have money to buy more groceries than they were buying before. So it's hard to keep the business growing in tonnage in that kind of environment. So if I look at any issue in the quarter, to me that's the macro issue that all of us are trying to deal with. The really good news and the thing I'm most pleased about is that even in the face of that, we ended up growing households, we ended up growing our business, we ended up growing our earnings per share. And so we're thrilled by that outcome, and we're thrilled in that environment that our strategy has produced such solid results.

Deborah L. Weinswig - Citigroup Inc, Research Division

Okay. And as we look down the road, what are you hearing from suppliers in terms of cost inflation? How do you think about 2012?

David B. Dillon

I'm going to let Mike comment a little bit on that, but we've seen, as you know, there's a lag between what we see in the commodity markets and what we see in the actual pricing that we receive and then what gets passed on at retail. And because for several quarters, we predicted higher inflation but it didn't happen. And then when it did happen, of course, it's been pretty strong inflation for the last several quarters. So looking forward, Mike, do you have some comments?

J. Michael Schlotman

Yes. I -- Deb, I think in the first half, we would expect inflation to continue close to where it is today. Keep in mind that we didn't really start to see a huge uptick in inflation until late in the second quarter and it's obviously continued in the third quarter. It kind of grew throughout the first half of the year. So we'll be lapping that when we get into 2012. If you look at basic commodities, corn and wheat are down a little bit but still well above the 5-year moving average. And I don't think there's been enough movement in those to actually think about having price declines. But I think there could price stabilization when we get to the back half of 2012.

Deborah L. Weinswig - Citigroup Inc, Research Division

Okay. And then last question just in terms of tonnage growth. Obviously, you guys have done an incredible job. Just when do you think we'll start to see that pickup, if you have -- if you can take out your crystal ball out of your pocket?

David B. Dillon

Well, I don't think I have a crystal ball on that. We do expect, given how our performance has been earlier this year, that even in this environment, we expect to do well. But the concern I have, of course, is as customers are pressed, and we talked about inflation. But the other factor that I think is the -- maybe the most important factor is what the economic environment going to look like to our customers. And that can put a dampening or an accelerating effect on how customers view their future and their own behavior. So we try to measure behavior. We try to react to that. You asked earlier about what kind of adjustments do we make. Well, we look at what consumer behavior looks like, and we try to focus on what can we do on behalf of the consumers at this point in time given what they're trying to live with. I think that's the biggest unknown is what that economy is going to look like. And so far, it's going to stay soft for quite a while.

Operator

Your next question comes from the line of John Heinbockel with Guggenheim Securities.

John Heinbockel - Guggenheim Securities, LLC, Research Division

David, if you could talk a little bit about maybe expand, as you look out to 2012, how you see the economic environment particularly since there may be a possibility here that unemployment benefits and the payroll tax cut does not get extended come January 1. Do you think it's a -- is it possibly a tougher macro in 2012 or about -- maybe it's the same? And then kind of what goes along with that when you think about the 8% to 10% comp earnings growth, will the comp be lower next year than this year or do you think that would be close or the same?

David B. Dillon

Well, I'll answer the last question first. I don't think we're going to try to give full guidance today so we're not going to answer that question. But I will talk a little bit about how we see the environment going forward. The bottom line in my mind is, is that we expect next year, at least the foreseeable part of next year, to be much like what we've seen this year from an economic point of view. There are 2 kinds of big factors that I think about in my own thinking on this question. First, what do the facts mean, and factually, how does the economy behave? And I think everything I've seen suggests that, that's going to be slow. I don't see it as crashing and burning, but on the other hand, I also don't see it as robust and climbing. So we see that as relatively flat. But the other factor that we don't talk a lot about usually gets played out is consumer confidence. And I think it really is more specifically looked at and what are the events that occur during the year that cause people to feel either good or bad about the world that they operate in which affect their behavior? And consumer behavior and confidence can have a lot to do with whether or not an economy can pick up or not. And it has a lot to do with how our business does. So we're very interested in how our consumers are feeling. They get affected by lots of things. We talked last quarter about how they had been affected by the debt crisis discussion in Congress and how that got played out in such a wild way in the media. Well, we're expecting a replay of something like that soon. And that could have a similar kind of effect. On the other hand, there's lots of positive optimistic things out there today, and if those get played up in a way that the customers see them and feel good about the world, then that part of the economic action actually is an improvement. Having said all of that, that's how I think about it. I think ultimately, we think it's going to be about the same as this year with high variability just like we experienced this year.

John Heinbockel - Guggenheim Securities, LLC, Research Division

As a follow-up to that, I mean, we've had I think you'd agree, this year has been remarkably stable in terms of competitive rationality. People have done the right things, not made many stupid mistakes. I guess in your forecast, do you see that continuing or is there a risk that as the macro stays soft, that we see some reversion back to more intense promotions and dumb decisions?

David B. Dillon

I can't speak, obviously, for competitors and wouldn't pretend to. But my answer from our point of view is yes. I think it's been a more rational marketplace. I think it's gradually been a more rational marketplace over the last 10 or 15 years based on what the economic forces are rather than based on emotion. And I think that everyone seems to be taking steps that make more economic sense. And certainly, we strive to do that at Kroger. Our whole point of view is to make rational choices that make sense for the long-term success of our business. And that's why I think you've seen our rational behavior, and I think that's probably why you've seen it elsewhere, too. So yes, I expect that to continue.

John Heinbockel - Guggenheim Securities, LLC, Research Division

And just one final thing. If you think about the ongoing need to make price investments, where do you see the best opportunities to take cost out going forward? And I assume it's in the store. Is it, what -- you may not be specific, but as you look at processes, is that sort of the biggest opportunity to take stuff out of receiving front end, those kind of areas or is it something else?

David B. Dillon

I'll let Rodney specifically comment, but let me generally comment by saying that we're interested in taking cost out of places that either don't matter to the customer or perhaps actually improve things for the customer. And we're also interested in things that can be high dollars, so those are often things that are in the stores because you multiply that times 2,500 or it can be in our distribution processes because you multiply that times all the items that go through the system. Having said that, Rodney, you might want to add a little more specificity.

W. Rodney McMullen

Well, yes. Obviously, we're not -- we won't be able to give specifics. But one of the things that we worked awfully hard is to try to get ideas across from the whole organization because we have awful lot of fabulous associates across the whole company. And then making sure that we could facilitate our process where we execute against those across the company. And what we've found over time is when you think you've got all the savings you can, that you know about, smart people come up with other ideas on how to make processes chain improve, as you mentioned. So we feel very confident that we've got a whole litany of lists of ideas to continue to improve the customers' experience and take costs out of our business.

Operator

Your next question comes from the line of Ed Kelly with Credit Suisse.

Edward J. Kelly - Crédit Suisse AG, Research Division

I want to get back to this issue on tonnage. Your tonnage is relatively flat, but it's down almost everywhere else out there, and I guess that's because of elasticity and a lot of your competition is showing fairly sizable declines. Are they okay in this situation where they're seeing negative tonnage? Do they just look at the top line and say, "Okay, my top line is getting a little bit better so I won't be more promotional?" What's the mindset as tonnage goes to negative at your competition?

David B. Dillon

I don't know about their mindset. My mindset is that I see the economy has changed. Customers only have so much money. And when you take 6% more of their money from higher prices, they have 6% less to spend on other things. And that's not to mention that fuel is a little bit higher this year, too, which if you haven't filled up the car lately, you haven't experienced it. But you'll find that it takes more money out of your available spending. And when that happens, there's only so much to give. And when that happens, you shouldn't chase. We can't. We don't try to chase the customer in that environment. You can't get them to spend money they don't have. So we're -- I think we're rational about that and I think that the market is rational about that, too. It does help that the sales are positive for nearly every retailer, and even those that aren't, they're close to positive. And that helps because that helps make ends meet. It helps you pay the bills. And as long as you can pay the bills, then you can continue to work down the path of rational operating behavior, which is what I think we have.

Edward J. Kelly - Crédit Suisse AG, Research Division

As we think about next year as inflation, let's say, it begins to ease in the back of the year, tonnage at some point probably starts to come back but my guess is there is some delay in that. So I guess, one, do you agree with that? And then two, that would mean that IDs, just mathematically, probably has -- have to at least slow a little bit. Does that make sense?

David B. Dillon

I'm not going to speculate on how that will end up playing out. I think that actually will be played out. In fact, we'll know the answer to that when we see the facts. And partially because if I were to answer that, it's starting to try to lock in on guidance for sales next year, which I don't plan to do today.

Edward J. Kelly - Crédit Suisse AG, Research Division

Okay. Actually I don't mean to ask you like that. I guess, my real question is that we're in a situation where back half of next year, let's say, your IDs are up, I mean, I don't know 3.5% because you've got less inflation rolling through about maybe modestly better tonnage. As an organization, how do you manage your business differently at all based on that decelerating ID?

David B. Dillon

Oh, we probably would manage the business a little bit differently, but I'd be pleased with a picture that was a growing tonnage like that because it would spell a healthier picture. But even in this environment where our tonnage is flat, we feel we're growing our market share a little, not as fast as maybe we were before, but that's the environment we're in. So you can grow. What we're mostly interested in is winning with households, and whether that is winning with households at flat tonnage or winning with households at positive tonnage, I probably would prefer positive tonnage. But on the whole, it's still winning. And we end up having a really bright future if we win in market share. As you know, that's more our formula, than not everybody requires market share to be successful. But our market share really is helpful to us.

Edward J. Kelly - Crédit Suisse AG, Research Division

Okay. And just last question for you, there's been a lot of talk about Walmart recently because, I guess, they've quantified what they're going to do from a pricing standpoint at their analyst meeting. You seeing anything different there at all?

David B. Dillon

I don't think I'll comment specifically on what we're seeing at Walmart or really any other competitor. We watch them all very closely as they watch us very closely. I'll leave that up to you.

Operator

Your next question comes from the line of Meredith Adler with Barclays Capital.

Meredith Adler - Barclays Capital, Research Division

I have a couple of questions. I'd like to talk -- you've mentioned that penny profit was up in the dry grocery category, which is really good to hear. I was wondering if you could talk about whether you see differences in the nature of the categories where you see the penny profit up? Is it that there are some categories that customers will accept the price increase and others they won't? Or is it more across the board?

W. Rodney McMullen

That's a great question, Meredith. The -- as you know, if you look at the perishable departments or the fresh departments, that is as much driven by what's going on in the competitive environment and how long do you think the inflation is there. So that, you'll see a lot more increase in -- or decline in pennies profit per item that may or may not align with the inflation. In grocery, we see much more predictability and we're seeing predictability so far this year, and Drug GM also. So I would really kind of separate the 2, and we actually -- you see a little bit different behavior in both areas. But one is really affected as much by the competition.

Meredith Adler - Barclays Capital, Research Division

Okay. And then I think there was a little bit of a question about CPG, but just maybe if you could elaborate a little bit. You have said all along that you would pass along the increases and they would have to make a decision how they felt about their volume being down or managing their gross margins. Are you seeing any change at this point? Are they increasing their promotional funding? Are they holding back do you think on any of the increases they're passing through to you?

W. Rodney McMullen

Well, the thing that we don't really know about what the CPG is how they've hedged their raw materials. As a general rule, we would see them holding back in terms of what the cost come through versus the inflation of the raw materials. But in a lot of cases, we would assume that they've hedged that so they probably haven't had the cost increase the same as what you would read in the marketplace. So as a general rule, we would see lagging there. Not necessarily a lot on promotion, no different than a year ago. You'll constantly see somebody feel like they're losing share a little bit and they'll come and be more aggressive with promotion dollars. They like a specific promotion, those kinds of things, but nothing really not huge change there.

Meredith Adler - Barclays Capital, Research Division

Okay. And then I'd just like to ask you about your labor negotiations. I just wondered if there are any themes that you can draw from all of the negotiations you've done, say, in the last 12 months. Healthcare clearly is an issue. Pension is an issue. But sort of how is it working out? And are there concessions being made on the wages to get keep healthcare and pension benefits?

W. Rodney McMullen

In terms of -- if you look broadly the 2 that you raised, obviously, every negotiation, healthcare and pension is a very critical part of that negotiation. If you look at wages, wage increases are not as much as what a lot of the increase ends up going in pension and healthcare where some -- where our associates receive versus the cash wage. But as a general rule, our cash wage increase also goes up when you look at in the basket. Now our associates are working together with us on changes in work rules. As we've talked about before, constantly changing processes, everything else, so that you try to balance all those things out. And so far, we feel pretty good that we've been able to have negotiations where we have competitive costs, but at the same time, we have an excellent benefit package and solid wages versus the market. So far, we feel good about where we've ended up. Now that road of getting there isn't always so smooth, as what I just outlined.

Operator

Your next question comes from the line of Alton Stump with Longbow Research.

Alton K. Stump - Longbow Research LLC

If you could just touch on the produce topic in a bit more detail. I think we all know the dry food prices are probably going up next year. But on the perishable side of things, is there any cost release coming there in your view over the next 3 to 6 months period?

W. Rodney McMullen

Yes. I mean, if you look at the perishables, if you look at like produce, it's really hard to predict because it really depends on what kind of growing seasons do you have, both in Mexico and California and Florida. So today, we don't see anything unusual, but you can have a freeze tomorrow that changes that comment. So it's really hard to say there. On meat, we would expect to continue to see inflation because of the things that Mike talked about. If you look at like corn, especially the -- it's lower than what it was, but still, when you look at year-on-year, it's a tremendous increase. So we would expect in meat to just continue to see some of those cost pressures there. Dairy, probably not quite as inflationary as it was, but that's also highly volatile based on how the weather is and how much the supply of milk is.

Operator

Your next question comes from the line of Scott Mushkin with Jefferies & Company.

Mike Otway - Jefferies & Company, Inc., Research Division

This is actually Mike Otway in for Scott. Just, I guess, stepping back a little bit. Last quarter -- I know you've touched upon this probably a little bit, but last quarter, you seemed a bit more cautious in pulling forward some of the price investment. Now with the raised guidance, it appears there's some more optimism. And just kind of want to get a sense for what may have changed between the third quarter and the second quarter and what may be causing that optimism?

David B. Dillon

I think if anything changed, I don't really think a lot changed. But if anything changed in my mind, it's we've seen more of the environment. What we saw looking down the road last quarter was an environment that was increasingly looking difficult for the consumer. And the question was how well would we be able to get through that with higher prices and would the customers stay with us? And the fact that we have grown households in that environment, loyal households have grown at a good clip compared to total. But total is up as well, but loyals are the ones we're most interested in. The fact that we've been able to do that and to make ends meet really well suggests to us that in this environment, we can be successful. And so we're very pleased and proud with what we accomplished, and it helps to be able to look back now and say, "Okay, we made it through that pretty well. We can work in an environment like this and make it successful." So I think if there's anything about attitude, that's how my attitude shifted. We went from the unknown to the known.

J. Michael Schlotman

I'd just add a couple of comments to David's comments. Part of the optimism, I would say, is more -- is driven by some of the things we did in the second quarter and how the customers reacted to that. The other thing is our strong free cash flow we've been able to buy back more shares than what we had originally planned to do. And that obviously helps earnings going forward too. So it's really both of those things together.

Mike Otway - Jefferies & Company, Inc., Research Division

Okay. And then, I guess, just a small housekeeping item on the tax rate. It was a little lower than I think the kind of 36.5% guidance in the back half, and I know there's always moving parts, but any color there?

J. Michael Schlotman

I would say there is nothing -- no one big item would have caused it to be slightly different. And we gave guidance for what to expect for the year in the 8-K, as well.

Operator

Your next question comes from the line of Todd Duvick with Bank of America Merrill Lynch.

Todd Duvick - BofA Merrill Lynch, Research Division

I want to ask about your financial policy and balance sheet, if I may. You may have heard that one of your competitors started down the path of a mini leveraged recap yesterday, and as a result, its credit rating was downgraded. That company's leverage is going up on a net debt-to-EBITDA basis while yours is flat to down. And Mike, I think early on the call, you mentioned an objective of maintaining your debt rating. So with that backdrop. I wanted to know, can you provide updated thoughts on how you plan to allocate capital in the near term and really what governs your share buyback appetite?

J. Michael Schlotman

Yes, good question, Todd. As I've said in the prepared remarks, we do expect to continue to use our free cash flow and balance the use of that between buying in shares, paying the dividend, strong capital expenditure program and maintaining our current BBB flat credit rating. We like to have the access to the A2/P2 commercial paper market. It's very deep and very liquid and very attractive rates to allow us to finance our needs on an overnight basis when we have those needs. And we will continue to expect to manage our net total debt-to-EBITDA ratio to stay under 2x, which we think is a good proxy for the way the rating agencies calculate our leverage. We think if we use that target, it transfers into the leverage ratio that the rating agencies will be comfortable giving us a BBB flat.

Todd Duvick - BofA Merrill Lynch, Research Division

Okay, that's helpful. And I guess, also, you have an $850 million in debt maturing in the first half of 2012. Can we expect you to refinance most or all of that closer to the time of maturity?

J. Michael Schlotman

Yes, about half of that comes due in April and the other half in June. And we would expect to, at this point, to refinance that sometime early next year. We've already, as you may have seen in our second quarter 10-Q, entered into a series of interest rate, of forward-starting swaps to lock in some of the interest rates as some of the 10-year and -- 10- and 30-year treasury. Those days where they have taken a dip, we've been active on locking in some of those in a forward-starting swap basis to take some of our exposure to rates between now and then off the table.

Operator

Your next question comes from the line of Ken Goldman with JPMorgan.

Kenneth Goldman - JP Morgan Chase & Co, Research Division

You talked a little bit about customers buying smaller pack sizes, seeing that across categories. But Heinz talked a couple of weeks ago they wanted to introduce a greater number of these packages but they were a little bit late versus their own expectations in doing so. Is this something you're experiencing that you want to fill your shelves with more of these reduced size items, maybe can't get them yet from manufacturers? Or are you happy with what you're receiving? And I guess along this line, can you help us understand a bit better in which categories consumers are looking for these smaller sizes, whether or not maybe where the strategy is effective or it's less so? Just hoping to get some color because it is a little bit of a sea change in how consumers are shopping.

David B. Dillon

Well, actually, what we're seeing is actually people shifting pack sizes, not just to smaller but also to larger depending on the item and the situation. So it's really customer-specific and customer-need specific. Rodney, you may have some comments to the rest of the question, though.

W. Rodney McMullen

Yes. Well, in terms of specifics, every category is different. So literally, you'd have to go through a hundred different categories for the answer. Whether we pick up an item or not, as you know, is really based on our belief in what customers tell us is important to them. So if they come up with something that we think the customer would want, we'll add it. If they don't, we won't. If you look in our own corporate brand categories, you'll find some items we've moved to smaller packs. Other items, we've actually moved to bigger packs. And it really -- it is category-specific.

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Okay. And then you've had the lead in consumer insights for years in grocery, and obviously, you do a great job with that. Some of your competitors, though, have spoken lately about getting better at this. So I'm just curious if you're seeing anything interesting in the marketplace in terms of other supermarkets benefiting more from loyalty cards or personal e-mails than they previously did, anything like that? I know you don't have specific insights but maybe how it's affecting you, if at all, or maybe nothing's changed as for as you can tell?

David B. Dillon

Everybody wants to get better than they are at this as we do, and we expect to improve just as they're expecting to improve. I don't think I'll speculate on what their success has been.

W. Rodney McMullen

The only other thing, Dave, I would add is that we're working really hard to make sure that we have that next generation of what's being done. We started doing some personalized offers and pricing 4 or 5 years ago. There's all kinds of things we're doing that's really the next version of that and in making it even better for our customers. So we're not standing still either, and we've always assumed our competitors will keep getting better.

Operator

Your next question comes from the line of Chuck Cerankosky with Northcoast Research.

Charles Edward Cerankosky - Northcoast Research

I'd like to ask a little bit about your pharmacy operations, how that's been tracking and are you happy with it? And are you doing anything there to tie it into the customer loyalty strategies?

David B. Dillon

If you look at pharmacy, we're just delighted with our trend and where we are. Obviously, there's a lot of things going on in the marketplace at the moment. In terms of using loyalty, that's something that, yes, we are working hard on improving, how to use loyalty data for the benefit of our customers. They are just like we are in every department. One other thing that I'm sure you know, if you look at -- as you look out to 2012, there's a lot of major drugs that will be moving to generics that will affect sales in that department. But gross profit rate will be helpful. But there's a lot of change going on right now in pharmacy as you know. We're very pleased with the quarter that we had and the trend that we're on.

Charles Edward Cerankosky - Northcoast Research

You do any gas rewards tied to the pharmacy? I don't recall, but I think you do.

David B. Dillon

That would be correct. We do. Get your prescription refilled at Kroger and you can see how it works.

Charles Edward Cerankosky - Northcoast Research

Open some stores here, Dave. How about gasoline profitability, just looking at that compared to a year ago and the most recent quarter?

J. Michael Schlotman

Yes, if you look at gasoline profitability, it was the dollars were essentially exactly flat so it didn't help that it didn't hurt the quarter on a year-on-year basis. The reported cents per gallon margin that we talked about was up. But when you reduce that margin for the debit and credit card fees, because they go up as the retails go up, that margin was essentially flat.

Charles Edward Cerankosky - Northcoast Research

And finally, what did Thanksgiving business tell you about the customer?

David B. Dillon

Well, let me give you sort of an update just through the quarter, the fourth quarter. We have, what, 3.5 weeks I think in this quarter behind us, and our identical sales have been consistent with where they were in the third quarter. And we would say Thanksgiving was at least that good. We were very pleased at the Thanksgiving holiday, because Thanksgiving is embedded in those numbers. But we're pleased. I don't think I can give you much more details than that but that will give you a sense that the quarter's starting out certainly in the right direction.

Operator

Your next question comes from the line of Karen Short with BMO Capital Markets.

Karen F. Short - BMO Capital Markets U.S.

First thing just on your next year's guidance. The 8% to 10% excluding the extra week, just curious what's driving the higher rate because you've obviously been fairly committed to the 6% to 8% rate for a while? And then, I guess, the second part of that is can you maybe just remind us what the impact on -- EPS impact was from the extra week last time you had a 53-week year?

J. Michael Schlotman

Part of the reason that we think next year will be a little bit higher, we think the base operations will perform in a similar fashion to this year. But it's really the benefit of the higher share buyback this year and the carryover effect of that next year. You don't only get the benefit that you can buy the shares, you get some next year, and it's recognition of that. Relative to the extra week, we will give you guidance on what we think the extra week is worth in March because I don't want to go back to what it was last time because every year is different. We have to look at which week the Super Bowl falls in and things like that before you really do it. And I frankly am not that far into the 53rd week yet.

Karen F. Short - BMO Capital Markets U.S.

Okay, that's fair. And then I know you're trying to veer us away from this but can you talk -- can you give us the selling gross margin trends in the quarter?

David B. Dillon

Well, we're not going to give the specific number but it was gently improved from where we were last quarter is about all I guess we'd say at this point.

Karen F. Short - BMO Capital Markets U.S.

Okay. And then looking at your sales trends, I guess, throughout the quarter and then now into the first few weeks of this quarter, you were kind of running -- I mean, you said you're kind of running in line with your second quarter results for the first few weeks of the third quarter so that was kind of a 5-3 type of number. Can you talk about this trend throughout the quarter? And then it would seem that at least when you look at the 2-year trend for the first 3.5 weeks of the fourth quarter, your ID has reaccelerated. So maybe just us a little color there?

David B. Dillon

Well, first, let me go back to the selling gross just for a second to make sure I said that in a way that's understood. When I said it's slightly improved from last quarter, what I meant was, as you would look at it, the amount of the investment we made last quarter and selling gross in the second quarter, it was a little less investment in the third quarter.

Karen F. Short - BMO Capital Markets U.S.

Right, that is what I figured. Okay.

David B. Dillon

I just want to make sure I explained it right. As for sales trends for the quarter, it was -- the quarter itself was basically consistent. Of course, we have several ups and downs, but I don't -- I can't see a pattern that I think would be useful to describe here. And in what I said about Thanksgiving, Thanksgiving was at least as good as where the trends were but which meant it would have been a good week, a good solid week. But I wouldn't characterize it as noticeably higher than, say, the trend in the third quarter. So I'd say the fourth quarter started out pretty much like the third quarter's average was, is what I meant to say. I hope that's what I said.

Karen F. Short - BMO Capital Markets U.S.

Okay, that makes sense. And then on the operating expenses this quarter, they seemed fairly encouraging. Anything to point to there and what was driving that?

David B. Dillon

Yes, they were encouraging, and even more encouraging when you realize the -- what was it, 45 basis points that we had to overcome on the incentive plan, the healthcare, the pension and credit and debit card fees, that made it even a stronger result. Nothing like strong sales to help, that's really important. But perhaps the most important is the attitude of the whole organization. Our associates are really focused on how they can reduce cost because they recognize, and that's why we repeat so often what our business strategy is. They recognize that the objective of lower costs is to fund investments in things that matter to the customer, which goes to produce more jobs for our employees, increased hours we're running on average in our stores, more hours per week used in labor this year than we used last year for the same time period. And that's a really positive trend. And that's because we're finding places to save in order to invest. So I think that attitude, the empowerment of our associates has probably driven that more than almost anything else.

Rodney, anything to add to that? Okay.

Operator

Your next question comes from the line of Jonathan Feeney with Janney Capital Markets.

Jonathan P. Feeney - Janney Montgomery Scott LLC, Research Division

I wanted to follow up on an earlier question. I'm not asking here about Walmart or any other competitors, pricing or execution in the marketplace. I'm asking specifically here about expansion plans and total square footage dedicated to your food retailing coming into your territories. It seems like several alternate retailers, hard discounters, you name it, are expanding. It seems like consumer that's a little bit more constrained is getting more creative about the places where they shop, particularly at the low end, and others are expanding assortments. And just wondering if you did any thinking about that and if you could put a number on, over the past year or the past couple of years, how much more capacity, if you will, has come into your markets and whether that's accelerating or decelerating right now?

David B. Dillon

We won't be putting a number on it, but I'll just tell you these 2 background points that may be helpful for your thinking about this. First, one of the trends that we saw 10 years ago, and it's certainly clear today, is the fragmenting of where people buy food. It's no longer -- and it hasn't been for many years now, no longer just in supermarkets. And if you look at where food is purchased, you can see that is obvious. And so that trend continues and that plays into a little of what you're describing. And second is that we see in every market, and have seen this in every year, changes that are always happening. It's a dynamic kind of business. And we look at it on a local market basis and what's happening in each market and we try to react in those markets. And so certainly you can describe markets where what you're saying is happening. But you can also describe markets where that's not happening. And so I would have to say that every year is different, every market is different. Rodney, do you want to add to that?

W. Rodney McMullen

Yes, the only thing I would add is we're finding in some situations the competitors when they open up, our estimates would show they take a lot more volume from their own stores than what we would have necessarily seen in the past. And there is a point where there's a certain amount of customers like to shop a certain store or format. But it's not 100% of customers want to shop a certain type of store. So we are seeing that. The other thing we're also seeing is competitors continue to fall out too. It's just the profile of those is not high as the ones that people open up.

Jonathan P. Feeney - Janney Montgomery Scott LLC, Research Division

What do you think -- just as a follow-up, what do you think needs to happen for that to slow down or stop? I mean, it seems like everybody in the industry is -- I don't think anyone in the industry is saying it's great out there. Even some of the faster-growing small and limited assortment players, so you've -- what do you think needs to happen to convince people or make them unable or unwilling to grow their commitment to compete with established players like yourself?

David B. Dillon

Well, I think we've said before it's a rational market place. And if you were to look at just at Kroger, for instance, what drives our thinking is what happens with the actual results. And so the question you're asking is if the results at the return on capital and assets doesn't end up paying the bill, in your experience, then you change your course. So I think what you see over -- if you'd go over a 10- or 20-year period of time, most retailers' behavior change is based on what they're actual experiences have been. Now they sometimes have to go learn that lesson the hard way by getting in the market and discovering that, hey, this doesn't work or that didn't work. But they, eventually all of us, learn those lessons and change our behavior when that happens. We have time for one more question.

Operator

Your final question comes from the line of Andrew Wolf with BB&T Capital Markets.

Andrew P. Wolf - BB&T Capital Markets, Research Division

Given the tonnage was up a little in Q2 and flat in this quarter and the gross margin got better, is it fair to take away from that, that the penny profit per item, not only was positive, but was -- the rate was better this quarter than last quarter? And if so, what's driving that? Is that pricing being passed through into the market? There's rationality and just sort of retail pricing market-wide catching up to the previously -- the inflation in product costs? Or is it just something Kroger rationing back because from -- in Q3 from Q2?

W. Rodney McMullen

Yes. Penny profit per item would be slightly higher in the third quarter than the second quarter. As Dave mentioned before, we certainly see the market being very rational out there. Tomorrow, that could change. But so far, what we're seeing is very rational. I wouldn't say it's so much of a Kroger change as -- it's the whole market needing to continue to make sure that the costs we get, we go ahead and pass that through.

Andrew P. Wolf - BB&T Capital Markets, Research Division

Okay, that's helpful. So then when I look at the guidance for the year, you bumped up the high end of earnings per share to $2 by $0.05, but you didn't take up the high end of same-store sales. So staying on the same theme, unless there's something going on in your cost structure or what have you, and you -- it would seem to me it's more about the marketplace rationality and given the consumer is not in great shape, nevertheless, is still accepting some further price increases and that it's fair to say retail pricing market-wide is, to some extent, still catch -- doing a better job of catching up to the inflation in product pricing.

David B. Dillon

I think it is. I think that's true really across the market that we see, generally speaking, prices are following the cost increases.

Andrew P. Wolf - BB&T Capital Markets, Research Division

And am I right that -- and this is the last follow-up, that, that's essentially mainly what's embedded in the way the guidance increase shaped up?

J. Michael Schlotman

I think, Andy, it's just a matter of we now know what third quarter was. Our guidance for the third quarter was we've expected it to be one of our softer quarters of the year because of the tax benefit last year. We actually were able to post a very strong third quarter. And where you look -- you look at where we are year-to-date of $1.50 and what we think we can generate in the fourth quarter given how we performed so far this year, that's your -- just where the world shakes out. You're right, we didn't raise the high end of our ID sales guidance, but starting out at 5%, that's a pretty strong trend and it's delivered the $1.50 so far this year and we expect it to be able to continue to deliver for the balance of the year.

David B. Dillon

Thank you. And so before we end the call today, I'd like to share some additional thoughts with our associates who are listening in today. We encourage them to listen.

You may recall that in November, Kroger was named the most generous company in America by Forbes Magazine. This is a great honor for our company, and each of you is responsible for having made it happen. Thank you for caring so much about the communities that -- in which we live and work.

Wherever we operate, our associates seek out ways to support the local charities and organizations that matter most to them and to our customers. Looking at cash alone, for example, in 2010, Kroger donated $64 million to charitable initiatives. Nomination of corporate and retail division contributions, our community rewards program and funds from vendors in our "Bringing Hope to the Table" and "Giving Hope a Hand" campaigns. That figure is much higher when you add in the food and product we donate to local communities. It's closer to $200 million for 2010. On the whole, Kroger donates the equivalent of 125 meals a year to local food banks -- 125 million meals to the local food banks. Even more impressive is your personal commitment and donation of your time as volunteers to support our neighbors in need. Whether you organize a local fund raising event, volunteer at a food bank or help deliver holiday meals to families, you make a difference. So special thanks to all of you.

In today's environment, the role we are playing in our communities is more important than perhaps ever before. We just talked about the stress that so many Americans are under and that includes many of our associates. Now is the time of the year they need our help most.

Finally, we thank our associates who work so hard throughout the holidays to keep our stores open and stocked for our customers. I hope each of you also celebrate the season with your family and friends. As one of our associates added to the blog this week, as retailers especially at holiday time, many of us made Kroger a part of our family. It's true for many of you as it is for me. So it is personal for me to say to each of you individually, Merry Christmas, Happy Holidays.

That completes the call today. Thank you all for joining us.

Operator

We thank you for your participation in today's conference. This does conclude your presentation. You may now disconnect, and have a great day.