The Kroger Co. (NYSE:KR) Q2 2019 Earnings Conference Call September 12, 2019 10:00 AM ET

Company Participants

Rebekah Manis - Director, IR

Rodney McMullen - Chairman & CEO

Gary Millerchip - CFO

Conference Call Participants

Rupesh Parikh - Oppenheimer

John Heinbockel - Guggenheim Securities

Edward Kelly - Wells Fargo

Michael Lasser - UBS

Judah Frommer - Credit Suisse

Robbie Ohmes - Bank of America Merrill Lynch

Karen Short - Barclays

Operator

Good morning and welcome to the Kroger Company Second Quarter 2019 Earnings Conference Call. [Operator Instructions] I would now like to turn the conference over to Rebekah Manis, Director of Investor Relations. Please go ahead.

Rebekah Manis

Thank you, Gary. Good morning and thank you for joining us. Before we begin, I want to remind you that today's discussions will include forward-looking statements. We want to caution you that such statements are predictions and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings. The 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. In addition, please save the day for our 2019 investor conference, which will be held in New York City on November 5th. Further details will be shared 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, Rebekah. Good morning, everyone, and thank you for joining us. Let's meet today to review Kroger's second quarter 2019 results, it's Chief Financial Officer, Gary Millerchip. Kroger is focused on executing the second year of our Restock Kroger plan to generate shareholder value by serving America through food inspiration and uplift. Restock Kroger has four main drivers, redefine the grocery customer experience, partner for customer value, develop talent and live our purpose. Combined, these drivers come together to create shareholder value. We are halfway through the second year of our three-year plan.

We continue making strategic investments to reposition the Company for the future, while continuing to grow and deliver today. We started this conversation the last two quarters by acknowledging we had our work cut out for us. As always, we remain energized by that challenge. While we're always continually driving for improvements, there are several examples in our second quarter results that reflect the disciplined focus of Restock Kroger blueprint is paying off. Guided by our customer obsession, Kroger delivered our best identical sales results since the launch of a transformational plan. Our internal customer measures are improving even faster than our identical sales growth. There is always a lag between improving the customer experience and when the customer will reward us.

Some other positive trends during the second quarter include FIFO operating margin that was stable and our supermarket business excluding fuel and pharmacy. 15 of our divisions had increasingly -- increasing supermarket identical sales without fuel, compared to the first quarter. We continue to reduce cost. We are on track to deliver $100 million in incremental operating profit through alternative profit stream growth. We continue to make significant investments to redefine the grocery customer experience. We are building a platform of seamless experiences to serve customers, anything they want, anytime they want, anywhere they want.

We know the seamless experience is essential to the customer experience both today and tomorrow, which is why we continue to invest heavily in our capabilities in this area. Kroger's digital sales grew by a solid 31% in the second quarter. Pickup and delivery sales growth continued to perform in the mid 30% during the quarter. Going forward, we expect our digital sales growth rate to moderate year-over-year, primarily due to the cycling of Home Chef and as a result of our disciplined focus on growing the ship customer of our other digital offerings like Vitacost. Vitacost remains an important part of our business in our growth and ship is in part thanks to what we've gained from their platform and talent. We've also expanded our digital coverage area to reach 95% of our customers. This means that 95% of our customers who shop Kroger in a brick and mortar store can also shop with us for pickup or delivery.

Importantly, we are starting to see improving operating profit trends in our digital business. Our digital business is becoming less of a headwind, which is an important inflection point as we continue to invest in new capabilities to support our transition to seamless.

However, I do want to note this is still a significant investment for the Company. A great example of partnering for customer value is our continued rollout of Ocado sheds. In July, Kroger and Ocado announced plans for a new high tech customer fulfillment center in Forest Park, Georgia. What's so exciting about Ocado is that their model to deliver to customers is significantly less costly than our existing model.

So not only will sheds accelerate our ability to provide customers with a seamless experience, they will also help us to do it in a much more cost effective way. We know Ocado's value is not just its current capabilities, but also in how quickly the Company is able to innovate to serve a rapidly developing online consumer market. Ocado's technology team of over 1,400 software engineers brings a huge depth of talent and a long track record of innovation to growing opportunities in online grocery retail.

We also announced an expansion of our relationship with Walgreens to a new test area in Knoxville, Tennessee. Starting this fall, 35 Walgreens stores in the area will feature a curated selection of Kroger's popular Our Brands products like Simple Truth, America's largest natural and organic brand, along with national brand products. Kroger's Our Brand sales grew 3.1% this quarter, retail and unit share growth led to the highest second quarter share in Our Brands history. We also introduced 203 new Our Brand items during the second quarter.

Our customers favorite new items key food and flavor trends we predicted and then shared with our investor community last year at Investor Day. And those new items delivered more than $137 million in incremental sales during the second quarter. Further bolstering our supermarket business. We were thrilled to share the news last week that Kroger is leading the way with the widest assortment of plant-based protein among US retailers through our Simple Truth brand. We continue to see progress in our alternative profit streams with media and Kroger Personal Finance as the primary growth drivers. Gary will share additional commentary on the progress of our alternative profit streams in his section.

Now, moving to talent development. As we've previously shared, we are proud that our average hourly rate is over $20 per hour with comprehensive benefits factored in, benefits that many of our competitors don't offer. As a result of Kroger's talent development investments, we are significantly improving employee retention in one of the tightest labor markets in years. We continue to invest in our associates as part of Restock Kroger by supporting associates in a variety of ways, including investment and wages, training and development.

Feed Your Future is our industry-leading education assistance program, continues to build momentum. Among all the participants more than 85% are hourly store associates. Since inception of the program last year, we've distributed 3,000 awards totaling $5.1 million in education assistance. In addition to continuing to develop talent internally, we continue to recruit talent from the outside, especially in the areas of digital, technology and supermarkets. Increasingly, customers, associates, stakeholders, and US investors are choosing who to partner with based on a purpose and values. We were pleased to see the Business Roundtables recent announcement acknowledging that businesses have a responsibility to be a positive influence on society. Kroger has always been focused on being a trusted partner in communities and committed to social purpose.

In the second quarter, we were proud to publish our 2019 environmental, social and governance report, reflecting our efforts across the Company to be environmentally responsible and a positive influence on society. The report detailed progress on Kroger's Zero Hunger/Zero Waste social impact plan, as well as our 2020 sustainability goals. Other items highlighted in the report included our 9% reduction in food waste generated by retail stores. We achieved a 13% improvement in supermarket food waste diverted from landfills, moving from 27% diversion in 2017 to 40% in 2018. We reduced the amount of plastic resin in Our Brands packaging by 9.1 million pounds so far, well, on our way to achieving our 10 million pound goal by 2020.

I will now turn it over to Gary for more detail into our quarterly financials. Gary?

Gary Millerchip

Thanks, Rodney, and good morning, everyone. Our second quarter results demonstrate our ability to deliver for shareholders while we reposition the Company for the future through Restock Kroger. For the quarter, we delivered an adjusted EPS of $0.44 per diluted share. I'd like to highlight a few areas in our business that were particularly robust. Our Brands contributed as both a sales driver and a profit leader. The entire Kroger team brought discipline to controlling costs during the second quarter and delivered on our Restock Kroger savings plans.

The alternative profit businesses achieved budget, setting us up to deliver our incremental operating profit target for 2019. And our fuel performance was strong, helping mitigate pharmacy gross margin, LIFO and tax headwinds in the quarter. LIFO charge for the quarter was $30 million compared to $12 million for the same period last year, driven by a higher than expected inflation in dry grocery, pharmacy and dairy. Our adjusted corporate tax rate for the quarter was 23.9%, compared to 18% in the same period last year. These two factors combined represented a $0.5 [ph] per diluted share headwind in the quarter compared to last year.

As Rodney mentioned, Kroger reported identical sales without fuel of 2.2% during the second quarter, marking our strongest quarter since we launched our transformation plan. Several departments outperformed the Company in the quarter, including key beverage categories, produce and natural foods. We were also pleased with top line momentum in our pharmacy business and experienced mid-single-digit increase in script counts. Overall, we are pleased with sales progress in the quarter and we will continue to work to build on this momentum in the second half of the year. Adjusted FIFO operating profit for the second quarter was $626 million, an increase of 10.6% compared to the second quarter in 2018. Gross margin was 21.9% of sales for the second quarter. FIFO gross margin, excluding fuel decreased 29 basis points from the same period last year, primarily driven by industry-wide lower gross margin rates in pharmacy and continued growth in our specialty pharmacy business. Retail supermarkets, excluding fuel and retail pharmacy saw a 12 basis points of gross margin investment.

Based on the needs of the business, we are focused on balancing margin investments and capturing cost of goods, sourcing savings and operational efficiencies to offset these investments. As a great example of this focus, our associates have done an impressive job managing shrink, which improved in the second quarter compared to last year. This represents the eighth consecutive quarter of year-over-year shrink rate improvement. OG&A costs as a rate to sales, excluding fuel and adjustment items decreased 14 basis points. This was achieved through continued focus on execution of Restock Kroger initiatives that drive administrative efficiencies, store productivity and sourcing cost reductions. We always look for opportunities to improve free cash flow and ROIC, important metrics to Kroger shareholders.

During the quarter, we accepted a substantial offer to some unused warehouse that had been on the market for some time. Kroger used to gain from this transaction as an opportunity to contribute a similar amount into the UFCW company pension plan, helping stabilize associates future benefits. The net impact of these transactions to EPS growth was neutral. As we have previously shared, fuel is an important part of our strategy to drive customer engagement, and our loyal customers continue to receive hundreds of millions of dollars in fuel rewards each year in the form of price discounts at the pump.

The average retail price of fuel was $2.71 this quarter, compared with $2.85 in the same quarter last year. Retail fuel profit came in above our expectations for the quarter. Our cents per gallon fuel margin in the second quarter was $0.35, compared to $0.26 in the same quarter last year. Fuel is a great example of Kroger sourcing teams continuing to improve buying practices. This allowed us to achieve improvement in fuel cost of goods in the second quarter. We now expect fuel to be less of a headwind in the second half of the year than originally anticipated. Alternative profit streams are on track to contribute an incremental $100 million in operating profit in 2019. Media and Kroger Personal Finance will be the primary drivers of growth this year.

Kroger precision marketing continue to build momentum in the quarter increasing engagement to over 300 consumer packaged goods companies and they experienced a 90% retention rate along with significantly higher spend. Kroger Personal Finance also saw growth in line with expectations during the quarter, as we successfully expanded the number of customers and the frequency with which customers utilized these products. And now for an update on labor relations. We ratified the new labor agreement with the UFCW covering associates in Fort Wayne, Indiana; Louisville, Kentucky and Nashville, Tennessee during the second quarter. We also reached a tentative agreement with the UFCW covering 17,000 associates in our Ralphs division in Southern California earlier this week.

We are currently negotiating with the UFCW for contracts covering store associates in Las Vegas, Memphis, Portland and Seattle. Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality affordable health care and retirement benefits for our associates. We continue to strive to make our overall benefit package relevant to today's associates. Our financial results continue to be pressured by inefficient healthcare and pension costs, which some of our competitors do not face.

We continue to communicate with our local unions and the international unions, which represent many of our associates on the importance of growing our business in a profitable way, which will help us create more jobs and career opportunities and enhance job security for our associates. Our financial strategy is to use our strong free cash flow to drive growth while also maintaining our current investment grade debt rating and returning capital to shareholders. We actively balance the use of cash flow to achieve these goals. We committed to prioritize free cash flow, to reduce the Company's net total debt to adjusted EBITDA ratio to within our target range of 2.3 to 2.5.

Over the last 12 months, net total debt has reduced by $1.3 billion and Kroger's net total debt to adjusted EBITDA ratio is 2.46 for the second quarter of 2019 compared to 2.59 a year ago. We remain committed to our target net total debt to adjusted EBITDA range and as we start to operate consistently within that range, we will explore options for returning additional capital to shareholders. Earlier this year, Kroger increased the dividend by 14%, marking the 13th consecutive year of dividend increases.

Turning now to guidance for 2019. We continue to expect identical sales growth, excluding fuel to range from 2% to 2.5% in 2019. We continue to expect adjusted net earnings to range from $2.15 to $2.25 per diluted share and adjusted FIFO operating profit to range from $2.9 billion to $3 billion for 2019. We are pleased with our second quarter progress and are maintaining full year guidance for 2019. With pharmacy gross headwinds expected to continue in the second half of 2019 and as we lap a particularly strong OG&A performance in the third quarter of 2019 -- 2018, we now expect EPS to be flat in the third quarter of 2019. In the fourth quarter, we expect double-digit EPS growth as we lap discrete items from prior year and continue to build strong momentum with our alternative profit streams.

I'll now turn it back to Rodney.

Rodney McMullen

Thanks, Gary. As Rebekah said earlier, our Annual Kroger Investor Day is coming up in New York on November 5th. As Gary just mentioned, we reconfirmed our 2019 guidance for identical sales, excluding fuel, adjusted EPS and adjusted FIFO operating profit, as well as reconfirmed that we are on track to deliver $100 million in incremental operating profit through alternative profit stream growth. We want to be clear on today's call that we are not reconfirming the three-year $400 million in incremental operating profit expectation. In November, we will give detailed 2020 annual guidance.

I do want to highlight that we do expect to deliver FIFO operating profit growth in 2020 over 2019 confirmed guidance. We've outlined a handful of key goals for our Investor Day and would like to use this opportunity to provide you with a preview. At Investor Day, we plan to reinforce our commitment to the overall framework of our Restock Kroger transformation plan, sharing what has worked well and what has not worked well, thus far. We intend to do a deep dive into our supermarket business, which underpins the redefining grocery customer experience pillar of Restock Kroger.

November 5th is the appropriate forum to be deliberate and to allow the experts on our team to spend the proper amount of time with our financial stakeholders to explain how we are thinking about Kroger's business model and how to measure the shareholder value created by Restock Kroger. Several of our Senior Executives will give detailed updates on our progress against the key metrics in our supermarket business and our momentum, as well as how we think about it going forward. We will reiterate the ongoing successful results behind our asset like margin rich alternative profit businesses. We will also talk about the continued strength in free cash flow since the announcement of Restock Kroger, which enabled us to get back to within our net total debt to adjusted EBITDA range earlier than expected.

In addition, we will share our views on the business as we look further out beyond to 2020, where growth is expected to continue. I've said it many times before, transformation is incredibly difficult and that's the journey we are on with Restock Kroger. As we reflect on this journey, we want to be transparent about what went according to plan and what didn't go as anticipated. Some things are coming to fruition, as we expected, but just later than we thought, such as identical sales momentum. Some things were unanticipated, such as the lower gross profit margins in the pharmacy business that the entire industry is experiencing.

Things we did expect and that are going even better than we thought, include productivity improvements and cost savings. Over the course of a three-year plan in today's retail environment, there are lots of puts and takes. That said, I want to reiterate that Kroger is committed to FIFO operating profit growth in 2020 over 2019 confirmed guidance. The Restock Kroger Transformation journey sets the Company up for long-term growth, looking forward and the benefits we have seen thus far have helped Kroger in our transformation from grocer to growth the Company. We have the right overall strategy and framework for this business and look forward to telling you more about it in November.

Now, Gary and I will take your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from Rupesh Parikh with Oppenheimer. Please go ahead.

Rupesh Parikh

Good morning and thanks for taking my question and also congrats on this quarter.

Rodney McMullen

Good morning.

Rupesh Parikh

I guess on the top acceleration, if you can give some more color in terms of whether you saw improvement in traffic or ticket? And also, what do you believe contributed to the top acceleration during the quarter?

Rodney McMullen

As I mentioned in the call, in the prepared remarks, it was broad based across most divisions. The area that we saw the biggest year-on-year improvement is average spend per item. Customers continue to go upscale and buy bigger product sizes. We also saw continued improvement in loyal households in terms of the numbers and the frequency of their visits. The other pieces to me that I was especially proud of our team is it's broad-based and it's really using our data to connect with customers on one-on-one.

Gary Millerchip

Rodney, maybe if I could just add a couple of things. I think what we're seeing, as Rod, you mentioned in the prepared comments, too, is many of the elements that we shared in the early part of the year around the accelerators that we expected to helps improve the trend in ID sales as we headed through the year have certainly started to show through in the metrics that we look at. So as you will recall, we talked about as we start to lap the heavier price investments from last year and the space optimization changes that we made in -- predominantly in Q2 and early Q3 last year. As Rodney mentioned, as we're seeing the customer metrics that we look at internally and continue to execute better on starting to show through a trend and improving sales performance.

And while we -- as we shared on the call and in the press release, the absolute digital sales growth was a lower rate that was already an adjustment for the Home Chef purchase a year ago and when you look at click list and home delivery, they're still performing very consistently and driving significant growth. And I think we see all those components continuing to build and certainly in the way that we looked at the year and expected Q2 and Q3 and beyond to play out, we're seeing a lot of those elements that we expect, it's starting to show through in the results.

Rupesh Parikh

Great. A quick follow-up question. Any color you can provide on the quarter-to-date trend?

Rodney McMullen

If you look at quarter-to-date, obviously a year ago there was a hurricane that affected a couple of our divisions in a meaningful way and we're in the middle of that -- middle that happened a year ago. If you exclude those two divisions, we would be slightly ahead of where we were in quarter two, but it's just slightly. And I excluded those two divisions just because until we get through the total cycling, it's really hard to say exactly where we'll be. But continue to progress.

Rupesh Parikh

Thank you.

Rodney McMullen

Thanks, Rupesh.

Operator

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

John Heinbockel

So Rodney, curious, your take on the pharmacy business right, where it sits today. Obviously it looks like a fair bit of pressure on EBIT margin, how transitory you think that is? And when you think about that business long-term, I know you've always wanted to kind of own that customer because of the loyalty factor. Do you think about ways to do something with that business to alleviate the pressure on the P&L?

Rodney McMullen

The one point you made, I think is incredibly important. If you look at the pharmacy customer, that customer is incredibly loyal to Kroger and when you look at their total spend, it's a fantastic customer to have. When you look at the pharmacy business overall, it continues to be very, very profitable relative to the assets invested and obviously year-on-year there is headwind, but when you look at the total business, it still continues to be a strong business.

The other thing is our pharmacy team has done an incredible job on -- two identifying opportunities to build the business, which obviously you get a flow through benefit of that and significant operating changes to take costs out of the business. Now, taking costs out of the business mitigated a meaningful part of the gross pressure, but still, there's more things to be done on taking costs out and process changes. So, when you look at the business overall, I'm incredibly excited about the progress we're making, but looking forward, I think it's still a critical and important component of our overall business strategy.

John Heinbockel

Okay, thanks. And then secondly, when you think about the Ocado rollout, right, one much pressure on 2020. I know they won't open until '21, but probably little pressure on '20. But then secondly, do you yet have sort of an ideal budget for the Ocado progression right from day one it opens, the shed is unprofitable by some amount and the time to profitability is ex number of months or quarters. I know it's a theoretical, but have you been able to get your arms around that?

Rodney McMullen

Well, I would say we have an estimate on expectations on that. And it would be different depending on whether it's an existing market or a new market. And if you look at our budget expectations in a new market, it would take longer for a ramp of profitable -- to profitability versus an existing market where you can move volume over on day one. The modeling that we've done is really using the experience Ocado has had in their ramp ups in England and adjusting it for, traffic patterns in the US, locations of our stores, location of customers and labor rates and those types of things.

Obviously, until you get a facility open, you don't know whether to follow those assumptions are correct. We would typically expect that facility to be somewhere year two to year three before it gets to profitability. But, that is -- time will tell. But the best of our estimates and best of the experience that Ocado has had. The other thing that we're hoping is if you look at each facility Ocado has opened, it keeps -- it gets better on a ramp up than the prior one. And one of the nice things is that Ocado will open up a facility in Canada that will be able to learn from as well, plus the learnings they've had. And that's the one piece that we haven't included in the budget is the fact that they keep getting better.

John Heinbockel

Okay, thank you.

Gary Millerchip

The other piece to mention, and you referred to in your opening comments as well, as we're learning a lot more as we continue to see as customers evolve digitally engaging with us and so we have a clear model in our mind of what our expectations are, but that model continues to evolve as we learn how customer behavior changes between delivery to home, between pickup at the store, and really making sure that we're optimizing the efficiency and the innovation from Ocado to really support the whole digital ecosystem. And I think that's going to take us more exciting as we think about how the way the customer is changing and how Ocado can meet those needs in the future as well.

Rodney McMullen

And Gary, just implied and I talked about it in the prepared remarks, Ocado is significantly more efficient than the way we're doing it today.

John Heinbockel

Thank you.

Rodney McMullen

Thanks, John.

Operator

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

Edward Kelly

Good morning. Rodney, I wanted to ask you about 2020, and I know you talked about -- that you're thinking grow FIFO operating profit. You didn't want to give a lot more detail, but I was hoping that you could provide some additional color around the key drivers to that? And then I also wanted to ask, because, you've pulled guidance now, which is okay because no one thought you were going to get there. But you've also introduced uncertainty to investors, because we don't know what you're thinking. Is there some minimum expectation that you could at least speak to today to help us out in terms of how you're thinking about 2020 and where this business is going?

Rodney McMullen

Yes, a couple of comments, as you mentioned. We'll get to a whole lot more detail in November on all the pieces and we'll also talk about 2020 and beyond. If you look at the key drivers, it would continue to be identical sales growth. Obviously, managing our gross profit margin, we continue to find a lot of cost opportunities, everything from process changes to cost of goods, the goods not for resell. And in fact, one of the things that we're identifying there is -- there's a longer stream of opportunities than what we did even originally expected as part of Restock Kroger.

On the guidance for 2020, that was the reason that I made the comment that we didn't want to be clear that we expect 2020 operating profit dollars to grow over 2019 provided guidance, just to make sure that people understood that we do expect a growth. We're in the middle of the process and that's a process, normally, we wouldn't finish until March of next year when we would give this next year guidance. We are accelerating it till November because we think it's incredibly important to do that. But, we are in the process on specifics. We did want to make sure that everybody understood that we do expect growth.

Edward Kelly

Just a follow-ups on it, so from a gross margin standpoint, your gross margin ex fuel pharmacy kind of flattening out, can we expect that to continue over time? And then secondly, at your leverage target, historically, you've been very good about returning cash to shareholders, particularly through share buyback when your stock is perceived to be undervalued. Could that be a larger portion or could that be a larger initiative next year?

Gary Millerchip

Thanks for the follow-up questions. This is Gary. I'll take them in the order that you asked the questions. On gross margin, certainly we do continue to invest in price and as Rodney mentioned, there are significant offsets in the investments that we're making in the way that we're managing cost of goods as a team. And over time, we expect, as we've shared, as we reclassified alternative profit, that will also become a tailwind that offsets investments and helps gross margin as well. So while we certainly believe that price investments are such a critical part of the strategy, we do expect it looks different from what you would have seen in 2018 and 2017 in terms of a level of investment, when you look at the [indiscernible] that we have for 2019 and the rest of the year. As you know, we use our data and insights to really understand what's important to the customer and we're continuing to make sure we're price right on the products that matter most to the customer, both from everyday pricing and from the way we personalize the offers through using the data that we uniquely have available to us, because 96% of data is tethered to a loyalty card.

But we also know from customer insights that it's not just about price and ultimately our customers decide to shop at Kroger because certainly of value, but then also the quality of the products, the personalization that we can offer through our data and the freshness and the experience and so we do feel good around the plan for the rest of the year as we head into 2020, around how we'll manage those levers. From a free cash flow perspective to the second part of your question, I'd really just maybe reinforce a couple of the comments that we made in the prepared remarks that you should certainly expect Kroger to be continued to be focusing on how do we maximize free cash flow for the value of our shareholders. We are now about within the range. It's important to us that we demonstrate, we are consistently back in the range because there can be some volatility in our retail business and we want to make sure that we've delivered on our commitment to operate within the range, but certainly now that we're there and we expect to continue to generate free cash flow, we will be looking very closely at what's the most effective way to return capital to shareholders.

Edward Kelly

Okay, thank you.

Rodney McMullen

Thanks, Ed.

Operator

The next question comes from Michael Lasser with UBS. Please go ahead.

Michael Lasser

Good morning. Thanks a lot for taking my question.

Rodney McMullen

Good morning, Michael.

Michael Lasser

Good morning. It's also a follow-up on 2020. You mentioned that your cost takeout and your productivity and issues are doing better than what you previously expected, but obviously for you to back off some of your prior target, there are things that are not going as well as you anticipated. So, can you give us more detail, whether it's your ID sales growth, the market being tougher than you expected, the alternative profit stream on each of those different levers, can you give us more detail on what's not going as well as you expected?

Rodney McMullen

Sure, yes. A couple of those tie back to what we talked about before, but the pharmacy obviously is at a different level than what we expected when we did the original expectations just in terms of markets change -- structural changes, that's happened to everybody in the industry. Obviously, identical sales made progress -- are making progress, but it's taken longer than what we expected. If you look at alternative profit, it continues to be ahead of what we expected and continues to grow strongly and in November, we will get more details on all of those and productivity and process changes and cost opportunities, we continue to see a big pipeline for those and even more than what we originally expected. And just to remind everybody, we're taking over $1 billion a year of costs out of it to operate the Company.

Michael Lasser

And my follow-up Rodney is, when you put together this plan, you had some assumptions about the competitive landscape, both from bricks and mortar players as well as the emerging digital threat. How is that the overall market environment relative to where you thought it was going to be? Is it, presumably, given that you're backing off some of these target, it's probably a little tougher than you anticipated? Is that fair?

Rodney McMullen

No, I would -- when you look at the competitive environment overall, I would say it's pretty similar to what we thought at the time, the pharmacy would be the exclusion to that, that I mentioned. But when you look at the new operators in the market, we assumed that it would continue to be important. We've been proactive, especially since we merged with Harris Teeter on making sure that we create a seamless experience and have a strong digital offering. And I always tell everybody, job one is to make sure we don't lose the customer; job two is, we'll figure out how to make it profitable and we're indifferent whether somebody shops digitally with us or in a store. And as I mentioned in my prepared remarks this quarter, we actually saw that headwind was less in the second quarter, year-on-year from a digital standpoint. So when you look at overall, I would say we would say pretty much what we expected. Pharmacy is a little different. And we knew that there would be a transition period that we needed to transform the Company, which is what drove us behind the Restock Kroger commitments.

Michael Lasser

Thank you very much.

Rodney McMullen

Thanks, Michael.

Operator

The next question comes from Judah Frommer with Credit Suisse. Please go ahead.

Judah Frommer

Hi, thanks for taking the questions and maybe just a couple more follow-ups here. I think, like Ed said, it's not a big surprise that the guides pulled. Can you clarify if it's just the operating profit piece that's pulled? Is the free cash flow guide still intact or is everything gone?

Gary Millerchip

Hi, Judah. Thanks for the question. So as Rodney mentioned, we really plan to give you far more detail in November and we felt it was really important that we committed to doing that in six or seven weeks from now to be out to provide all the color. We still have obviously a huge confidence in the level of free cash flow that we're generating within the Company and continues to be a strength this year. I do think we would want to provide additional guidance on that alongside, as Rodney mentioned our future financial strategy and how we create value for shareholders at the November meeting.

Judah Frommer

Okay. That's really make sense and kind of in terms of what hasn't gone right versus what has, I would imagine that this quarter gives you more confidence in kind of the go forward process, ID is above to gross margin ex fuel and pharmacy down in the low double-digit range. Is part of the -- I would say pulling or pushing out operating profit dollar growth to perhaps, beyond 2020 is part of that getting back to a more normalized supermarket operating environment and delivery of supermarket operating income growth and can we expect that kind of this quarter and the guidance for the next couple quarters is indicative of what you think a normalized level is?

Gary Millerchip

We'll get into more details in November. But a couple of comments I would add to your comments. And I mentioned it in that first quarter earnings call, if you look at the things that we measure internally in terms that have the feedback, customers give us somewhat kind of experience, we're giving them. What we find is that there's always a lag behind identical sales and when the customer tells us we're doing a better job. And when you look at the second quarter, we certainly felt like that was a reflection of that and we continue to improve the experience. I want -- to get into a lot more details on it, I really think we're probably better off to where we have a lot of time in November, where we can go line by line. But I do think it was important for everybody to understand we do expect 2020 to have operating profit growth over the '19 confirmed commitment.

Judah Frommer

Okay. If I could just squeeze one follow-up. Is there a way you can address maybe market share in the quarter relative to your market share trends over the last few, I mean Q2 is certainly well above of industry scanner data?

Gary Millerchip

If you look at market share overall, we would say basically it's flat. It's within -- it's probably up or down a smidgen, but I would say we're not satisfied, but it's moving in the right direction.

Judah Frommer

Okay, thanks.

Gary Millerchip

Thanks.

Operator

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

Robbie Ohmes

Good morning, guys. Thanks for taking my question. Actually, two questions, you know, Rodney or Gary. The continued rollout of delivery and pickup, can you give us some help thinking about the shape of that impacting your EBITDA margin? Is it -- do you get to a point later this year or next year, where you start to anniversary pressures and you see alleviation from the pressures of that rollout? Any kind of help on that would be great? And my second, I just want to follow-up on the sorry the dry grocery inflation commentary, is that -- is that something that's building momentum? Is that CPG company pressure? Is that something that, you know is a tailwind for IDs in the back half and maybe into next year, that would be helpful as well? Thanks.

Gary Millerchip

Thanks, Robbie. So on digital, first of all, we are certainly continue to be very excited around what we see in the way that customers engage with us differently as they start to become more of a -- Rodney referred to as a seamless customer, where we're delivering for the customer both -- whether it's delivery to home or ship to home. And everything we see about the way that customer engages more deeply with us shows the value of that overall relationship across all the channels of store and digital working together. I know we've shared before that when we look at [indiscernible], we see a significant [indiscernible] from the customer when they fill that first basket. It's a much higher basket and a significant part of that stand is incremental. And then over time, we also see customers actually move to a position where their visits in the store actually increase as well as they overall build our loyalty with us.

And so you're right Robbie, it's very much a maturation curve, if you like. So we monitor every store and every vintage of the business that goes through that maturation of launching pickup and launching delivery to home. What we see is that curve where -- by about year two, year three of the customer engagement in those stores, we start to become really agnostic around how the customer is shopping with us because of the instrumentality that we see overall in that behavior and how they're more loyal to Kroger. So as we're starting to come through that maturity curve, that's really what Rodney was referring to when he mentioned that we start to see digital as less of a financial headwind in Q2 this year and then into the second half of this year, because we're really starting to see the maturation of that business, partly the customer behavior obviously accelerating, but also because we don't have the same startup costs and the same investments in launching those services.

So we certainly expect that to continue and we are very focused on how do we maintain and accelerate the growth of customer engagement through digital. We were pleased that we had a continuation of digital household engagement growing again during the quarter, and that's very much a focus for us. As we continue to grow their loyalty and we get past that maturation point. As Rodney said, it's still an investment overall for the business. So where we get even more excited when you think about the technology with Ocado and the opportunity to automate some of the back-end operation, if you like, providing those services, because that has the potential to significantly shorten the path to profitability as well when you think about the way the customer shops with us seamlessly overall.

Robbie Ohmes

So would you say, Gary, that the peak EBITDA margin pressure from the rollout of pickup and delivery has been passed? And we just passed it this quarter?

Gary Millerchip

That's essentially what we're seeing overall within the way we look at our digital business and the way you look at that custom maturation. That's right. That's kind of what Rodney was referring to.

Rodney McMullen

And Gary -- I agree with Gary's point, and we also continue to invest in ship and some of the other components as well -- that is a high start-up costs, but that's even reflected in the numbers that Gary has talked about.

Robbie Ohmes

Great. And then just on the -- sorry, the inflation outlook for dry grocery and what's driving that?

Gary Millerchip

Sure. Obviously, we deal with the question of CPG partners addressing price increases all the time. It's something that we deal with others on a case by case basis. And we feel we're in a particularly strong position to really understand what's happening there because of our own brand products and the way in which we can have those conversations to make sure that the price increases are legitimate cost increases coming through to us. Certainly, as we share, we are seeing our range for the year on inflation was we were assuming it would be somewhere between 0% to 1%. And what we're actually seeing in a couple of those categories that I mentioned in the prepared comments that we're slightly ahead of that range. We continue to obviously manage to try and mitigate those through cost of goods opportunities, and certainly where we do see the price increases coming through and we believe they are legitimate we are looking to pass that on to customers where it makes sense. And like you always do in the competitive environment.

Rodney McMullen

The other thing Gary, just wanted one edition that I think is always important to remind and we always remind our CPG partners, if they're raising costs more than the market's going up, our own brands always gains share. And it's an incredible strong quality product. Obviously, it's something that has been part of Kroger for a long, long time. And we continue to even be add more innovation in the lines in terms of the Kroger brand itself private selection and simple truth. So anytime a CPG adds -- changes cost versus what the market is doing from raw materials, what happens is Our Brands gain share as well. And that's also something I think it's important to remind everybody.

Robbie Ohmes

Great. Thanks so much.

Rodney McMullen

Thanks, Robbie.

Operator

The next question is from Karen Short with Barclays. Please go ahead.

Karen Short

Hi, thanks for taking my question.

Rodney McMullen

Good morning.

Gary Millerchip

Good morning.

Karen Short

Hi, I'm just curious. So back to the 2020 goals, I mean, obviously, you gave a pretty detailed answer on what was a little tougher. I think pharmacy stands there and ID is obviously taking a little longer. But fuel has obviously been a much bigger tailwind for you. So -- and I guess that hasn't changed. That's been the case. Fuel continues to be a tailwind for you. So I guess what I'm curious about is what really changed from 1Q when you reiterated the 3.5 to today?

Gary Millerchip

Thanks for the question, Karen. Certainly from a field perspective to kind of cover the first part. You're absolutely right from an overall performance of the business this year.

We feel the fuel business has continued to demonstrate great strength and for us, it demonstrates that the sort of value we believe in the diversity of the portfolio of businesses that we now have. Obviously everything is built on the foundation of food and that frequency of shop and the way customers are engaging with us and the loyalty data we create. But when you think about food alongside healthcare, the fuel margins that we’re generating are now alternative profit streams.

We feel good about the way it allows us to manage through some of these changes as they -- as we see them that are outside of our control and particularly in the case of pharmacy headwinds that we referred to earlier on the call. As we talk around 2020, as Rodney mentioned, we do want to make sure we provide you with a lot more color at the November meeting, around how we're thinking about the growth in the business. I know Rodney has obviously already referred to a couple of elements around areas of the business that we've learnt a lot. And as you alluded to in your comments, we've shared, I think very openly that we embarked on a major transformation for the Company, which involved transforming the experience in the stores and digitally that involve standing up to a number of new businesses around alternative profit streams and taking a dramatic amount of cost out of the business.

So, I think a lot of what we've been learning as we've shared, is that as we get smarter and better in understanding how all those pieces come together and the speed at which they will deliver, the benefits that we're expecting to Restock Kroger, we thought it was important to have to share with you today that we do believe that will deliver growth next year and operating profit over the confirmed guidance for 2019. And that we want to make sure that we spend the appropriate amount of time in November, really taking you through what's worked, the areas where we believe we still have opportunity to improve and how we see 2020 fully shaping up.

Rodney McMullen

And 2020 and beyond as well.

Karen Short

Okay, that's fair. And then I guess looking at the results this quarter, given obviously, again, strong fuel, I get core down 30-ish -- 31% in Q2. And I think it's fair to say that some of that is not within your control because it is pharmacy related. So wondering if you could just get me -- give some color as to whether or not that number is kind of consistent with where your numbers shake out? But also, maybe if you could parse out what the actual pharmacy, both specialty and regular pharmacy might have done in terms of pressuring the core?

Gary Millerchip

Yes, I think that the best guidance we can give Karen will be just refer back to a few of the points that we shared and the release and some of the comments that we made. Rodney mentioned it, from a supermarket perspective, when you take out fuel and retail pharmacy, essentially the operating margins were relatively stable. The pharmacy and the Kroger specialty pharmacy business were obviously a meaningful headwind during the quarter because of some of the industry headwinds that we see overall. But when you look at the investment in gross margin of 12 basis points that we shared around the supermarket business, excluding retail, pharmacy and fuel, and then the 14 basis points of OG&A benefit that we saw in the quarter, that's kind of really where I think is the best kind of data we would point you to give you a sense of what's going on in the business. And obviously, the gross margin, excluding fuel gross margin investment was 29 basis points. You've only got a sense of the disconnect, if you like, between what the health business impacted the quarter versus what the core retail gross margin investment was excluding pharmacy.

Karen Short

Okay, thanks.

Rodney McMullen

Sorry, we just have time for one last question.

Operator

And that question will come from Ken Goldman with JP Morgan. Please go ahead.

Unidentified Analyst

Hi, it's Tom Palmer [ph] on for Ken. Thanks for squeezing us in. Just a couple of quick one's for you. First, you called that hurricane as a tailwind a year ago for the third quarter. I mean, is there going to be some offset in the southeast, just given what we've seen with maybe people stocking up for Dorian?

Rodney McMullen

Dorian was -- helped a little bit, but not to the same degree as the hurricanes last year hit that center. And if you look in terms of just timing, the next three or four days will look altogether different because when the hurricane actually hits, then you have stores closed and customers aren't able to get into our stores. The thing about, as you know, on hurricanes, you never know when the next one's going to hit. And what we always strive to do is to make sure that we're ready there in advance for our customers. We support our associates and we're there as soon as it's safe to be back. We get our stores back and open and operating and we'll have our associates will go to whatever store they can get to, to work versus their home store. But anything at all, as soon as it's safe, we understand where a central component of a community and make sure we're there for them. So it's -- I would say Kroger is at its best when there's events like this, happens in terms of supporting communities and people.

Unidentified Analyst

Thanks for that. And then you've alluded to kind of the ability to look towards share repurchases again. Is that contemplated in your guidance for this year or would that essentially be upside if you go that direction?

Rodney McMullen

At this point, we really haven't made any decision on repurchases for the balance of the year. And if there was anything, it would be extremely modest. As you know, we are -- we just now got back into the range. As Gary mentioned, we want to make sure that we're judicious and not -- and look at cash flow as it's being generated and balance all the pieces. So at this point, I think it's a little early to say. I don't know Gary, anything you want to add to that?

Gary Millerchip

I think that's right, Rodney. Certainly, we're actively looking and making sure that we're maximizing free cash flow. But at this point, we want to make sure we were consistently within the range and as soon as we feel we're in that position, but it's certainly not contemplated currently in the guidance that we've provided for 2019.

Unidentified Analyst

Okay. Thank you.

Rodney McMullen

Thanks, everyone, for all the questions. So as always, before we end today's call, I'd like to share a few final comments directed toward our associates who listen in and how we all live our purpose every day, to our associates, thank you for your hard work. I am fortunate to meet so many of you across the Company and you are the incredible stories of what you do every day for each other in the communities. From our stores to plants and distribution centers and our corporate and division teams, you inspire me beyond my ability to express in words. Your passion for and focus on our customers is just incredible. More importantly, I am so proud of how you support each other and come together as a team. We are 460,000 strong and we are Kroger proud.

September is a special month for us as it marks the second anniversary of Kroger Social Impact Plan Zero Hunger/Zero Waste. We know we can't achieve this goal alone. And recently, the Kroger Co Zero Hunger/Zero Waste Foundation announced its inaugural cohort of seven innovators, who will join us in achieving our bold goal.

Thank you to all of our customers, associates and suppliers who make our business successful every day of the year. That completes our call today. Thanks for joining and we look forward to seeing you in November.

Operator

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