Kroger Co. (NYSE:KR) Q2 2018 Earnings Conference Call September 13, 2018 10:00 AM ET

Executives

Rebekah Manis - Director, IR

Rodney McMullen - Chairman & CEO

Mike Schlotman - EVP & CFO

Analysts

Edward Kelly - Wells Fargo

Judah Frommer - Credit Suisse

Erica Eiler - Oppenheimer

Karen Short - Barclays

Chris Mandeville - Jefferies LLC

Kelly Bania - BMO Capital Markets

Paul Trussell - Deutsche Bank

John Heinbockel - Guggenheim Securities

Robert Holmes - Bank of America

Operator

Good morning and welcome to The Kroger Company Second Quarter 2018 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] Please note this event is being recorded.

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, that 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. Thank you. Please save the day for our 2018 Investor Conference, which we'll hold in Cincinnati on October 29th and 30th. Details will be coming soon, and we hope you can join us.

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

Rodney McMullen

Thank you, Rebekah. Good morning, everyone, and thank you for joining us. With me to review Kroger's second quarter 2018 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

Restock Kroger is designed to reposition our core business by 2020, so we can achieve our long-term vision to serve America through Food and Inspiration and Uplift. We outlined the four main drivers of our plan last October. First, redefine the grocery customer experience. Second, partner for customer value. Third, develop talent; and fourth, live our purpose. Delivering on our objectives under each of these areas between now and 2020, will generate incremental operating margin dollars and free cash flow to create shareholder value. And while we are only two quarters into our three-year plan, we are making solid progress.

More importantly, I want to help you understand how all the steps we take today and in the future are set in motion with clear strategic intent in line with our vision. Everything we are doing is intended to create a truly seamless shopping experience, so we can serve customers anything, anytime, and anywhere. As we create a seamless experience, we will use our data to provide convenient and personalized food inspiration to help customers to be the hero to their families at meal time, every time.

You can see this through our exclusive arrangement to bring Ocado’s smart platform to the US, and in our recent launch of Ship. Kroger's new direct-to-customer shipping platform and in our continued expansion in home delivery, including our driver less delivery test with Nuro. You can also see this in our merger with Home Chef, part of what makes our merger so exciting is their data-driven and customer-centered approach to menu creation and meal solution development. Home Chef is accelerating our ability to deliver convenience, simplicity and a personalized food experience.

We are also building an expansive network of innovative partnerships to create new customer value. Alternative revenue streams will expand and enhance our strong core business and increase profitability. Partnering with innovators like Ocado will both accelerate our core business and serve as the foundational platforms for new opportunities. Our decision to launch our brands in the international markets through Alibaba's Tmall global platform is another example of our willingness to develop alternative revenue streams. And our people, generosity, and passion for Zero Hunger Zero Waste will make the world a better place.

We are incredibly excited to see that our Zero Hunger Zero Waste commitment earned Kroger a place among the top companies on Fortune Magazine's Change the World List. You can see our vision coming into focus in several of the exciting announcements we've made over the last couple of months, and we're obviously not done. As we share more of these very intentional puzzle pieces with you in the months and years ahead, a very clear picture will emerge. Every one of these announcements is both the culmination of a new beginning, and they are a culmination of the long focused strategic work by our teams, and they are the new beginning of the exciting innovations and growth platforms for the future.

Kroger's digital sales grew by over 50% in the second quarter. We are executing our digital strategy in growing our seamless coverage area which now reaches more than 80% of our customers, up from 75% in the first quarter. This includes our network of ClickList pickup locations, stores offering home delivery through Instacart and other partners, and ship to home capabilities such as our new Kroger Ship platform. Kroger Ship launched in four markets in August. Cincinnati, Houston, Louisville, and Nashville. We have since launched in Atlanta and anticipate rolling out the service to additional markets over the next few months.

During this first phase of Ship, customers can shop from a curated selection of over 4,500 of our brand products, which are not available anywhere else online, and more than 50,000 grocery and household essentials that matter most to our customers. A list informed by the 8451 [ph] data and insights. Executing our strategy and innovating our core business requires tremendous digital and technology talent. I'm pleased to share that this summer, Kroger Technology was named one of the best places to work in IT by Computerworld Magazine.

Also this summer, we announced Kroger is establishing a new digital headquarter in downtown Cincinnati. In the city alone, we expect to grow the digital team from about 600 today to over 1,000 people by 2020. Then in August, we signed an agreement with the University of Cincinnati to operate an Innovation Lab within the school's new innovation hub creating another talent pipeline to support our business. All the changes we are making to build digital platforms will also create opportunities to grow our business and improve margins in the future.

We are aggressively investing in these transformational opportunities, and while we are investing for the future, we are delivering for customers and shareholders today. Our Brands continue to resonate with customers both in-store and online. Since August launch of Kroger Ship, 41 of the top 50 items sold are our brands, and 4 of the top 5 items on ClickList are Our Brands. In the center of the store, premium Our Brands including Private Selection, HemisFares, and Abound grew double digits during the second quarter as well. In the second quarter, Our Brands made up 28.2% of unit sales and 26.5% of sales dollars, both of which are record results for our second quarter.

Our Brands continue to outpace Kroger's identical sales growth led by more than a 15% growth in our popular Simple Truth and Simple Truth Organic lines during the second quarter. Simple Truth has quickly become the second largest brand sold in our stores since launching five years ago. In 2018, Simple Truth reached more than $2 billion in annual sales, making it the largest natural and organic brand in America. Simple Truth's popularity and explosive growth is a major reason why we're starting with the brand in our first international pilot with Alibaba's Group Tmall Global platform.

Restock Kroger is just getting started. We like what we're seeing so far, and we're working to keep that trend going. The outcome of our key Restock Kroger drivers is a creation of shareholder value, which we remain committed to delivering over the long term. In June, we announced that Kroger's board approved a dividend increase for the 12the consecutive year. Our dividend has grown at a double-digit compound annual growth rate since it was reinstated in 2006.

We continue to expect an increasing dividend over time. We are on track to generate the free cash flow and the incremental FIFO operating profit that we committed to in Restock Kroger through 2020, and to deliver on our long-term vision to serve America through Food Inspiration and Uplift.

Now here is Mike to share more details on our second quarter results and to update you and our guidance for the remainder of 2018. Mike?

Mike Schlotman

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. As noted in our press release this morning, for the first half of 2018, Kroger's adjusted net earnings per diluted share result was slightly ahead of our internal expectations due to the solid early execution of Restock Kroger, including process changes that led the sustainable cost controls, and higher margin alternative revenue streams. This performance will allow us to continue making incremental investments, while delivering on our guidance range for the year. We also noted that the second quarter adjustment items relate primarily to the change in the market value of Kroger's investment in Ocado securities. Since our investment and partnership announcement in the second quarter, the share price has doubled.

As you know, we accelerated several planned Restock Kroger investments starting in the first quarter and continuing during the second quarter These include investments in price especially in support of Our Brands and in space optimization. Our pricing strategy isn't new. Since 2000, we have invested more than $4.2 billion in lower prices for customers, while also striving to provide the best full-service grocery experience in America. Even as we pursue our long-term strategy, we always look for ways to bank savings before we make significant investments as we did in the first half of the year.

We noted in June that pull forward investments in Restock Kroger that began in the last four weeks of the quarter, and continued space optimization roll out would be headwinds to ID sales in the second quarter. So this effect is not a surprise to us. We expect the headwinds from space optimization during the first half of 2018 to become a tailwind late in the third quarter.

Looking at our ID sales in the second quarter, 20 of our supermarket divisions had positive IDs, demonstrating Restock Kroger is resonating with customers across the company.

Several departments outperformed our total ID sales in the second quarter, most notably natural foods, seafood and pharmacy. We also continued to see growth in households during the quarter. Looking at gross margin, we were pleased to see that shrink rate continue to improve during the second quarter. The gross margin rate reflects the company's price investments, some rising transportation costs, and the growth for the specialty pharmacy business. Part of our price investments was to support Our Brands especially to reduce starting price points. The improvement-- new movement in the quarter demonstrates these investments are resonating with customers.

We intend to continue to invest in price to drive unit growth, while also delivering on the bottom line for our shareholders. OG&A cost increased as a rate of sales driven entirely by higher expense for incentive plans as compared to last year. We continue to face raising credit card fees especially as more customer shift to using credit cards with higher interchange rates. This is a growing problem and we are taking steps to address it. You likely saw the news this summer that our Foods Co. supermarket division announced that it would no longer accept visa credit cards as a form of payments.

This is because visa rates and fees are among the highest of any credit card brand. We stopped accepting Visa credit cards to save on the high costs associated with credit card companies interchange rates and network fees. The savings will be passed along to Foods Co. customers in the form of every day low prices on items shoppers purchased the most. Foods Co. stopped accepting the cards in mid-august and we are currently assessing our next steps. We're prepared to expand not acceptance to other banners if that's what it takes to get a level playing field for negotiated interchange rates. It's also worth noting that we recently changed our Kroger rewards credit card from visa to MasterCard.

We will continue to aggressively manage OG&A costs and implement new programs to reduce our cost of goods. A big focus continues to be on the store productivity and waste. We manage our business every day to drive shareholder value. Our investments in Restock Kroger and redefining the grocery customer experience, partnering for customer value and developing talent will be paid for by cost of good savings, strong ID sales and productivity gains. This is how we will generate $400 million in incremental FIFO operating profit by the end of 2020.

Now for an update on a retail fuel performance store in the second quarter. Our cents per gallon fuel margin was approximately $0.263 compared to $0.217 in last year second quarter. Average retail price of fuel was $2.85 versus $2.28 in the same quarter last year. We expect our 2018 tax rate to be approximately 22%. Excluding the 2018 first and second quarter adjustment items, we expect the 2018 rate to be approximately 20%. Favorable tax resolutions with certain states during the quarter benefited adjusted second quarter net earnings by about $0.01 per diluted share.

As previously announced, we are actively exploring strategic alternatives for our Turkey Hill Dairy business, including a potential sale. We want to ensure Turkey Hill has every opportunity to meet its full growth potential. Turkey Hill's unique CPG food business within Kroger as it is a strong nationally known brand. Much like our convenience store business, Turkey Hill is such a beloved brand thanks to the 800 dedicated associates who would contribute to its success. We remain committed to generating to $6.5 billion of free cash flow by 2020 as part of Restock Kroger. The original amount was $6 billion and we increased it to $6.5 billion after the passage of the Federal Tax Act.

We expect the Tax Act to reduce cash taxes by about $1.2 billion over the next three years. We used $700 million of those savings to fund our investment in Ocado and our merger with Home Chef. On one other note to this is we have working capital improvements built into the guidance, and we're off to a great start with a $300 million improvement in that operating capital so far this year. Kroger's net total debt to adjusted EBITDA ratio on a 52-week basis is 2.59 Our net total debt to adjusted EBITDA ratio target range is 2.33 to 2.4. For the remainder of fiscal 2018, we expect our leverage ratio to remain slightly above the target range, primarily due to increased borrowings to fund the company's merger with Home Chef and investments in Ocado.

Kroger remains committed to bringing the leverage ratio back into the target range. Our financial strategy is to use our free cash flow to drive growth, while also maintaining our current investment grade debt rating and returning capital to shareholders. We continually balance the use of cash flow to achieve these goals. Over the last four quarters, we've used cash to contribute an incremental $1.1 billion pretax to the company sponsored pension plans, and $467 million pretax to satisfy withdraw obligations to the Central States pension fund. We repurchased 103 million common shares for $2.6 billion, which includes $1.2 billion repurchased with after-tax proceeds from the sale of Kroger's convenience store business unit under a previously announced accelerated stock repurchase plan.

We paid $435 million in dividends and invested $2.9 billion in capital. As of the end of the second quarter, we had approximately $546 million remaining under the current share repurchase authorization. We're investing an incremental $500 million in our associates, in wages, training and development over the next three years through Restock Kroger. This will be in addition to our continued efforts to rebalance pay and benefits, while also focusing on certifications and performance incentives, career opportunities and trainings.

In March, we also announced investing in a portion of our tax savings in our educational assistance program Feed Your Future and an increased 401-k match for our non-union associates. We recently ratified a contract with the UFCW covering Kroger associates in Fort Wayne and enrichment in Hampton Roads areas. We are currently negotiating with the UFCW contracts for stores covering associates at Smith's in Albuquerque and Fred Meyer in

Portland. 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 for today's associates. Our financial results continue to be pressured by inefficient health care 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 and profitably, which will help us create more jobs and career opportunities and enhance job security for our associates.

Turning now to guidance for 2018. We continue to expect identical sales growth excluding fuel to range from 2% to 2.5% in 2018. We updated our GAAP net earnings guidance range to $3.88 to $4.03 per diluted share for 2018 from the previous range of $3.64 to $3.79. This increase in guidance is due to the unrealized gain and Ocado shares recorded in the second quarter and do not reflect any ongoing changes in the market value of Ocado shares because those cannot be predicted.

On an adjusted basis, our net earnings guidance range remains $2 to $2.15 per diluted share for 2018. We continue to expect capital investments, excluding mergers, acquisitions and purchases of leased facilities to be approximately $3 billion through 2018.

And now I'll turn it back to Rodney.

Rodney McMullen

Thanks Mike. Everything we are doing supports are Restock Kroger vision to serve America through Food Inspiration and Uplift. And we are executing our strategy. We are building a truly seamless shopping experience, so we can serve customers anything, anytime, and anywhere. We're using our data to provide convenient and personalized food inspiration to help customers be a hero to their families at Meal Time every time.

We are identifying partners who will help us deliver customer value today and the future. We are laying a foundation for more profitable alternative revenue streams that will also accelerate core business growth, and we are serious about living our purpose to Feed the Human Spirit because associates, customers and stakeholders are increasingly deciding where to work, where to shop, where to invest and who to support based on a company's commitment to making the world a better place. It's no surprise then that we are very proud of Kroger was recognized in Fortune Magazine's 2018 Changed the World list for Zero Hunger And Zero Waste.

Our plan to end hunger in places we call home and eliminate waste across our company by 2025. It is exciting to see our vision taking shape especially because we know that the delivering on our vision will create value for our customers, associates and shareholders.

Now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions]

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

Edward Kelly

Hi, guys. Good morning. Well, I wanted to start with the IDs. Can you talk about the cadence of your IDs throughout the quarter? What you're seeing so far in the third quarter, and then part of this, can you quantify the impact that optimization had on the IDs during the quarter and just generally how is that playing out so far relative to what you've expected?

Rodney McMullen

I'll start out, and I'll let Mike fill in. If you look at the space optimization and the other projects that we mentioned, without those, our identicals would have been a little over 2%. If you look at so far in the third quarter, we're trending a little bit better than where we were in the second quarter. Michael, I'll let you talk about the cadence during the quarter.

Mike Schlotman

I think the cadence was actually fairly consistent. There -- actually there was a blip or two when you look at some things like in Texas last year, when we had the disruption down there from Hurricane Harvey, and those kind of comparisons to the prior year make things a little bit difficult to compare, but when you factor out some of those kinds of items, it was actually fairly consistent. I think the encouraging thing is when Rodney talks about where we would have been and why we are very comfortable continuing to give guidance for the year of 2% to 2.5%. What we're seeing on the space optimization stores when they come out of the period of disruption, and they get back to business as usual.

We're seeing exactly what we expect to see, and obviously as we get to the back half of the year with the holiday selling season, we won't have stores disrupted, and we'll have the stores-- we're going to realign completed, so we expect to have a great fleet of stores going into the important holiday selling season in the fourth quarter, and 600 of those redone in a way that is resonating with the customers.

Edward Kelly

Great, thank you. And just as a follow-up on the guidance, from an EPS standpoint, it does seem like so far this year things have been a bit better than what you've expected, and you just talked about that. I think Mike that you raised guidance or you lowered the guidance for your tax rate, if you could just clarify that? But either way, this quarter you didn't touch the guidance at all from an EPS standpoint. Is there something out there that incrementally you're concerned about or is this simply a case of conservatism and as you're comfortable around the guidance you are really thinking about investing in the business for the next couple of years?

Mike Schlotman

Yes. When you look at the tax rate, obviously, we had the benefit of the favorable tax resolution from a state standpoint in the first quarter. With and without the C stores effects, the tax rate a bit as well, so it's a little bit confusing. So, I know it is a little bit lower, but I would remind you that we lowered -- we raised the low end of our guidance range in the first quarter, and all of those kinds of things would have factored into our decision to do that including at what the time once the C store transaction closed and the like and where we were on state tax issues knowing things that we weren't going to say publicly yet, all factored into that decision to raise the lower end. Relative to what we do with over performance, I think you know as well as anybody Ed, and we have a very long history as I indicated in the prepared comments. We like to deliver some results before we make all the investments that we plan to make. We, obviously, this year is a little different in that we had the Tax Act savings to invest and pull some pricing moves forward, while still being able to deliver on our earnings per share growth.

And I think you will see us probably decide how we manage through the rest of the year, and where we think the dollars are going to be, continue to make investments to grow the business for the long term. If you look at the midpoint of our guidance range today, that's a little over 6% earnings per share growth rate, which I think is a very respectable result in an environment where we're making dramatic investments to reshape the future of the company.

I think the management team here at Kroger is proud of being able to refocus our future efforts, and still deliver on the bottom line for shareholders.

Rodney McMullen

And Mike, the last point there, I think it's important to remind everybody that we aggressively continue to invest in our digital businesses, and connecting with that customer will increasingly be important in the future obviously because what we find is when a customer engages with us in all channels, they spend more money with us.

Mike Schlotman

Growing 50% in the digital business doesn't happen without those investments and focus.

Operator

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

Judah Frommer

Hi, good morning and thanks for taking the question. So maybe first just to follow up on the guidance point, I think there's a little confusion because like it said, the EPS range didn't change. The tax rate came down, so is there some implication that operating income could be lower than you anticipated in the back half of the year or is the range just wide enough that there's a range of outcomes considered in the guidance?

Mike Schlotman

I think it's your latter point. We’ve guided all along when we gave original guidance and even back last October when we discussed Restock Kroger with everybody that we expected 2018 to be a year of investment, and that we would expect operating profit margin to be down. We also talked about the fact in March that once the Tax Act got passed, we were going to take some of those savings, about a third of them would fall to the bottom line, which you have seen through the lower tax rate over time. About a third of it would be invested back in the business, meaning some price investments that we pulled forward into this year out of future years.

So these are planned investments that we did early, which means that was a conscious decision to lower operating profit a little more than our original plan this year. I think we were as clear as we could be about that and in March as compared to where we would have been in October. And then the third leg of that stool is the investment in people that we talked about with the Feed Your Future where part-time and full-time associates if you've worked with us for at least six months can get $3,500 a year to continue their education or get a GED or get a specific trade certification as well as the increased 401-k match for our associates.

I think when you balance all of that, the fact that we're going through, everything we're going through making the investments to space optimization work, incremental benefits for a lot of our associates. and that $3,500 is also associates that store associates and office associates alike. I think that I'm very happy with how we're managing through this significant year of change, and still at the midpoint delivering what would be expected to be a 6% earnings per share growth rate or so at the midpoint of our current estimate.

Judah Frommer

Okay, got it. And just to follow up maybe on the gross margin, the investment a little bit bigger ex fuel than we anticipated, but can you break down for us a little bit investment in price relative to the freight pressure and how much of the price investment is related to competition that you're seeing from other channels versus an internal plan? And was there anything above and beyond what you anticipated investing because it was such a strong fuel quarter?

Mike Schlotman

I think we're right on track with what we expect to invest in price and the pull forward investments we wound up making. One of the comments we made in both the press release and the prepared remarks was the growth of our Kroger specialty pharmacy business. Their growth has been quite impressive and their ability to gain new relationships in that world has been quite impressive. That is a very high sales model, a very low gross margin compared to the overall Kroger gross margin. So that mix as it grows pulls our gross margin down, but it drives very nice growth and gross margin in that business because of what those pharmaceuticals wind up costing.

So when you mix all that out, I don't think we did anything out of the ordinary from our price investments. It's just what --it's just what's out there. And I would be remiss and talking about gross profit, if I didn't give a shout out to our cost and waste team and a very continued. I think it's four quarters in a row now where we've had improvements in our shrink rate. And with our sales when you have some very nice improvements in the shrink rate, that's one of the cost savings we expect to help fuel Restock Kroger, and they are delivering on what our expectations are. So we have that fuel for the engine.

Operator

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

Erica Eiler

Good morning. This is actually Erica Eiler on for Rupesh. Thanks a lot for taking our questions. so I wanted to touch on guidance here as well. I was hoping maybe you could talk about what gives you continued confidence on delivering on the 2% and 2.5% ID sales growth, given it implies a meaningful acceleration even with more difficult comparison. You talked a little bit about Kroger Restock and the benefits you're expecting to see there in the back half, but is there anything else that we should be thinking about that's going to drive that acceleration here.

Mike Schlotman

Well, I think when we look at it and decide to keep the 2% and 2.5%, it's something that we certainly think is achievable, and I said on when I was on Bloomberg and CNBC this morning, we're laser focused on delivering on those results. And when you think about Rodney's comment that without the headwind of price investments that we made late in the first quarter that really affected the second quarter pretty dramatically as well. Space optimization without the effect of those headwinds in the second quarter we would have been over 2%.

And as the price investments are in for a longer period of time, the effect as a headwind diminishes because the unit's start to pick up like I spoke up in the prepared comments with the pickup in units and Our Brands where we've made some price investments. And the --we are more than halfway through our space optimization work about 55% of the stores that we would expect that. We completed -- are behind us, so as those stores start to mature and come out of the cycle of disruption, they will feed the ID sales as we get later this quarter and into the fourth quarter.

So it's the combination of those that we expect to come together and be able to deliver in the 2% to 2.5% range.

Erica Eiler

Okay, great, that's helpful. And then just hoping maybe you could talk a little bit about inflation deflation here. What you saw during the quarter? Your latest outlook, and are you starting to see price increases come through from your vendors? And are you starting to see shelf prices move up? Any additional color here would be helpful as well.

Rodney McMullen

I'll let Mike fill in some of the details, but if you look at overall, really, it was basically zero on inflation deflation. You have some of the fresh departments that had a little bit of deflation, but there wasn't anything substantial. So looking forward, we really don't see much change. I would say at this point, we --obviously there's been several announced increases, but we've seen very limited number of increases so far. And the customer certainly wouldn't be experiencing any increase either in terms of the prices they're paying. And in fact, it's a little bit less than a year ago. So Mike, I'll let fill in some of the details.

Mike Schlotman

And I would agree with you on. It's flat overall and there are pluses and minuses in all the different categories, and our LIFO estimate for the year would be substantially if not entirely driven by where our pharmacy inflation is in the amount of pharmacy business, and an inventory we have to support that business.

Operator

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

Karen Short

Hi, thanks. Sorry just on that last question just to clarify, on cost inflation versus retail inflation, you're saying both are basically flat or could you just clarify that?

Mike Schlotman

We were referring to, at least I was referring to and I believe Rodney was referring to cost inflation is what we were talking about. We're not going to get into retail inflation because it's pretty difficult to calculate as we continue to make price investments as well as see the investments we make in our brands and the growth of Our Brands. It can look like retail deflation, but a lot of times it's just growth in the lower price point item, but a higher margin item on the shelf causing that.

So we stay focused on where costs are going and deciding how to react to that at retail.

Karen Short

Okay and I know on the last earnings call you indicated that you might be willing to give some more concrete data on what kinds of sales lists you're seeing in the optimized stores? Are you willing to do that today? Can you just give a little more color?

Mike Schlotman

Well, I think when you think about what we reported in the second quarter of 1.6 IDs. And if you were to factor out the headwind that's out there for space optimization and the price investments late in the first quarter that we would have been over 2%. I think you see one that the headwind of that as well as what the potential tailwind that's out there. I won't get into specifics of exactly what those are generating, but as we see them --as we see those stores coming out and what they generate and knowing that we're more than halfway through what we want to get done, we're looking forward to that turning into a tailwind late this quarter.

Karen Short

Okay and then I guess I just wanted to switch gears to the IDs a little bit and look at the spread between the new definition and the old definition. Obviously, you gave us the historical spread. I mean from last year in the net 8-K, so obviously that spreads widening and I guess what I want to ask is it seems fair to think that spread will continue to pretty meaningfully widen as we go forward given the strong growth in digital. Is that fair to think about it because I mean I think at the end of the day people still want to cut some sense of where your IDs are excluding the digital component.

Mike Schlotman

Well, I spoke of the fact that we had broad-based ID sales growth in our operating divisions with 20 of them having positive ID sales. And that would have been on the traditional calculation. That would include ClickList because they are fulfilled at the store level and would have always been in there. So we're happy, very happy with the trends we are seeing. Obviously, that's disrupted by the space optimization, space optimization and the price investments at the store level don't really affect things like shift and Kroger Specialty pharmacy.

Rodney McMullen

Yes. Karen, on your question as you look forward, we would certainly expect the gap increase over time. It's becoming increasingly difficult when a customer engages with us and they engage with us on Ship, they engage with us on Vitacost and some of the other parts of our business. When they engage multiple places, we get a bigger share of their total and our total sales grow, but in terms of historically the way we would keep track of that it does change the mix and where --how the customers engaging with us, which is the reason why we changed the definition. But we would expect that gap to continue to increase as we've become more multi-dimensional.

Operator

The next question comes from Chris Mandeville with Jefferies. Please go ahead.

Chris Mandeville

Hey, good morning. Thanks for taking my questions. I guess I'm still a little bit uncertain surrounding the back half guidance here. Mike, just to be clear on the tax rate, you're implying that we're looking for an 18% tax rate in the back half. Is that correct? And the street expectations at the very least on EBIT it's going to have come down quite considerably, so just trying to get some incremental color on what's driving that versus what we were initially expecting back in March. Is it more on the gross margin line? Is it more OpEx? Just any color would be helpful there.

Mike Schlotman

I mean when you look at --when you look at the back half, I don't think we're that low on a tax rate. When you look at the 20% for the year or so will probably be above that in the third quarter, maybe below that in the fourth quarter because we - we do try to factor in when we might see things like the tax settlement that happened in the second quarter with three different states. There are things out there like that to wind up happening as well.

I'm not going to get into what our EBIT Guidance might or might not be on a quarterly or annual basis because we have guided that it will be down. And we do continue to make the investments we expect it to make. And we are using -- we are making incremental investments in the business using the tax savings that we spoke about in March. I would remind you that all of that said we generated about $1.8 billion of free cash flow in the first half of the year when you look at cash provider from operating activities minus our CapEx, which is the pretty standard definition. And we're promising $6.5 billion over the next three years. So I think we're off to a pretty nice start to the $6.5 billion. And when you think about the valuation of a company, its ability to grow free cash flow over time. I think we are pretty solid in that respect.

Chris Mandeville

Okay and then one quick clarification then the follow-up. The comp you actually have seen over 2% in Q2. Was that both price investment and space optimization or strictly space optimization?

Mike Schlotman

It's both of them together.

Chris Mandeville

Okay and then so my follow up would be, just obviously as relates to pending storms, all are of course unique but can you just remind us the general dynamics that you observe on both the top-line and margins during these sort of events and then how well do you feel from an inventory standpoint in advance of the hurricane and did you see any element of acceleration in transportation or freight costs in the southeast quarter to date?

Mike Schlotman

Well, I don't know if I would go specifically in the southeast, that's pretty narrowly focused. We talked it that rising transportation cost affected the gross margin rate overall. When you look at the dynamics of what's going on in the southeast of the country today before I get into the specifics, I want to repeat something I said earlier today, and our hearts and minds and prayers and thoughts are with both our associates and customers in that part of the world because they stand to face a pretty difficult next couple of three weeks. And we hope we come through it as well as possible from their standpoint, And the business will be the business.

I would tell you that last year this time we had a run-up to Hurricane Irma that people forget about, and this-- and right and that would have been prior to today, and today we have the run-up to Hurricane Florence, and they kind of offset one another. So we had the comparison to the run-up to Irma that was a headwind at the beginning of the quarter. And now that's been replaced by the incremental sales you get from Florence. And when you factor those out, they pretty well negate one another and we're trending above with both of those in there, where we finish this --the second quarter.

So we feel like we're off to a good start.

Rodney McMullen

Mike said it, but there's no two hurricanes the same. We have a lot of experience on reacting and addressing hurricanes and our teams always do an incredible job and work beyond anything that one could expect. But our customers and we all appreciate everything they're doing. Obviously, the first thing is making sure everybody stays safe. But I know yesterday, I received an email from a customer whose daughter lived in one of the affected markets. In the email, she said how much she appreciated the fact that we had water and some other things because other retailers didn't have it. And to the degree that we're able to do things like that, it really is a reflection of our store teams and our warehouse teams and delivery teams making sure that our stores stay in stock. And it's one of those things we do have a lot of experience at it.

Mike Schlotman

Yes. And Rodney, when you look at what our Atlanta, Harris Teeter, and mid-Atlantic division teams have done to serve the customers and keep our associates safe -- our hats are off to them.

Operator

The next question comes from Kelly Bania with BMO Capital Markets. Please go ahead.

Kelly Bania

Hi. Good morning. Thanks for taking my questions. Just a clarification and then a longer-term question. On the space optimization, the comment that the IDs would be over 2% if you take that out, is that more of a traffic disruption or a ticket and pricing disruption?

Rodney McMullen

Yes. It actually is both. And it's more the average ticket because customers have trouble finding stuff. But it's actually a little bit of both. What we find, once you get through it though, the customers -- you reallocate the space in the stores, you'll have products that the customer wanted to buy from us that we didn't have before, and we stay better in stock as well because you reallocate space. So the customers never like it during that. But once you get through it, the customers appreciate what you do and reward us accordingly.

Kelly Bania

Okay. That's helpful. And then just some longer-term questions. I guess first, on Ocado, just a simple question. But with all the growth in Instacart and expanded partnership there, it seems like the same day delivery, maybe there's a lot of demand for that. But I'm just wondering if Ocado will be also able to offer same day one- or two-hour delivery or if that's more of a next day type offering. Any comments on that would be helpful. And then on Alibaba, just wondering if you're willing to frame what you think the potential could be for that longer-term in terms of dollars, when that starts, and if you'll include that in your IDs. Thank you.

Rodney McMullen

Yes. In terms of Ocado, the Ocado team continues to work on improving their model using even better machine learning and everything else. There will be certain areas that they will be able to do same day end. I think the key thing gets back to the comment that we talked about regularly. That's being able to deliver anything any time, anywhere. And it really will be able -- the key will be able to, for the customers, to do it in a seamless way. And we'll use all of the assets, including Ocado, our store facilities, and other things to be able to get deliveries to the customers based on when they want it.

What we find is there are certain items that customers want more immediately, if you think about what's for dinner tonight. There are other things that you could help them plan out. And the thing that they're more focused on there is getting it in a convenient way. And a convenient way sometimes is picking it up, not necessarily at the store they shop at, and in some cases, delivery. So, the key is all of the backstage assets tying together but delivering it seamlessly for the customer.

And what we find is some customers like same day or a couple hour delivery windows. Others are more focused on pick up. And next day is not -- they view that as equally convenient. On Alibaba, on the identicals, Mike, I'll let you --

Mike Schlotman

Our definition is sales to customers. So, over time, those will probably wind up being in the ID sales. As we've said, we're kind of dipping our toe in the water at this point to make sure we have systems and processes down. And it's just an expansion of our ability to attract customers regardless of where they are.

Rodney McMullen

Yes. On Alibaba and what I've been doing at investor meetings recently on Simple Truth, the question -- they ask you the same thing in terms of how big. And it really is, for us, hard to estimate. It's something that we haven't done before. But what we find is that our Simple Truth brand has incredibly strong customer connection. And we believe that it's a brand that will work across the world not just the US. And learning and doing that in China is an easy first step.

And Alibaba's Tmall is an incredible platform to reach over a half a billion customers. So it's really learning and looking at it in terms of is it a brand that will travel internationally. And then does that create a platform for growth? And we certainly think the opportunity is there. It's going to take a lot of work to achieve that.

Operator

The next question comes from Paul Trussell with Deutsche Bank. Please go ahead.

Paul Trussell

Thank you. Good morning. Just circling back on -- as you mentioned numerous times, 2018 is a year of investments for you guys, as you pull forward actions on labor and price and store remodels. Just kind of remind us or as we look to the second half, are there a different set of puts and takes that we should keep in mind versus the first half on the EBIT front? And just kind of remind us of what's embedded in that 2020 plan in terms of the margin profile.

Mike Schlotman

I won't get into EBIT on a short-term period like the back half of the year because we haven't given guidance on that. What we've given guidance on is we expect to grow operating profit or EBIT by $400 million over the course of 2018, 2019, and 2020, as compared to where 2017 ended up when you adjust out the 53rd week and you adjust out the convenience store business because obviously, we don't have that going forward. But we sold that for a very nice multiple. So that's what we're very focused on.

We talked about the fact in March; when the tax act was there that we're gonna make investments that would reduce EBIT this year. That would be offset by -- on the bottom line by a lower tax expense, and from a cash-based standpoint, a lower cash tax expense. And a lot of those investments were pulled forwards from either later in 2018, meaning there'll be less effect in 2019 or actual pull forward investments from 2019 into 2018. So we will expect ourselves from an internal standpoint to grow EBIT more in 2019 and probably into 2020 than we would have in the original Restock Kroger because we were able to get some of those investments behind us in 2018. And hopefully, see those take root and create that extra EBITDA to support our strategy.

Paul Trussell

Got it, thank you. And then just some quick ones. In this past period, to what extent did your private brands outperform national brands? And also, if you can just give an update on the Click and Collect program and all the contributors to your digital growth being over 50% this past quarter.

Mike Schlotman

So in Rodney's prepared comments, he talked about Our Brand being 28.2% of units and 26.5% of dollars, both of which are record results for the second quarter. The second quarter is usually a bit of a dip as compared to the first quarter and other quarters, but primarily because of soft drinks because with the summer holidays, national brand soft drinks have a very strong performance because of the promotions that wind up happening.

And when you look at the ClickList and the expansion of digital and the fact that it's up 50%, we talk about the fact that we're up to 80% of our customers now have the ability to either interact with ClickList or one of the home delivery services we have which is up from about 70% in the first quarter. So we can see continued growth of our customers being able to interact with us that way.

Operator

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

John Heinbockel

So, Rodney, let me hit private brands first. What have you found your data with price elasticity, private brands versus national brands? And then when you make some price investments on the private brand side, what is the national brand response, if any to those? Or do they do nothing?

Rodney McMullen

Okay. I love the question and there are a lot of pieces behind the question. If you look at our brands and the broad spectrum of our brands, each brand would have a little bit different answer to the question. So if you look at Private Selection, as a general rule, those are unique items where there really isn't a comparable brand somewhere else. So our brand on Private Selection really is very innovative, new approaches. Same for like HemisFares and some of those.

So the customer reaction is more in terms of doing something when we keep it fresh and exciting or a flavor that they can't find somewhere else. And that engages with the customer that way. Simple Truth really doesn't have a comparable brand in the market at all and to the degree that obviously, there are a lot of smaller natural and organic brands, but it would compete against one piece of our overall brand not the overall brand.

And certainly, what our strategy always has been on natural and organic products is you shouldn't have to pay a premium just because it's a natural or organic. It shouldn't have a higher margin in it. And that's been our strategy for numerous years. And our customers have reacted to that very well. When you look at the core banner brand, it really depends on the category. So you think about milk, the market share is so high, there's really not a lot of elasticity there.

Others would have a different type of elasticity. Overall, you really don't find the national brands reacting much at all in the short term. Usually, the reaction is more longer term. And it's usually after a year or two of losing share that they decide that they want to do something about the share. And then they'll come back and be more aggressive. The key to all of it -- and we want the national brands and our brands both to grow. And one of the key is innovation. And I know almost every time I talk to a national brand partner, I always tell them that, you need more innovation. Our teams feel the same way in terms of -- the key is really more innovation.

John Heinbockel

And then real quick, on the $400 million, roughly what comp is required over the two years to get there? And with Ocado investments right as you start to move toward implementation of the first three or five, would they impact the $400 million at all? Or no, it's immaterial?

Mike Schlotman

The pick of those investments won't start happening until 2020. And it's factored into our ability to generate the $400 million. And we would still be targeting to generate the $400 million of operating profit margin growth, even in light of having the Ocado investments and starting to come online or close to coming online or early. Hopefully, some time in that timeframe.

Operator

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

Rodney McMullen

Good morning, Robbie.

Robert Holmes

Okay. Thanks for fitting me in. I was hoping --

Mike Schlotman

In under the wire.

Robert Holmes

Really appreciate it. Just a couple of quick follow-ups. The price investments, Rodney or Mike, can you just talk about how much of it is skewed toward own brands versus history? Is it a massive investment in your own brand pricing that's driving your gross margin down and you've eased off price investments on national brands?

Rodney McMullen

It would really be across both national brand and our brands. And it really is using our 8451 insights to understand where is the best return for the price investment. So it's actually very much both.

Robert Holmes

And then just the very last question would just be some of your Walmart example, as one example, you saw some strong results from some very large retailers, even in their food retail businesses in the second quarter. And just maybe help us think about what the consumer is doing from your standpoint. Are you seeing signs of trade up? And should we see a reversal of market share trends back in your favor at some point when you get through this?

Rodney McMullen

Well, if you look at market share overall on the data, the way that everything's been historically tracked, we continue to gain share. If you look at overall, we're pretty much on track where we thought we would be, as Mike mentioned earlier. We continue to see overall market growth which is good. And we see great opportunities out there to continue to do well what we do good. And that's our strength with our associates and their service and freshness of product. So we continue to see plenty of opportunity to improve our identicals and gain share.

Rodney McMullen

Thanks, Robbie. As I just mentioned, we are incredibly confident about the future of Kroger and especially with our execution of Restock Kroger. One of the exciting things about our earnings call is that many of our associates listen in to better understand and gain insights into our business. And of course, as all of you know, many of our associates are shareholders as well. So before I end today's call, I'd like to share a few final comments with our associates.

First, as Mike mentioned before, I would like to acknowledge that many of our customers and associates are bracing for Hurricane Florence. I know our stores and logistics teams on the east coast have been working tirelessly for the past week to help our customers and each other be prepared for the storm. For those of you in the hurricane's path, please stay safe and look out for each other. Second, as I mentioned earlier on the call, we are thrilled that Kroger was included in Fortune Magazine's 2018 Change the World list for Zero Hunger Zero Waste.

This is such an awesome recognition of the work that each one of you are doing to help us achieve our goal. The same week we received the news from Fortune, Kroger was making news of our own. We added a bold new pledge to our existing Zero Hunger Zero Waste commitments by 2025. And that was that we will be phasing out single-use plastic checkout bags. The feedback on that announcement has been enormous and overwhelmingly positive. I know everything that you are doing are steps to make this become a reality. Thank you for all you do. That completes our call today. Thanks for joining.

Operator

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