The Kroger (NYSE:KR) Q1 2012 Earnings Call June 14, 2012 10:00 AM ET

Executives

Cindy Holmes - Director of Investor Relations

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

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

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

Analysts

John Heinbockel - Guggenheim Securities, LLC, Research Division

Deborah L. Weinswig - Citigroup Inc, Research Division

Charles X. Grom - Deutsche Bank AG, Research Division

Edward J. Kelly - Crédit Suisse AG, Research Division

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Meredith Adler - Barclays Capital, Research Division

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

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

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

Mark Wiltamuth - Morgan Stanley, Research Division

Alton K. Stump - Longbow Research LLC

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

Operator

Good day, ladies and gentlemen, and welcome to The Kroger Co. First Quarter 2012 Earnings Conference Call. My name is Fab, and I'll be your operator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to your host for today, Cindy Holmes, Director of Investor Relations. Please proceed.

Cindy Holmes

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

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

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

David B. Dillon

Thank you, Cindy, and good morning, everyone. Thank you for joining us today. With me to review Kroger's first quarter 2012 results are Rodney McMullen, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

We're very pleased with Kroger's excellent first quarter results. We achieved strong overall sales and solid operating performance. Our core business is growing, and we are rewarding shareholders through earnings growth, increasing dividends over time and stock buybacks.

Identical supermarket sales were up for the 34th consecutive quarter, growing by 4.2%. We are able to deliver this kind of consistent performance quarter-after-quarter, thanks to our associates' commitment to our Customer 1st strategy.

Here are a few highlights. Every supermarket department had positive identical sales, led by significant growth in natural food, pharmacy, bakery and deli. Every supermarket division had positive identical sales. Kroger's FIFO operating profit dollars grew, both with and without fuel, and it is our expectation to slightly increase our FIFO operating margin rate excluding fuel for the year.

As a result of these strong results, we exceeded our expectations and, as a result, raised our earnings per share guidance for the year. Mike will provide detail on our full year guidance, as well as some other items that factored into earnings growth for the quarter shortly.

So before I turn it to Rodney and Mike, I'd like to spend a little time discussing a question that came up during last earnings call. The essence of the question was how is Kroger growing market share and performing well, especially compared to traditional competitors? How are we different?

Several years ago, we took a hard look at who we were really competing against, and that helped us realize we're competing against more than just traditional grocery retailers. Also, based on our research and our identical sales, we were not connecting with customers as well as we needed. In fact, customers told us we weren't doing a very good job. Their needs were changing, but we had not changed with them.

These realities led us to develop our Customer 1st strategy and the 4 keys: people, products, shopping experience and price. We've pushed hard to save money in places not important to customers and to reinvest -- invest it in places that are important to them. This is the essence of the Kroger difference: solving needs for our customers, sometimes in massive ways and sometimes in a very targeted, personal way.

Customers tell us they notice the difference. I believe this difference is why -- that we've had 34 consecutive quarters of positive identical sales. Identical sales are the most visible indicator available of a retailer's relevancy to its customers. I want to repeat that, it's very important. Identical sales are the most visible indicator available of a retailer's relevancy to its customers. That's why we pay such close attention to the identical sales trend.

As we've grown our market share, some of you have also asked who is Kroger gaining from? But since we're targeting customers and not other retailers, there isn't always a clear answer. One thing that is clear, as we've grown market share, our customers come from a much broader base than just supermarkets. It is also clear that we compete very well with a broader array of food retailers, and this includes restaurants.

We thought this background would be helpful to put in context our strong results and to project that at Kroger, we have and will continue to separate ourselves from our traditional competitors. In fact, we are creating a new industry.

Rodney will now share some additional insight into Kroger's positive business trends in the first quarter. Rodney?

W. Rodney McMullen

Thank you, Dave, and good morning, everyone. Dave talked about how we have differentiated ourselves. One example of this is the joint venture we formed to create the consumer insight giant dunnhumbyUSA. Years of experience with dunnhumby have made us exponentially better at personalization and individual rewards. By deepening our focus on our customers, we have redefined our business model. It is more sustainable today than it was 5, 10 or 15 years ago.

We also leverage our partnership with dunnhumby to better understand shopper behavior over time. In the first quarter, Kroger increased the total number of loyal households. Those households are making more visits. And while they are buying fewer items per trip, the total units we sell to our loyal customers have increased.

We regularly seek customer feedback on how well we are executing in each of the 4 key areas of our Customer 1st strategy. Our customers tell us we've improved performance in each key. This improvement is consistent across all the keys, and we are 60% of the way towards the goals we originally set.

We are happy with where we are, and we are a different retailer as a result. But there is offside to this. We still have more work to do, which is also very exciting.

Product cost inflation continued in the first quarter. However, the rate of inflation is decreasing faster than what we expected at the beginning of this year. Identical store sales growth exceeded the rate of inflation, which we estimate was 3.9% excluding fuel. Deflation in the produce department offset somewhat the inflation in all other departments, including grocery, meat and bakery.

Total tonnage change was slightly better than the fourth quarter. However, it was still essentially flat. Looking at one department with deflation, produce, we saw a significant growth in tonnage for the quarter.

Kroger's corporate brand share and sales grew more than national brands in the first quarter. Corporate brands represented approximately 26% of grocery department sales dollars. Grocery department units sold are up 60 basis points to 33.6% compared to the same quarter last year.

Our corporate brands team continues to create fresh and compelling products that fill unmet customer needs. We recently launched Private Selection's Snack Chips in 13 new flavors, including sea salt, cinnamon sugar and a new gluten-free rice and bean chip made from rice and azuki beans. And by the way, they're all very good.

Finally, an update on labor relations. Our associates at King Soopers ratified a 2-year extension to the labor contract. We also secured a new labor agreement covering associates at our Smith's and Food 4 Less stores in Las Vegas. We have many contracts that have expired or will expire soon, including contracts in Columbus, Dayton, Indianapolis, Louisville, Memphis, Nashville and Portland. Our objective at every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide good wages; a quality, affordable health care; and retirement benefits for our associates.

Next, Mike will share additional detail on Kroger's first quarter financial results and guidance for 2012. Mike?

J. Michael Schlotman

Thanks, Rodney, and good morning, everyone. Our identical supermarket sales increased 4.2% in the first quarter, which contributed to net earnings totaling $439.4 million compared to $432.3 million in the same period last year.

Net earnings per diluted share showed strong growth to $0.78 from $0.70 per diluted share last year. Our earnings per share growth was driven by EBITDA being higher than our expectations. Additionally, a tax reserve adjustment helped by about $0.015. FIFO gross margin was 20.7% of sales for the first quarter of fiscal 2012. Excluding retail fuel operations, FIFO gross margin decreased 53 basis points from the same period last year.

We are pleased with this performance, which was consistent with our plan for the quarter. Last year, we saw a very strong gross margin in the first quarter. Kroger recorded a $46 million LIFO charge during the first quarters of both 2012 and 2011.

Operating, general and administrative costs were 15.36% of sales. Excluding retail fuel operations, OG&A declined 27 basis points from the same period last year. Including rent depreciation, it was a 40-basis-point reduction. The benefits of leverage from productivity improvements, outstanding cost control and positive sales more than offset rising health care costs and credit card fees. Additionally, the consolidation of 4 UFCW pension plans in the prior year benefited operating expenses in the first quarter as we anticipated.

Identifying and delivering sustainable operating cost reductions allows us to invest at all 4 keys of our Customer 1st strategy consistently over time. The company's FIFO operating margin, excluding fuel, on a rolling 4-quarters basis decreased 11 basis points. This was a little better than we expected due to the higher EBITDA versus our original expectation that I mentioned a moment ago. We still expect FIFO operating margin, excluding fuel, to slightly increase for the full year of 2012. Additionally, we generated more operating margin profit dollars this year compared to last year.

Turning now to Kroger's retail fuel operations. In the first quarter, our supermarket fuel centers and convenience stores produced positive identical gallon growth. These outlets earned approximately $0.121 per gallon compared to $0.124 in the same quarter last year. The benefit to earnings per share was the same as last year.

Now I'll update you on our financial strategy. During fiscal 2012, Kroger plans to use cash flow from operations to fund capital expenditures, repurchase shares, pay dividends to shareholders and maintain its current debt rating. Kroger repurchased 14.6 million common shares for a total investment of $345.3 million in the first quarter. The Board of Directors have authorized a new $1 billion share repurchase program that replaces the prior authorization which was exhausted on June 12, 2012, just a couple of days ago. Over the last 4 quarters, Kroger has used its strong free cash flow to return more than $1.6 billion to shareholders through share buybacks and dividends.

Capital investment, excluding acquisitions and purchases of lease facilities, totaled $539.1 million for the first quarter compared with $573.1 million for the same period last year. We continue to expect full year capital expenditures to be in the $1.9 billion to $2.2 billion range.

Net total debt was $7.8 billion, an increase of $662.1 million from a year ago. This is primarily the result of debt issued to fund our UFCW pension plan consolidation. On a rolling 4 quarters basis, Kroger's net total debt to adjusted EBITDA ratio was 1.91 compared with 1.79 during the same period last year.

In March, we told you that we expect the external environment to be a little better in 2011. Generally speaking, this has been our experience through the first quarter. We continue to monitor changes in gas prices and inflation. And as the headlines continually remind us, macroeconomic issues will continue to affect consumer sentiment throughout the year. We are confident in our ability to make tactical adjustments as needed to successfully navigate these factors while continuing to deliver on our Customer 1st strategy.

Kroger's long-term business model is to generate earnings -- annual earnings per share growth averaging 6% to 8% plus a dividend of 1.5% to 2% for its shareholder return of approximately 8% to 10%. We expect this total return to compare favorably to the S&P 500 over a rolling 3- to 5-year time horizon.

We continue to expect fiscal 2012 earnings per share growth to be higher than our long-term business model, and our strong first quarter positions

Kroger's for an even more robust 2012 than originally expected. Therefore, we've increased our earnings guidance for the first year to -- for the fiscal year to $2.33 to $2.40 per diluted share. The original guidance was $2.28 to $2.38 per share. The increase reflects the strength of the company's first quarter results.

I'd like to share a little bit more about pharmacy's better-than-expected performance, which helped sales as well as earnings in the first quarter. Pharmacy achieved double-digit identical sales, about half due to new Express Scripts business and half from exceptional overall pharmacy performance. Even without Express Scripts, it was an excellent quarter for our pharmacies.

Our ability to project pharmacy performance over the course of the year remains difficult when factoring in the benefit of Express Scripts and prescription drugs coming off patent. This quarter was good, and we were -- and we think we are satisfying new customers who transferred because of Express Scripts.

We continue to expect identical sales to trend down throughout the remainder of the fiscal year as prescription drugs come off patents. For these reasons, we continue to expect identical supermarket sales growth, excluding fuel, of 3% to 3.5%.

As we said at year end, we expect second -- the second quarter growth rate to be in line with our long-term growth rate of 6% to 8%, and the third and fourth quarters will be higher than that. The fourth quarter will also benefit from the 53rd week.

Now I will turn it back to Dave.

David B. Dillon

Thanks, Mike. This was another great quarter. We exceeded our expectations and, as a result, raised our earnings per share guidance for the year. Kroger's performance this quarter, like the 33 quarters of positive identical sales that preceded it, was the result of our focus on our customers. We're building relevant and personal connections with each customer, and that requires fresh new ways of thinking about our markets and our competition. That customers tell us we have significantly improved in the 4 key areas of our Customer 1st strategy, lets us know that we are not the same company today that we were even 7 years ago. We have differentiated ourselves from traditional food retailers and expect to drive loyalty, cash flow and earnings growth in 2012 and beyond.

We now look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And your first question will come from the line of John Heinbockel with Guggenheim Securities.

John Heinbockel - Guggenheim Securities, LLC, Research Division

So a couple of things, guys. When you look at your expectation for comps through the remainder of the year, what do you think happens to tonnage from where we are right now? Do you think we see any improvement? And it looks, by the work we've done, that competitive rationality continues to prevail. People aren't doing anything dumb at this point. Do you see the same thing? And would you expect that to continue?

David B. Dillon

On the tonnage for the year, we've said, I think all along, that as inflation comes down, which is what we expect to have happen, that, that -- while that's not negative, that doesn't mean prices are going to go down. It just means the rate of growth would slow. But we do think that, that will, in the long run, be positive for tonnage. However, tonnage will be slower to recover than the rate of inflation will come down, I believe. That's a personal opinion. We don't have any way to prove that till we actually go through it. And the reason I think that is because the economy, from a shopper's point of view, is not in all that great a shape. So it's not going to cause customers to jump back on the wagon unless they've got more money to spend. But we do expect it to positively affect tonnage, just at a slower rate, that's all. As for competition, we would agree with you. It's been a rational market. I think everyone realizes it's a tough market out there for customers, and I don't see a lot of overreacting going on. Rodney, you want to add any color to that?

W. Rodney McMullen

No. No.

John Heinbockel - Guggenheim Securities, LLC, Research Division

All right. Secondly then, if you think about deployment of your cash flow, arguably, you're in the best position you've been in, in a very long time competitively. Stock is as cheap as it's been in 10 years. So how do you think about 2 things: one, being more aggressive with your buyback effort to the point of possibly levering up a little bit to do that? And secondly, how do you think about the dividend payout ratio? I know you have a target in terms of yield, but where do you think you ought to be in terms of payout?

David B. Dillon

I'll have Mike answer both of those in detail here in a second, but I will tell you that part of the answer you can find in the fact that our board authorized stock repurchase to start back up again as we finished that earlier this week. And that was intentional because, we agree with you, our stock prices is cheap. So Mike?

J. Michael Schlotman

Yes. Relative to the buyback, we finished the quarter at 1.91x net total debt to adjusted EBITDA. We think being in the 2 to 2.2x range is something that the rating agencies would be comfortable with and allow us to continue to be a BBB flat credit which is important to us. It's not saying I want to be a 2.2x because you do like to have a little cushion, operating cushion and not live life on the edge necessarily. And over the last 4 quarters, we've returned $1.6 billion between buybacks and dividends. I think that's a pretty healthy return back to our shareholders. And relative to the dividend payout ratio, this will be our seventh year of paying a dividend since we've reinstituted it, and we've increased it every year. And we said at the outset and we continue to say, our plan would be to: once you start a dividend, you want to maintain it and not have to stop it and continue to grow it over time.

Operator

Your next question will come from the line of Deborah Weinswig with Citi.

Deborah L. Weinswig - Citigroup Inc, Research Division

In terms of categories, I thought it was very interesting. You talked about every supermarket had positive identical sales led by growth in natural foods, pharmacy, bakery and deli. I was wondering if you could provide some more color around those particular categories.

W. Rodney McMullen

Well, obviously, the pharmacy department, as Mike mentioned, was benefited from Express Scripts. But even without Express Scripts, pharmacy had a very strong identical sales growth. And the team, when they put together a plan on addressing -- getting the identical -- the additional Express Scripts business, really did a nice job of making it broader than just trying to get that business. And they've done a very nice job. Obviously, in natural foods, it's a trend change or a continued trend of people eating more organic and natural foods. And as we do a better and better job in that area, we're able to -- for a customer to eliminate one extra shop, and they can get those items from us at a price point that's very reasonable. On produce -- well, in deli, bakery, we've had strong results there for a while. Produce is kind of interesting. They had fabulous tonnage growth. The identical sales weren't so -- it was positive, but not so much, but the tonnage was just outstanding.

Deborah L. Weinswig - Citigroup Inc, Research Division

And then, Dave, you had talked about this idea of kind of creating a new industry, and I know that when your peers talk about your performance -- I mean, they really do stand in awe. I mean, as you look into the future, and I know that Kroger is always on the cutting-edge of technology, what do you think continues to differentiate Kroger from the pack?

David B. Dillon

Well, I really think it's the way in which we've looked at the business, and that was the point of the opening comments that I had, is that in the past, if you go back 15 years ago, we kept thinking like a traditional grocer. And we kept thinking that our competitors were traditional grocers, and we kept thinking about where you get customers is by competing with traditional grocers. The difference for us has been by focusing on customers, we're defining the industry we're in by how the customers think of it, not how we previously thought about it. So as an example, we used to think about it as people who buy food in supermarkets. But today, they buy food everywhere. They go to the club stores, the dollar stores, the mass retailers. They go to lots of places that are not supermarkets. And in fact, if you were to list our top competitors based on market share of the markets we operate in, the top 2 or 3 would not be traditional supermarkets, aside from us. And as a result, we don't really see that to be the universe that we're operating in. We see it as totally different, and we've had to approach it differently. And I think that, that's the reason we've had better results, because we're swimming in a pool that's bigger -- we were thinking about it as bigger -- than simply what the market was for traditional retailers. It's almost a classic business school case study, to show how you define your market and how you think of yourself will often determine who you become. And I think that's very true for us.

W. Rodney McMullen

Dave, the only other thing I would add, Deborah, to your question, one of the things that we've really been working on hard, and this has really been over the last several years, is not having a strategy that's only dependent on one competitive advantage. And if you look behind the strategy, there's really 10 or 12 different critical pieces. We often obviously talk about dunnhumby, and that would be one of the piece. But that isn't the only piece. And we believe over time that creates a bigger and bigger competitive advantage because the competitor can try to get as good on one particular part, but to do all the pieces is a lot harder. And that's really -- when Dave talks about creating a new industry, that's one of the things that -- we don't know quite what words to use other than we know it's a new industry, because there's really not anybody else competing on such a broad level of experiences. Obviously, technology is one piece of that, too.

Operator

Your next question will come from the line of Charles Grom with Deutsche Bank.

Charles X. Grom - Deutsche Bank AG, Research Division

Just wondering if you -- a 16-week quarter, just wondered if you could shed some light on how your ID trended throughout the period? And if you could, how things are going in the first few weeks here of the second quarter?

David B. Dillon

Well, let me answer the second part first and then I'll let Mike give you a little color on the trend and how we see it. Currently, for the quarter that we're in now -- and we're only, what, 3.5 weeks, I guess, into it -- we're down slightly from where we ran in the first quarter. But I wouldn't read too much into that because we have seen in the last -- well, even in the last year really, higher volatility between weeks than what we had been -- customers experiencing maybe years back. And as a result, it would be real easy to over-read a number like that. But after just 3.5 weeks, that's really not enough to read. But it is slightly down. In addition to that, we're seeing clearly the effect of the generics that we talked about in pharmacy. That is some of the brand name prescription items that are going to generic, which brings the price down very quickly. And you can see it literally by week. In fact, I'm looking right now at a graph that shows by week the way in which these are coming off of patent and how it changes our sales. So that makes a really big difference. And I probably ought to add, someone in here reminded me to make sure I emphasize the point, is that when I say we're down slightly, I'm saying down from the 4.2%. We're not negative at all. We're still quite positive. We're still quite positive and quite pleased with where we are in sales. I wanted to make sure that got clarified. Thank you.

Charles X. Grom - Deutsche Bank AG, Research Division

Okay. And then the trend during the quarter?

J. Michael Schlotman

Yes, it's kind of hard to answer the trend during the quarter, to break it down into distinct 4-week periods, primarily because holidays shifted between some of those periods this year. But when you kind of lap over those kinds of issues, it was relatively consistent. Obviously, when we've reported March, we said we were close to the fourth quarter numbers. So it trended down a little bit throughout the quarter, but that's kind of consistent with what Dave talked about. As prescription drugs come off generics, that's kind of the trend we expected. So relatively stable, a little bit of noise. Clearly first of the month, end of the month kind of phenomenas. But overall, fairly consistent throughout the quarter.

Charles X. Grom - Deutsche Bank AG, Research Division

Okay, great. And then just my follow-up, Mike, for you, is your core FIFO gross profit margin compares get real easy here over the next few quarters. Can you hold our hand on how we should think about that line item over the next 3 periods? I know you're saying total EBIT core, you expect to be slightly up. But how should we think about the components of FIFO, GPM and SG&A?

J. Michael Schlotman

Yes, I won't give guidance on the specific lines. Obviously, the rolling 4 quarters is down 11 basis points at the end of the first quarter, and our guidance is for that to be slightly better at the operating profit line. So that means we need to make up the 11, plus a little bit throughout the rest of the year. And to your point, the first quarter was our toughest compare quarter. A significant amount of the EBITDA we generated last year over 2010 was generated in the first quarter last year. And that's why we're comfortable that we can continue to slightly expand that by the end of the year. And the 11 basis points down did not alarm us. In fact, it was better than we had expected because of the stronger EBITDA in the first quarter.

Operator

Your next question will come from the line of Ed Kelly with Crédit Suisse.

Edward J. Kelly - Crédit Suisse AG, Research Division

My question for you is on the ID guidance. You had mentioned on the call that inflation is decreasing or decelerating at a faster rate than you thought. So what have you embedded in the guidance, the ID guidance for the rest of the year on that? And since it's unchanged but there's less inflation, does that mean that you changed your outlook for the way that you think tonnage is going to play out the rest of the year?

J. Michael Schlotman

I don't know that we would change the way we think tonnage is going to play out. We ended the first quarter at just under 4% inflation. If you look inside the grocery category, which is half of our sales, it actually got lower every 4-week period, the way we measure it internally. So clearly, there's a decline going on at a pretty ratable measure throughout the year. If you look at where we think it might be at the end of the year, we're guessing under 3%, 2% to 3%. And when I talk about lower, I mean lower inflation, not lower tonnage. We would actually expect some tonnage increase as we go throughout the year. And Rodney's illustration in commodities like produce that are very price-sensitive, and lower prices means a great crop that eats very well, we saw extraordinary tonnage growth in produce in the first quarter. So we would expect tonnage to get a little better throughout the year and inflation continue to trend down a little bit.

Edward J. Kelly - Crédit Suisse AG, Research Division

Just say we talk about an environment where maybe inflation in the back half of the year is -- let's just say it's not 2% to 3%. Let's say it's something lower than that. And for you guys, it's fine that your ID goes from 5% to 3% or 2.5% or whatever it might be, provided it's still a good number and that's not really in your control. But you've got this pretty big gap with your competitors. And under that environment, it means that their sales maybe turn negative. And what does that mean from a promotional standpoint, I guess, number one? And then if inflation's a little bit lighter, how do you manage your business if that ID, let's just say, ends the year at less than 3%?

J. Michael Schlotman

I think at the end of the day, it depends how you wind up getting to the 3%. I can't speak to how a competitor may manage their business. We spend enough time trying to figure out how to manage our own, let alone worrying about how others are going to manage theirs. Obviously we think about things, would they get promotional or do something hotter if there's negative ID sales. But at the end of the day, the important component is the tonnage. And when you look at some of the things that are elastic, that have elasticity of demand inside the grocery department, things like milk, milk prices continue to trend down. And the reported ID sales, to the extent that the generics coming off of patent affect that, that actually has a higher gross profit rate. So I think if -- stepping back and looking at your business overall, is tonnage moving in the right direction? What are your ID sales trends doing, unaffected by prescriptions coming off patent? And understanding all that, I think it's manageable for us. We don't foresee deflation by the end of the year. We foresee a little bit less inflation. That doesn't mean -- which doesn't mean lower prices. It probably means stable shelf prices or slightly up shelf prices.

Edward J. Kelly - Crédit Suisse AG, Research Division

Okay. And just lastly for you, can you maybe give us an update on the state of the consumer as you see it now? I mean, obviously, volumes across the industry have been fairly weak. Are customers just kind of getting by with buying less? Is there differences in income brackets? Just your sense as to really what you're seeing at the customer level.

David B. Dillon

Well, what's going on with the customers today is much like what we described in March. We're seeing those whose life and economic status is strong. Feeling and acting a little bit like they're -- that the recession is over or, certainly, that the economy has improved. We're seeing those who are on tight budgets and those who are more price-sensitive. Their behavior is being affected more by the economy. And I think overriding all of that is the fact that if you look at just generally the geopolitical world right now, people are a little bit nervous. And so there's a little bit of anxiety out there on the whole that kind of dampens their enthusiasm, even for those that are on the high end. That's how I would read it. Rodney, you want to add any more?

W. Rodney McMullen

I mean, I think overall, it would be pretty similar to what we said at the first year end. We continue to see it getting a little better but boy, it is very slow and bumpy from week to week.

Operator

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

Kenneth Goldman - JP Morgan Chase & Co, Research Division

It's our understanding that the price investments you made in California recently were successful. So 2 questions. First, is that the correct assessment, that you got the tonnage response you wanted? And second, if so, based on that success, to what extent might we expect maybe an accelerated investment in other banners down the road?

David B. Dillon

Well, I'll let Rodney answer the particulars, but let me just remind you that what we've said about price investments for actually many years now is that it's a long fuse. It's not the kind of thing that you invest one day and the next day you declare victory. You invest one day, and the next year, you decide whether or not it was a really good move or not, and you make adjustments maybe week-to-week and month-to-month. But it's not something that you can read that quickly. So Rodney, you want to give any color to this?

W. Rodney McMullen

Just a couple of comments. Our team at Ralphs and our -- have really done a very nice job of explaining to the customer the changes we made and the total value that we're offering versus before. So we really think it's our associates that have done a nice job of communicating the value to the customer, is the reason the customers are reacting in a positive way. Some of the things that we did at Ralphs were things that we'd already done in other parts of the country earlier. So it's really just from -- some of it was just from a timing standpoint that we now had the resources to do it at Ralphs. So overall, pleased with where we are. Probably be about all the comments I'd make.

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Okay. And just to follow up on a point you made earlier, you talked about one of the reasons not to raise the payout ratio is that you wouldn't want to have to cut it once you raised it. I'm curious, one, why you'd ever have to cut it. And two, if you're buying back stock, you're rewarding investors for selling your stock. And if you're paying a dividend, you're rewarding investors for keeping it. Wouldn't you want to reward the latter more than the former? And I guess, just as a lower growth company versus the S&P, not your peers, and you do throw off a lot of cash, a higher payout ratio might seem somewhat befitting, and you might attract more income-oriented investors. So just curious how you do think about that, if we can get any more color.

W. Rodney McMullen

Sure. I don't think I said I was worried about having to cut it. I said, from an overall dividend strategy, a company, once you start a dividend, you go down that path wanting to make sure you can maintain it and grow it over time. That's more of a textbook dividend philosophy, not a Kroger worry that we're worried about cutting it. We have grown it every year since we've instituted our dividend. We would expect to continue to grow our yield and payout ratio over time. We think our stock, where it's been trading particularly of late, is a very inexpensive buy, and we think the potential return for us on buying the stock and at this point in time really rewards that share -- I think it does reward that shareholder who continues to own our stock and not sell the stock. I'm not really rewarding the shareholder who sells the stock to me at $22 a share. I'm rewarding the shareholder who continues to hold that and is going to enjoy the ride up from $22 with us as we continue to generate great results.

Operator

Your next question will come from the line of Robbie Ohmes with Bank of America Merrill Lynch.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

It's Robbie Ohmes. Just a couple of quick questions. The first was if you could comment on -- is the percentage of your customer base on EBT, has that continued to totally flatten out? Or is that still increasing? I was just curious. And then the second question was just on the strength of your natural foods business and how you're approaching that. I was just curious if you could maybe shed some light going forward, how you see that area of your business linking in with dunnhumby. Is it linked in with the dunnhumby JV already and being used to continue to drive loyal customers? Or is it an area that you merchandise that is just gaining momentum on its own? And maybe just give us some color on how you foresee that part of your business playing out over the next year or 2.

David B. Dillon

I'll comment on the EBT and then I'll ask Rodney to comment on the natural food trend and the rest of your question. We are not seeing an increase in the EBT percent of our business. What we are seeing though, of course there's been some variations from week-to-week and even month-to-month in various markets, and a lot of that has to do with the way states are paying out those benefits; often, they're spreading it out now rather than all at the first of the month, which is what they used to do. And so it's a little bit hard to read, but it's definitely not rising. If anything, it's settling down just a bit. But it's just a bit, so I wouldn't read a lot into that either. Rodney, you want to comment about natural food?

W. Rodney McMullen

Yes. On the question on dunnhumby, natural foods has always been tied into dunnhumby. Now -- it would be true for natural foods and other parts of the store, too. We continue to get better at target marketing personalization for all customers to make sure that they understand what we offer in natural foods. The biggest growth in natural foods is really regular customers that aren't just diehard natural foods or organic shoppers are finding some of the products taste better, some of the items -- they just like the item, it's more creative. So you'll see customers that aren't necessarily just natural foods shoppers but shoppers that find something they like and they'll buy in that category. And certainly, my wife and I would be one that would fall into that category.

David B. Dillon

Rodney keeps bringing examples of new stuff in for us to try, so he speaks from experience.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Great. And just one last follow-up question. I was curious, I know Wal-Mart has launched a sort of a different TV advertising campaign in a bunch of markets and, I think, in some cases, or at least in one, they've included polling someone who's shopped your store and tried to show a more competitive average basket. And I was curious if you could comment on whether you've felt any significant impact from that approach.

David B. Dillon

Well, we won't talk about any specific competitive issues, I don't think. But generally speaking, I think you can see, with our sales and the trends that we've identified, that's probably the best way to describe where we are. And remember that what we've said is our whole program is more than price. We've invested a lot in price certainly, but what we've tried to do is neutralize price from being the main issue, to where the main issue for us is our people and our products and our shopping experience.

Operator

Your next question will come from the line of Meredith Adler with Barclays.

Meredith Adler - Barclays Capital, Research Division

I want to talk a little bit about gross profit dollars. It seemed -- and people kind of obsessed with comps when they look at slowing inflation, but I think gross profit dollars are more important. What happens when -- with the deflation in produce and you saw a big increase in volume, would you also say that gross profit dollars were up?

David B. Dillon

Mike, you want to comment? Or -- we're actually going to look that up and see if we can give a more specific answer.

J. Michael Schlotman

I don't have that at the tip of my fingers [indiscernible]...

David B. Dillon

I would agree with you though on the theme of gross profit dollars. We think about our business in terms of dollars and not in terms of percents.

Meredith Adler - Barclays Capital, Research Division

And certainly, we know gross profit dollars per script are higher with generics.

David B. Dillon

Yes, yes. In fact, in pharmacy, it's crystal clear that while we're -- our sales change, because of the generics, is actually pretty radical on those items. But the gross profit dollars is similarly radical in the other direction.

J. Michael Schlotman

Yes. When you look at the produce department, our gross profit rate would have been down because of the deflation. But because of the tonnage, we generated a pretty good amount of incremental gross profit dollars.

David B. Dillon

Yes. Just exactly what you were thinking, Meredith.

Meredith Adler - Barclays Capital, Research Division

Yes. And I guess you had talked about moderating inflation in some other categories, not outright deflation, and that inflation could come down faster than tonnage would go up. But do you think that still the net impact of all of that would be the gross profit dollars, at worst, would be flat?

W. Rodney McMullen

I would think -- I mean, if you look at specific guidance, you'll always have exceptions. But when you look at it overall, we're still expect and focused on having improving gross profit dollars when you look at it overall.

Meredith Adler - Barclays Capital, Research Division

Okay. So I can tell people who are worried about the moderating inflation to cool it, just calm down.

David B. Dillon

Yes, we think so.

W. Rodney McMullen

Yes.

David B. Dillon

I would completely agree with that view.

W. Rodney McMullen

And remember, part of the change in our expected identical sales is because of the -- all the prescriptions coming off patent, as Dave and Mike mentioned. And that improves gross profit, and that's something that's -- this year, the number of drugs, as you know, coming off patent, is significantly higher than any year, certainly since we've been involved in this business.

David B. Dillon

Yes. And we've overemphasized that point for a reason, because we're really kind of nervous that when you see what we've forecasted for the identical sales for the year, you'll -- someone will read that and conclude that things are getting worse. But in fact, the pharmacy affects most or all of that.

Meredith Adler - Barclays Capital, Research Division

Just talking about pharmacy quickly, first, do you still think you're getting more than your fair share of Express Scripts customers, the ones who are leaving Walgreen? And then also, how sticky do you think they would be if there was a resolution between Express Scripts and Walgreen?

W. Rodney McMullen

To me, that's a great question. It's always tough to answer because it's one of those where I'll answer it both ways. You never get -- unless you have 100% of something, it's never your fair share. So -- but if you look at the share that we think we're getting of the Express Scripts, it's certainly higher than our market share is of pharmacy in the markets that we operate in. So we certainly feel like we're getting more than our fair share based on that. On the stickiness, the real key for us is making sure that we're delivering great service to those customers that come to us. Because when they come to us, that's one less shop they have to go to, and we should be able to save them time. As long as we have good -- great service and the prices are right, that should be the stickiness. And we're doing an awful lot of work making sure that the customers tell us how we're doing, specifically those customers, and making sure any things that we can do better, we're focused on doing better. So if that did change, there would be more stickiness to that customer.

Meredith Adler - Barclays Capital, Research Division

And do you have tie-ins with your frequent shopper program and deals to create loyalty? I mean, one of Walgreen's weaknesses, in my opinion, is that they don't have a frequent shopper program. Is that something that you think helps you keep the customers?

W. Rodney McMullen

We certainly do. And you should assume that anything that you can imagine, we're trying to do those things to help improve that stickiness.

Operator

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

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

This is actually Mike Otway in for Scott. Just kind of in terms of a follow-up from a question earlier. With fuel having come down pretty decently and going below that $3.50, an important $3.50 mark in some markets, have you noticed a change in the consumer or in consumer spending in the last few weeks specifically?

David B. Dillon

Not that I can discern. Rodney, anything you could...

W. Rodney McMullen

No, I would agree with that.

David B. Dillon

And I don't remember exactly where it was the same week last year, but -- the real issue on fuel, at least in the quarter, was that it did not rise as much as had widely been anticipated. It was still generally up.

W. Rodney McMullen

The other thing I think from a consumer standpoint, they're still nervous about is it a permanent decline? Or it just happens to be 2 or 3 weeks? And I think that really have behavior change, customers have got to get comfortable with more than just 2 or 3 weeks.

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

Understood. And then I guess just switching over to SG&A quickly. You guys had some nice leverage there. As inflation continues to decelerate and comps come in further, at what point do you start to delever? Maybe perhaps some color around there would be great.

J. Michael Schlotman

Yes, I think we'll be fine on our ability to do that with the productivity processes we have and getting better execution on the productivity. Also keep in mind, as the sales, ID sales in the back half of the year get more affected by the generics, those do generate a higher gross profit. So when you look underneath the dollars we have to spend on that OG&A, we should be able to get sufficient coverage of that, which is the cornerstone of us guiding to a slightly improving operating profit for the year.

Operator

Your next question will come from the line of Karen Short with BMO Capital.

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

Just quickly again on Express Scripts. I just was wondering, were you guys actually -- did you gain more share on Express Scripts than you expected to? Or can you maybe just give a little color on that?

W. Rodney McMullen

I'd say we're -- so far, it's been a little bit better than we expected, and we continue to stay focused on that. So yes.

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

Okay. And then looking at operating expenses, I guess, if I remember correctly, in the first quarter of last year, you seem to have a similar pattern where you got the expense savings ahead of spending, which is just kind of what you plan on -- you indicated you planned on doing going forward. So is it fair to say that, that's kind of what happened this quarter? You definitely saw some expense savings ahead of the investment in price, and we may see investment in price accelerate throughout the rest of the year?

W. Rodney McMullen

I wouldn't read too much into that. I mean, it's one of the reasons why we wanted to make sure that we raised the guidance, so that you could see that some of the extra improvement in the first quarter, we actually think it will flow through for the whole year. If you look at our expense savings versus what we expected, we're pretty in line with what we expected. And we did a nice job of balancing between gross and OG&A improvements. And we're really focused on trying to make sure the 2 tie together. I don't know, Mike or Dave.

J. Michael Schlotman

We have to balance it for the rest of the year because at the end of the first quarter, with the operating profit margin down 11 basis points and guidance to slightly grow that by the end of the year, we have to remain in balance. Otherwise, that won't be the result.

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

Okay, that's helpful. And then just looking at your cash flow, I was just curious, accrued expenses definitely was a benefit for you guys. Is there anything to talk to there?

J. Michael Schlotman

Nothing specific. We can talk offline on that. Taxes are in there, but nothing outlandish that I can think of.

Operator

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

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

I wanted to follow up a little bit, because you -- an earlier caller mentioned lower gasoline prices' effect on the consumer. But what I'm interested in is when you -- first of all, when you go '08 into '09, you saw some significant dis-inflation and then deflation, and the tonnage went through the roof at that time. And are there -- I guess what I'd ask is are there areas outside of produce where you believe a significant -- I know you're not calling for that this year, but let's just say relief and perhaps decline in some of your costs and some of the prices you're able to offer consumers would stimulate more demand and actually drive tonnage? Because I've been hearing from some of the food manufacturers for a long time, about this consumer whose got $100 to spend at the grocery store and has been having to stretch it further and further. Do you get more discretionary buying if that $100 actually winds up going further at some point over the next 6 to 12 months?

David B. Dillon

Well, when I think about inflation, I always separate the perishable departments from the packaged products in the center of the store. That's important because the behavior is actually quite a little bit different. So I would expect some inflation and deflation happening over any course of the year in both produce and meat as examples. And we just manage that in the course of business. And you have behavior that happens like what happened in produce last quarter, which we've described. But the essence of your question really goes to the center of the store and the packaged goods. And normally, when I'm talking about food inflation, I'm usually talking about that because it behaves a little less erratic. The deflationary times that you talked about before was where the CPG operators needed more tonnage. Their costs were such that they needed to reinvest back in their products. They'd let their prices get too high. As commodity costs went up, they went up, and they went up a little higher plus some, and then they had to overcorrect actually in the other direction. So tonnage then did pick up. You were right about that particular case. I don't think we've seen quite the same overreaction so far on the upside this time, although I could be wrong. Some individual operators could have a different view of that. And so it remains to be seen how they'll behave. I don't know, Rodney, if you have any additional color.

W. Rodney McMullen

No.

David B. Dillon

So I don't think -- we're not really thinking that there's going to be some erratic change here.

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

So you think a decline and -- a significant decline, let's say down 1% or 2% versus, let's say low-single digit we're thinking about, by the end of this year now would drive additional tonnage in the center store?

David B. Dillon

Well, I think that's -- first, it's hypothetical, and I just as soon not get into all the possible scenarios that could happen. But second is that it would be highly dependent upon individual companies. So if a company invested in their products and sold them to us at a lower price and had them retailed as a result at a lower price, it sees tonnage in those items. But whether or not you'll see that or not is really going to be up to those individual companies.

W. Rodney McMullen

The other thing that was going on back in '08, '09, as Dave mentioned, some of the CPGs were making way too much in margin. And part of the huge tonnage growth we experienced and saw was in our own brands. And it's one of the values that we have because we have such a strong corporate brand program across so many categories. When the economics of the product is different than what the CPGs are charging, we can't -- we will give that benefit to the customer, and we always get rewarded in huge tonnage increases. And if you remember, we had tremendous improvement in market share on our corporate brands at that point, too.

Operator

Your next question will come from the line of Mark Wiltamuth with Morgan Stanley.

Mark Wiltamuth - Morgan Stanley, Research Division

Mike, it's not that often that we hear you talking about pharmacy during the call, so I wanted to ask if that was a meaningful swing in year-over-year EPS contribution for pharmacy this quarter.

J. Michael Schlotman

Well, it certainly helped the EBITDA growth in the first quarter, but there were plenty of other items inside the other departments that contributed to the EBITDA growth being stronger than we expected for the quarter. As Dave and Rodney have both said, every department inside the store had positive ID sales. So it was a pretty good broad-based improvement across the whole complex. There's always rough spots anytime you have to do as many things as we do. There's always things that could be better. But we were pretty happy with the overall balance inside the quarter.

Mark Wiltamuth - Morgan Stanley, Research Division

As you look at the year, how big do you think the overall ID drag could be from pharmacy because of the generic effects? And do you think it makes sense to maybe call out the ID without the pharmacy in some of these future quarters?

J. Michael Schlotman

We've made a commitment to talk about the pharmacy as we go throughout the year and try to describe the effect of that. I don't want to commit right now what I will give or not give, and we'll look at that throughout the year. There's just so many moving parts with some moderating inflation, some higher gross profit rates from generics, the addition of Express Scripts. It's kind of early in the game, if you will, to make a decision on exactly how we'll break that out.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. And just -- can you -- any way you can give us a magnitude on how big the overall drag effect could be for the whole year?

J. Michael Schlotman

We think, for the whole year, it could be as much as 50 basis points drag on IDs. But it will be increasing as we go throughout the year, to Dave's earlier comment.

Operator

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

Alton K. Stump - Longbow Research LLC

Just to follow up on a couple of questions earlier. The talk with the CPG companies moving into the back half of the year and how they got huge margins looking back to '08, '09, if that happens again, how much leverage does Kroger have to push back on CPG companies to bring down their pricing?

David B. Dillon

Well, first, let me comment that since it's 11:00, this will be our last question.

W. Rodney McMullen

[Indiscernible]

David B. Dillon

Oh, we'll have time for one more. Okay. Before we get to that, I wanted to make sure you had a time reference here. But in thinking about CPG companies, one of the reasons Rodney pointed out about our Kroger brands and its success, and we had continuous success in the first quarter, was to illustrate that we do have leverage, particularly when the underlying commodity economics don't match what's happening in the market. We, of course, would experience some of the same costs that other manufacturers would experience. But when they stray from those basic economics, we have pretty good leverage. Do you want to add anything on that?

W. Rodney McMullen

No, no.

David B. Dillon

I think that's how we see that, and so we feel actually pretty good about it. The other thing I actually would add, and I've said this several quarters, is at Kroger, we have had really good success and we have partnered with a number of national brand vendors in very successful ways. And so we have a number of places where our tonnage is up with particular vendors because of plans that we've laid. So that actually is some leverage, too, on the other direction, because we have the capacity to produce really good results for individual companies out there.

Operator

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

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

Just wanted to ask you 2 questions on your sales trends. First, Dave, I think you said the volatility was pretty high in weekly ID sales.

David B. Dillon

Yes.

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

Now is that a change in trend? Is that new? Or has that been sort of the way it's been for past few quarters or so?

David B. Dillon

Well, it's certainly been true in the last few quarters. It's different than it was several years back. And the reason I called it out is it makes it hard to read individual weeks. And when you only have 3.5 weeks in a quarter and any of that included an end of the month or first of the month which are the hardest to read, and especially when you have a 2-day shift because of the leap day that is now in our numbers, so the first of the year in any future month this year is 2 days removed from where it was last year, you see even more erratic swings in those weeks. So I just think it's hard to read such short periods of time, and you have to take a little longer to look at it. That's really what I meant.

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

Got you. And the other question is on the slowing in ID sales you're describing kind of incrementally. Should we think of that as basically all due to inflation and volume trends are kind of sticking around flat? Is that what you're trying to tell us?

David B. Dillon

I think that's fairly close. I mean, a little more positive than that, actually. Because as you know, it's hard -- it's really hard to read tonnage. It may sound like it shouldn't be, but it actually is because of the mix changes and all these other things. And we're really trying hard to give you a fair picture of what we think is happening. And it sounds contradictory, but we don't think it is to say, first, as we clearly saw, that tonnage is mildly in the positive direction from where it was last quarter. But it's not so great that we're trying to call that up. We're still calling that basically flat.

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

Got you. Okay, great.

David B. Dillon

So it's a positive message, not really a neutral message.

Before we end the call, though, I would like to share a few additional thoughts with our associates who listened in today. We encourage them to listen, and so I'll take just a minute or 2 of your time still. I want to thank all of our associates for your tireless efforts to keep food safe for our customers and their families. The International Association for Food Protection recently named Kroger the recipient of its Black Pearl Award for 2012, which recognizes excellence in food safety and advocacy. Rodney and I are especially proud of you for this recognition. Only 4 other retailers have been so recognized by this association. I'm certain that what the association saw in Kroger is our success in continually raising the bar on food safety. Keeping food safe for millions of our customers every day is a tremendous responsibility, one that reflects our deepest commitment to putting customers first. Food safety is everyone's fight every day. Our latest program, FAST, which stands for food at safe temperatures, reminds us to keep products below the low limits in cases, minimize stocking time on refrigerated products and keeping cooler and freezer doors closed. These simple steps help us serve safe and delicious food every day. Thank you for this gift to our customers. This completes our call today. Thank you all for joining us.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a wonderful day.