The Kroger Co. (NYSE:KR) Q4 2009 Earnings Call March 9, 2010 10:00 AM ET

Executives

Carin Fike – IR

David Dillon – Chairman and CEO

Rodney McMullen – President and COO

Mike Schlotman – SVP and CFO

Analysts

Scott Mushkin – Jefferies & Company

Karen Short – BMO Capital Markets

Jason Whitmer – Cleveland Research Company

Jon Feeney – Janney Montgomery Scott

John Heinbockel – Goldman Sachs

Ed Kelly – Credit Suisse

Meredith Adler – Barclays Capital

Chuck Cerankosky – Northcoast Research

Andrew Wolf – BB&T Capital Markets

Operator

Good day ladies and gentlemen, and welcome to the fourth quarter 2009 The Kroger Company earnings conference call. My name is Jasmine and I'll be operator for today. At this time all participants are in a listen-only mode. Later we will conduct a question and answer session. (Operator Instructions)

It is my pleasure to introduce your host for today, Ms. Carin Fike. You may proceed.

Carin Fike

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 fourth quarter press release and our prepared remarks from this conference call will be available on our website at www.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 topic with one question, and one follow-up question if necessary. Thank you for your cooperation.

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

Dave Dillon

Thank you, Carin and good morning everyone. Thank you for joining us today. With me to review Kroger's fourth quarter and full 2009 results are Rodney McMullen, Kroger's President and Chief Operating Officer, and Mike Schlotman, our Senior Vice President and Chief Financial Officer.

The Kroger team delivered solid quarterly and full year results for both our customers and shareholders during what continues to be a difficult operating environment. We are strengthening Kroger's overall competitive position by increasing the number of households that are loyal to Kroger, and earning a great share of their business. As a result, we continue to generate tonnage growth in both perishable and non-perishable categories, that is among the strongest in the industry.

Identical supermarket sales increased 1.2% in the fourth quarter without fuel. For the year identical supermarkets sales without fuel increased 2.1% over 2008. Sustainable, identical sales and earnings growth remains one of Kroger's key long-term objectives. We continue to widen the gap between Kroger's identical sales growth trends and those of most of our competitors. We believe this has extremely positive implications for our associates, customers and shareholders, both now and as we grow our business.

As we described to you last quarter, several factors continued to influence Kroger's business in the fourth quarter. They include deflation and the slow pace of the economic recovery, which continues to restrain consumer spending. In the fourth quarter, we estimated our product cost deflation excluding fuel was nearly 100 basis points, a further drop from the 80 basis points of deflation we experienced in the third quarter.

This compares to product cost inflation, excluding fuel of approximately 590 basis points during the fourth quarter of 2008, to another words the year-over-year swing of almost 700 basis points. The swing is even more staggering when you isolate the grocery department. In 2008, we experienced nearly 800 basis points of inflation in Kroger's product cost for the grocery department during the fourth quarter.

In the fourth quarter of 2009, on the same internal measurement we experienced approximately 285 basis points of deflation. I'll do the math quickly for you, that's a swing of over 1,000 basis points on a year-over-year basis. This is unprecedented in, at least in my time in the grocery industry. The economic recovery continues to sluggish and unemployment levels remain high, suppressing consumer spending. The slow pace of the recovery will continue to influence our consumer's feel about their own spending decisions.

Against this backdrop, our team performed well in a number of areas, and we believe our financial results well good and relative basis don’t fully reflect the progress Kroger is making. We made significant strides in 2009. These include positive trends and feedback from our customers, the strong rise in the number of loyal households we serve, continued growth in tonnage and market share gains. We also made meaningful progress in our sustainability efforts, which Rodney will share with you. We are proud of what our associates accomplished throughout the year and we look forward to building on this momentum. Rodney and Mike will update you on Kroger's performance in these important areas and we will start with Rodney. Rodney?

Rodney McMullen

Thank you, Dave, and good morning everyone. As you know, a fundamental part of our strategy is listening to what our customers tell us is important to them and acting on that information. Every quarter we track what our customers are saying about us in four key areas; our people, our prices, our product and services, and the overall shopping experience in our stores. We measure our progress in specific categories, such as the friendliness and attentiveness of our store associates, for example.

In 2009, our customers told us we improved more in each of the four key areas than in any year since we begin these customer surveys in 2004. We saw good balance of the improvement across all four keys. These surveys which track feedback from more than 50,000 customers each quarter provide meaningful insight that we can act on immediately and we will continue to seek feedback from our customers and incorporate what they tell us into our future business plans. We believe it also demonstrates the sustainability of the strong sales and tonnage growth we are producing. We conduct similar surveys of our associates and continue to make improvements based on what our associates tell us is important to them. Associate engagement is an important part of our customer first strategy.

During the quarter, the total number of households we served increased over the prior year. We saw an even stronger growth in the mid-single digits in a number of loyal households that shop our family of stores. These households represent our very best customers. Our data shows these customers are making more trips into our stores and over the course of month these households are spending more total -- buying more total items from Kroger then they did a year ago. This is another indication that our strategy is resonating with our best customers.

Our robust field discount programs are one example of how Kroger is able to build customer loyalty by developing unique offers that reward customers for shopping in our stores. In 2009, Kroger customers saved over 200 million through fuel discount programs tied to our loyalty cards. And we continue to expand our fuel discount programs for our most loyal customers.

We recently introduced a partnership with Shell in select markets. This industry leading program gives customers more opportunities to save on gas at Kroger fuel centers and participating Shell locations. As Dave mentioned earlier, we continue to maintain strong overall tonnage growth that was driven by both corporate brand and national brand sales. In the fourth quarter, we saw mid single-digit growth in sales of our own brands and national brands. This is on top of the double-digit growth we saw in our own brands during the same period last year.

During the fourth quarter, corporate brands represented about 27% of our grocery department sales dollars and approximately 35% of our grocery sales units. Both of these are consistent with the trends we saw in the fourth quarter of 2008. So, while we are seeing good growth in national grand tonnage, the popularity of our industry leading corporate brands has not diminished with customers. We believe this is the another indicator of the health of our business.

Kroger's strong tonnage growth is a direct result of several different customer focused efforts. The customer insight we drive through our unique partnership with Dunnhumby, USA enables our associates to strengthen Kroger's connection with our customers. A strong tonnage growth is also a direct result of our associates providing service in a broad high-quality product assortment we offer at good prices.

Turning now to our retail fuel operations. We continue to see strong gallon growth, both in total and on an identical basis for both the fourth quarter and the full year. Other retailers are reporting gallon declines, and the overall market indicates that the US consumers are buying fewer gallons of gasoline, but they are obviously buying more gasoline at Kroger's supermarket fuel centers and convenient stores.

While margin in our retail fuel business has significant impact on Kroger's annual earnings per share results, they did not materially impact the year-over-year change in EPS for the fourth quarter. This was largely due to cents per gallon margins that were fairly consistent with last year. $0.094 per gallon for the fourth quarter of 2009 compared to $0.097 for the fourth quarter of 2008. On a rolling four quarter basis, the cents per gallon fuel margin was $0.106 in 2009 compared to $0.147 in 2008. Our guidance for fiscal 2010 assumes a normalized margin for this business of approximately $0.11 per gallon.

One area that we have not talked a lot about but are very proud of what our associates have accomplished is our sustainability efforts. Kroger continues to make considerable progress in our top sustainability focus areas. These are waste reduction, plastic bag reduction, energy conservation and transportation. In partnership with our customers, we have increased the amount of plastic we recycled from 9 million pounds of plastic in 2007 to 22 million pounds in 2009. We saved nearly 200 million plastic bags last year, about 20% of the way to our goal of saving 1 billion plastic bags. Our approach includes engaging our associates in more efficient bagging techniques and engaging customers in using reusable bags.

Our energy teams have helped us achieve impressive utility cost reductions through technologies, such as LED lighting and energy efficient motors and our freezer cases. And our fleet efficiency improved by more than 7% in 2009, meaning our logistics team delivered more cases of products per each gallon of fuel used.

During the quarter, we continued to make progress in labor relations. We completed successful contract negotiations for our associates in several markets including Fry's in Arizona, King Soopers and City Market in Colorado, Fred Meyer in Oregon and Kroger in Atlanta and Savannah, Georgia.

In 2010, we will negotiate agreements with the UFCW for associates in Albuquerque, Cincinnati, Dallas and Detroit, Fort Wayne, Houston, Little Rock, Portland, Seattle and Toledo. We will also negotiate agreements with the Teamsters for associates in California and Portland. Rising healthcare cost continue to be an important issue in our labor discussions.

Entering contributions and expense will continue to be an issue as well. During 2009, we contributed approximately 233 million to several different and multi-employer pension funds. In 2010, we expect to contribute approximately 250 million to these funds. We continue to work diligently and cooperatively with other employers, union groups and legislators to address the underfunded status of many of these plans. While we have made progress through these efforts and plan asset values have risen along with the market recovery we continue to believe this is a serious issue for all participants. The ultimate solution will be a combination of benefit reductions, legislative changes and the increased employer contributions.

Last year at this time, we thought our annual multi-employer pension contributions had the potential to double in the next few years. Based on current market conditions, we believe the potential for that scenario to develop over the next five years to be less likely. We still anticipate meaningful increases in expense each year as a consequence of the increased contributions that Kroger and other participating employers will be required to make in order to rehabilitate the funding status of many of these plans.

Now, Mike will offer you more details on the fourth quarter and full year 2009 results and our outlook for 2010. Mike?

Mike Schlotman

Thanks, Rodney. Good morning, everyone. As we described for you last quarter, from an operational perspective our fourth quarter was very similar to what we experienced during the third quarter. From an earnings perspective, a lower LIFO charge and tax rate each worth about a penny compared to our expectations caused Kroger's earnings to be higher than the forecast we shared with you in December.

Kroger's net earnings for the year adjusted for the asset impairment charges in the third quarter were $1.71 per diluted share. These results represent a decline of 10.5% compared to fiscal 2008 earnings per diluted share of $1.91 excluding Hurricane Ike charges. As we review our financial results, keep in mind that the lower LIFO charge this year was offset by the lower fuel margin.

We are very pleased with our cost controls. Our positive identical sales and cost saving efforts allowed us to leverage our OG&A. Excluding fuel and one-time items, our OG&A rate declined 3 basis points. This was an outstanding result in a period of deflated retail price points, mid-single digit tonnage growth and increasing credit card fees.

Our sustainability efforts Rodney described earlier also contributed to this result. We also had good results with some of the expenses that are accounted for in the gross profit line. For example, our warehouses handled significantly more tonnage with essentially the same warehouse cost as last year. We are committed to process and productivity improvements to continue this result.

Another topic of interest to investors is market share. Growing market share is an important part of Kroger's long term strategy. Nielsen Home scan data shows that Kroger's overall share rose approximately 60 basis points during fiscal 2009. This data also indicates that our share increased in 13 of the 17 marketing areas outlined by the Nielson report, declined in three and remained unchanged in one.

Wal-Mart is a primary competitor in 12 of these marketing areas. In those 12 marketing areas Kroger's overall market share grew approximately a 100 basis points. Our share increased in the 11 of those markets and declined in one. According to our internal tracking of competitive store openings Kroger divisions compete with about 1190 Wal-Mart supercenters, an increase of roughly 60 new supercenters over last year.

The reason we cited Nielsen's Homescan data is because we learned the government data used as part of our internal methodology has not been updated to reflect the impact of significant deflation and restrain consumer spending have on sales in 2009.

Using the government data as it currently exists shows Kroger's overall market share decline in 2009. We do not believe that that accurately reflects our market share results for 2009, particularly considering our strong tonnage growth and positive identical food store sales. Adjusting the government data to include the decline in the CPI are now also share Kroger's overall market share increased. We plan to continue to grow our business by maintaining Kroger's existing strong market share and building on additional opportunities for growth.

Turning now to fiscal 2010, we anticipate identical supermarket sales growth up 2% to 3% without fuel. We expect net earnings to range from $1.60 to $1.80 per diluted share. Kroger's quarterly dividend enhances total shareholder return by approximately 1.5% to 2%.

We believe several factors that influenced our business in the last half of 2009 will continue through at least the first half of fiscal 2010. Inflation or deflation in product and operating costs, the competitive environment, fluctuating fuel margins and the pace of the economic recovery are uncertain and causes to be cautious about our fiscal 2010 forecast. We expect trends in these areas to influence our results throughout fiscal 2010.

Five weeks into fiscal 2010, our identical sales trend is slightly ahead of the guidance range we have outlined. Please keep in mind, this trend benefited from the timing of the Super Bowl and snowstorms in many regions we serve. We do see plenty of opportunities to invest capital and generate strong returns on those investments in today's environment. We expect to invest approximately 1.9 billion to 2.1 billion in capital projects with a strong bias towards remodels and infrastructure projects.

Our remodel stores continue to generate favorable returns and we believe pursing a steady course of remodels keeps our assets fresh and inviting for our customers. Infrastructure projects we undertake are designed to enhance the overall shopping experience for our customers, which helps drive sales or improve efficiencies, which generates cost savings we can invest in our strategy.

We expect to use free cash flow to maintain our current debt coverage ratios and reward our shareholders, both through share buybacks and quarterly cash dividends. I encourage you to take a look at the 8-K we filed earlier today, it contains additional details on Kroger's 2010 guidance that maybe helpful to you. As we give annual guidance, we are often asked how we see earnings play out over the course of the year. This question is particularly important this year, given the volatility of 2009. We anticipate our first quarter 2010 results will be below the results we reported for the first quarter of 2009, assuming many of the operating conditions we experienced in the second half of 2009 continue into fiscal 2010.

The second quarter should be more comparable with the prior year as we begun to lap many of the significant price investments we made in 2009. And we expect solid growth in the third and fourth quarters of 2010 assuming favorable trends in product and operating costs, the competitive environment, fluctuating fuel margins in the pace of economic recovery.

Now I will turn it back to Dave.

Dave Dillon

Thank you, Mike. As we move forward in 2010, I am inspired by the overall performance of Kroger Associates in 2009. During the year that proved to be extremely trying, Kroger successfully achieved identical sales growth, increased the number of households loyal to Kroger stores and generated strong tonnage growth. In addition, we reduced debt, increased the dividend we pay shareholders and prudently invested capital to keep our stores and other assets fresh and innovative, strengthening our competitive position.

During the last two years, we added 24,000 new jobs to support our growing business, a direct reflection of the health of our business. All of these achievements strongly support the continued growth of our company. As our performance during the quarter and throughout 2009 demonstrated Kroger's strategy generates value and good times and bad. Our team knows how to compete effectively in any operating environment to strengthen the connection we have with our customers. We believe Kroger will continue to be in the best position to deliver shareholder value now and as the economy and consumer confidence improves.

We now look forward to taking your questions.

Question-and-Answer Session

Operator

(Operator Instructions) Your first question comes from a line of Scott Mushkin with Jefferies. You may proceed.

Scott Mushkin – Jefferies

Hey, guys. Thanks for taking my questions. I just wanted to poke at the selling gross margins a little bit and explore sequentially a decline, again, in trying to understand what's driving at that competitive environment I know you guys have mentioned much about the competitive environment, but it seems to be improving. Are you seeing that selling gross margins now as you are in to the first quarter get better, and did you see it improve as you went through amidst the first quarter as in -- are you seeing -- did you see it improve during the fourth quarter, I know November was really tough?

Dave Dillon

Thank you, Scott. Let me comment this way, I would look at the fourth quarter selling gross investments as a continuation of what you saw what we saw in the third quarter. There's two things to think about, first is that there was a certain trend or trajectory setup in the third quarter that continued at the end of the fourth and that's actually partly what we saw. In addition, you've mentioned already the thanksgiving which we already indicated wasn't that particularly strong holiday for us. Christmas on the other hand, we were pretty satisfied with.

The other comparison that makes it a look little worse than it actually was, was a comparison to the prior year. And that's true not only in the fourth quarter, which we just finished, but it will also be true, I think, in the first quarter when we report that out in June. That we had particularly strong, relatively speaking strong, gross profit quarters in the fourth quarter of 2008 in the first quarter of 2009. So, I don't see it as anything other than that. As to the competitive market, we would say it's still aggressive, however it has shown some stabilizing, and as a result I think that I wouldn't blame the gross profit investment is continuing more aggressive competition, I think it really is just the factors that I described.

Rodney McMullen

And in addition in terms of the deflation and some of those factors that we would have had, we continue to see that, and as Dave mentioned when you have swinging grocery from inflation to deflation a 1000 basis points, that certainly creates some pressure on gross and we would expect those types of pressure to diminish, especially as we have past the first quarter.

Dave Dillon

I agree in adding that particular point, in fact that by itself probably can produce this kind of a delta from the third quarter.

Scott Mushkin – Jefferies

So, maybe backing up, and I appreciate that answer, the color. Backing up a little bit, Dave, we talked a little bit about how EBITDA dollars have been growing at a slower pace in sales, before we even gotten to this economic malaise. I was just wondering if you kind of reflected back how, and customer first, how you get EBITDA dollars kind of growing faster than sales, should we start leveraging and getting the returns moving in the right direction, I mean, do you think there is lots of leverage for the company to pool and do you think we get that done some time in fiscal year 2010?

Dave Dillon

Well, I think the – I certainly sympathize with the objective you are describing. I'd like to take a multi-year look at the question. If you go back three or four years ago, we had several years where it played out pretty nicely, where our gross profit investment was about the same or little less than what we invested – what we saved in cost. And we have indicated and it still is our objective to invest what we can save but not to invest more than what we can save.

Then 2008 was a little bit off track with that, and we admitted that and recognized that, and it was little different than what we think our norm ought to be. But then the economy really got off the rails and I really continued to see 2009 as an anomaly. As I said before, I don't think the financial results, even though I think on a relative basis they were good, I don’t think they fully reflect the progress we made in the year. I think we actually had a strong year.

But on the metric you are looking at, in an economy like that we are just not going to see that happen. I do think it comes around over time though, whether you see it in 2010, it is purely after lots of factors. I am pretty sure you won't see it in the first quarter or the second quarter of 2010. But as we indicated by the third and fourth quarter, you may be able to see some improvement in that, and the year should not end up being quite like the first and second quarter might imply.

Mike Schlotman

And as Dave just mentioned, we would certainly expect when you look at the third and fourth quarters that you would start seeing slight improvement in operating margins, it's really consistent with our long-term model.

Dave Dillon

Yeah, and I think we fully expect the picture you described and what we hope to see latter part of the year to be much more a norm. Going forward once some of these factors have stabilized or improved.

Scott Mushkin – Jefferies

Great. Thanks for taking my questions.

Dave Dillon

Thanks, Scott.

Operator

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

Karen Short – BMO Capital Markets

Hi, thanks for taking my questions. Little more color on the gross margin, and I guess when you think about '09, the problem you got into I guess is that, you had some initiatives in place in early part of the year, say you take us – the term you used was gunpowder used a lot of gunpowder in the first half, not really exciting to opening gunpowder in the second half. Could you maybe talk a little bit about the timing of your gross margin investment plan throughout 2010?

Mike Schlotman

Well, I don't think we'll give specifics on it. I will tell you that we have attempted to learn the lesson from 2009, so that first we would put whatever investments we plan in a more measured way, and we would do it a way that recognizes – in fact you can look at our guidance and realize that 2010 in our view is going to be an uncertain year. It's hard to predict, much like 2009 was.

So the lessons of 2009 for us was that, be cautious, be ready to move and change through the year, and we are going to try to leave room and our plans to enable us to do that. But, we recognized it is an uncertain year and it will be a little hard to predict what that back half is going to look like. I think we could see with the first period -- first quarter or two might look like that it's harder to see what that back half is going to look like.

Karen Short – BMO Capital Markets

So, I mean, just philosophically, I guess, do you -- I mean help us understand, we understand why do you think you need to be as promotional as you are being, I mean, you have a loyal, you have an unbelievably loyal household customer base, could you not let up a little bit on the gross margin investments?

Dave Dillon

Well first it's not really being promotional. A lot of our investments are in everyday pricing plan, what you would think of as everyday pricing plan, and some promotions which is different type of contrast that was being promotional, programs, for instance, the gas program is an example of that. But, some of the programs once you get them started and you give customers where they like them, whether it's everyday pricing or some other program to take it away, runs the risk of derailing the very process you got started.

And, we drew those conclusions actually going into the third quarter and recognized that we needed to be careful about making adjustments. We did indicate last quarter and we did make some minor adjustments and continue to make some adjustments in our tactics, but the strategy itself is the same as we have been describing and we think we believe it would be a long-term mistake to have a change course. Our promotional levels really from the point of view that you described haven't really changed very much. Now we have a full bag from them but we really have not gotten more aggressive I mean maybe some individual cases you could describe but on the whole that's not been the case.

Karen Short – BMO Capital Markets

And what do you think from your competitors in terms of promotional?

Dave Dillon

No, we saw in the third quarter as we mentioned that things got a lot more aggressive. I believe a lot of that was because of what happened with the economic environment and what was happening with people sales. And, most people thought their sales going down might be the result of them not being strong enough as the competitors so they got more aggressive. Then discovered, as all of us have, is that there is some weakening in sales trends because of the economy and I think that's caused people now to stabilize a little; still very aggressive but promotions that are out there on a weekly basis from our competitors remain strong, but we don't see it getting more erratic or more unpredictable or deeper. It seems a little bit more of the same, to be more predictable now because we know what's going on.

Karen Short – BMO Capital Markets

Okay, thanks very much for taking my questions.

Dave Dillon

All right. Thanks, Karen.

Operator

Your next question comes from the line of Jason Whitmer with Cleveland Research Company. You may proceed.

Jason Whitmer – Cleveland Research Company

Thanks, good morning. Dave, also that comment in terms of your long-term thinking and re-adjusting over the last three to six months, maybe just down the rethinking through some long assumptions in the last three to five years, are you scared right now, not just looking at 2010 but maybe the next three to five years, what has really changed within your mind, within your business model? Is there anything that you feel like you need to structurally shift a few degrees to either respond to what has changed in the consumer behavior, the consumer climate or more importantly the flow-through of your model in terms of driving the top line?

Dave Dillon

I think we actually continue to feel pretty strong about our plan and our model. I think the areas that we have identified, that we have not done as good a job in, reducing our costs on an ongoing basis while we have done a decent job there, we have not done a stronger job there as we would like to do, and as we believe we can do, as we believe the opportunity presents itself to do.

And, we see that as the ticket really to be able to have more to invest not just in price, I realize in this environment and with this kind of investment in gross that appears all about price but actually it's not, and a lot of what we do has more to do with the other three keys and not just the price key. But I would say that we see the model pretty much like we saw before, we just think we need to get to some more normal times for you to be able to more graphically see it. The rate of deflation and the suddenness of that deflation and the persistence of that deflation, frankly surprises as we indicated last quarter. And I think it has masked the otherwise strong results of the program we have in place.

I can't tell you how important it is to look at the growth that we had in loyal customers at Kroger. That is significant. It's the growth in the households that shopper does most often, and we've seen it now for some time, but we saw not only that happen but we also see over the course of the month that they are buying more items in those loyal households. All of which are really healthy signs, and are signs that as the world improves, you'll begin to see – we believe you'll begin to see in our financial results.

Jason Whitmer – Cleveland Research Company

I actually wanted to follow-up on some of those loyal household metric that you look at, and that's obviously has been quite a bit of change in consumer behavior, and I haven't heard quite some time actually through all of this gross margin pinch, but as you look through the data or try to approach it, maybe a little bit differently there. I am curious if you have different tactics or different tools now to maybe reset the bar even a different way to go after those loyal households who have build up the best customers versus the price sensitive customers. Is there anything that you have tweaked there that could be more of a sales callous [ph] and as not as diluted potentially to margins going forward?

Rodney McMullen

Jason, this is Rodney. If you look at, certainly we would be looking at – a little different strategy approach to each customer segment, and one of the things that I think it's important to note when we talk about the tonnage growth and our strong household growth, we had it with all customer segments. So if you look at upscale customers or if you look at value customers or mainstream customers, we had very similar growth across all those customer segments. And we do approach each customer segment a little different, and each one of the offers would be a little different for each customer segment.

We think that some of the changes that we've had in gross and other things is much more driven by the swing from inflation to deflation, the speed of that swing and the competitiveness reacted because of that. We don't think it's something that's fundamental going on to the business other than what's happening today.

Jason Whitmer – Cleveland Research Company

And my final thought on that particular point in terms of deflation, obviously you quantify the deflation, and it is more wholesale versus retail but, and the tonnage growth there's a general range there. How significant do you also see mix and the price you've seen within mix and the treating down in lower price points in general as customers have been migrating toward that, and is there – or even within categories or brands versus probably, how significant is the mix pressure been in the basket over the last six, 12 months?

Mike Schlotman

If you look at over the last six to 12 months, basket changes have been pretty painful and aggressive, certainly through trading down and other things. Now if you look at more recent data, we are starting to see some improvements in a few selected areas. If look at like our jewelry business had a very strong quarter. If you look at our coffee shops, some of those other things, we are beginning to see some improvement in basket but it's very, very early in that process. But if you look at over your question on the six to 12 months, there was a quite a bit of headwind. If you look at much more recent, we are starting to see a few small glimmers of hope.

Jason Whitmer – Cleveland Research Company

Thank you.

Rodney McMullen

Jason, one other thing I would add to Jason's question when you look at the long-term thinking it's a balance between OG&A and gross, we see tremendous opportunities to continue to reduce costs of doing business through process change. In addition to that, if you look at the free cash flow we would expect to generate every year, we would continue to use that to pay the dividend, reduce debt and buyback stock. So that's a couple of other things, elements to that strategy.

Operator

Your next question comes from Jon Feeney with Janney Montgomery Scott. You may proceed.

Jon Feeney – Janney Montgomery Scott

Good morning. Thank you very much.

Dave Dillon

Good morning, Jon.

Jon Feeney – Janney Montgomery Scott

I am wondering if you've seen, there is a lot of talk about -- you talk about market share, for a decade it seems like the -- given that non-traditional retailers were gaining share for a while, it seem like that stabilized particularly for Kroger, and now when we at non-traditional retailers it seems like this more deflationary environment has brought that boogey man back, if you will. I guess, how high to inflation or deflation is the ability of non-traditional retailers to gain share do you think from longer-term perspective?

Dave Dillon

I actually don't think there is a relationship in that question, it's my personal view. The only way we play out to where there is a relationship is if the change in inflation or deflation occurred in say in the non-food categories, different than it did in food then it will tend to affect the behavior and the abilities of the non-traditional competitors, but otherwise I don't see that as a element that is particularly important in that environment.

Jon Feeney – Janney Montgomery Scott

Thanks. And just one follow-up, if you wouldn't mind? There are certain items where they are -- particularly dairy that there are those on the manufacturing side who think have been used as a traffic driver to a much, much greater extent, say the past six months. Have you seen dairy or any other particularly perishable category used more as a traffic driver by your competitors, and if so, how much has that changed at all in the first quarter?

Dave Dillon

Well, first, dairy is one of the most important categories in almost any way you want to look at it particularly as you think about where customers want to shop. So, we pay a lot of attention to it. It's also important from your point of view because it's such a big part of our overall business and so it can affect the results by itself single handedly it can affect our results.

But what we have seen this past year, we had a period of time where the cost on dairy were quite low through the year, and as a result it was used in many promotional ways throughout the year throughout the industry. However, now the cost have begun to rise, and as they begin to rise, typically at least, it ends out getting a football slightly differently or maybe a little less. And so, I think I characterize fourth quarter as a little less aggressive on milk, than it was earlier in the year.

Jon Feeney – Janney Montgomery Scott

And how about so far in the first quarter?

Dave Dillon

We won't add any comments on the first quarter on milk.

Jon Feeney – Janney Montgomery Scott

Okay. Thank you very much.

Dave Dillon

Thank you, John.

Operator

Your next question comes from the line of John Heinbockel with Goldman Sachs. You may proceed.

John Heinbockel – Goldman Sachs

Couple of things, what do you think the natural or automatic growth rate in operating expenses O&A would be prior to any proactive cost reduction effort on your part? What do you think that, that inflation rate in cost would be?

Mike Schlotman

Haven't quite thought of it that way. I think in part it depends upon what ends with the sales and tonnage. But Rodney you want to –?

Rodney McMullen

I mean if you didn't factor in tonnage or anything else, I think probably 2% to 3% would be a pretty good number to use.

Mike Schlotman

That's probably fair.

Rodney McMullen

If you just want to use a rough expectation.

John Heinbockel – Goldman Sachs

Because what I am trying to think about is, what is the comp you need? I know it depends on tonnage to a degree, what is the comp you need in a normal environment to get leverage on expenses if we assume. Gross isn't going to move that much. And it would seem that you could probably do that on 2% to 3% or certainly the upper end of that range. I don't know if you agree with that. And then secondly, you made reference to being able to make some process improvements. How low do you think you could get that or change that breakeven comp? If it is 2.5% to 3%, could you have an environment where you get leverage that have that or is that too much to ask?

Mike Schlotman

Well, I understand the nature of your question. I tend to believe that we did get leverage in 2009, even though the basis point change for the year, I know G&A was not high. And I'd describe it for this reason, let me describe it maybe in this context. First, process change as we introduce it leads to better productivity and allows you to get leverage even when there is not much change in sales growth. And we certainly had some of that last year and the benefit of some of that last year.

Second is we get leverage from tonnage, now it didn't show – that part didn't show up as much because of the deflation, have we not had the deflation. I think that would have shown up very strongly, as a matter of fact. And so we would have easily been there. And it's those factors really that lead me to conclude that 2009 we had good leverage, we expect to have a good leverage in 2010. But obviously when you get some positive growth in identical sales it begins to shrink rather quickly. And the advantage really, the big advantage is, look at our relative position to our competitors. We have been growing our positive identical sales now for a long time, and many of our competitors have not.

I mean one of the things we strive to do is to get leverage at flat identicals. Now, time will tell whether we are able to identify and create enough of those opportunities, for that's true or not. But as we mentioned earlier, we see plenty of opportunities to continue to reduce cost through process change, and we think we have a ton of those examples in 2009 because we were able to reduce OG&A as a percent of sales with tonnage growth significantly higher than what our identical sales growth was.

John Heinbockel – Goldman Sachs

Okay. And then, I guess, related to that just finally, you guys do take a long-term view of the P&L, and your view historically has been that EBIT margin would be pretty flat ex-fuel, and that was when we were back at around 3.5. We are now close to the three, because what's happened in the last year and a half. Is there the new base, that you work also from a flat standpoint or do you think it's a somewhat depressed number because of deflation, and 3.5 is still the right base one day to work off of?

Mike Schlotman

Well, on one hand it's clearly in our view a depressed number this past year, and probably this year too, the new 2010 year too. So on one hand I think is depressed but on the other hand I would caution you about thinking, it just snaps back to some previous level as a new level. I think it gets redefined in the industry as what is the new level and I don't know what that gets redefined at, although I would expect it to be a little bit higher than where it is currently.

Rodney McMullen

And as Dave and I both mentioned, we would certainly expect to have modest improvement once we get through kind of the changes -- the headwind from the deflation on sub we are going through right now, and where that ultimately can be it's hard to say. We do really make sure -- we focus to make sure we are earning more than our cost-to-capital and certainly slightly at this higher than 3% we are earning more than our cost-to-capital and strive to continue to slightly improve that from where we are.

John Heinbockel – Goldman Sachs

Okay. Thank you.

Dave Dillon

Thanks, John.

Operator

Your next question comes from a line of Ed Kelly from Credit Suisse. You may proceed.

Ed Kelly – Credit Suisse

Hi, good morning.

Dave Dillon

Hi, Ed.

Ed Kelly – Credit Suisse

I have a question for you; I want to come back to the gross margin, it seems to me like the gross margin this year is a lot more complicated than what it's been historically. Historically, we just look at the selling gross margin that's what you invest in pricing, and you get some return on that. This year it seems like you have already talked about the negative impact of mix. I heard you talked about after the last quarter that you may not gone to return you are hoping forms on vendors programs and you are just aggressive on pricing on categories because of the competitive response.

Could you -- as we think about the 90 plus basis point decline in the selling gross margin this year, how much of that is sort of an unusual decline based on the environment? And then, as we think about into next year and particularly into the back half, as things begin to normalize again, could we see the selling gross margin up as you cycle what would be some of these unusual impacts on the results?

Dave Dillon

That's an interesting question. First of all, I think the investments that you see in the basis points last year in 2009 certainly were deeper than I think would be enormous if we were to write a description of multiple years over time. I think what the future holds is going to be highly dependent upon our ability to reduce costs because if we could reduce more costs it maybe a little more, maybe not more investment in this past year, but more than what I would have otherwise thought.

On the other hand, if we don't, we will be a lot more conservative. I do tend to think that the long-term trend though will be down not because we are trying to make it go down, but because I think that's the pressures of the overall industry and I mean, now the nontraditional competitors and the traditional competitors, the pressure that brings to bear in the industry will tend to keep pressure going down a little, but not dramatically, at least that's my personal view.

So, I think I can see both directions. Now, whether we would see it actually go up, it's certainly possible and we're not trying to keep it from going up. Our objective is not to drive gross margin down, that's not our plan, it's not our objective. Our objective is to try to balance this out and to pick those areas that really matter to the customer and generally that is meant an investment in gross profit and so we follow that direction. But if costs, for instance, in the industry radically changed in an upward direction, I would think all of us will tend to move gross margins up a bit in order to cover that, and I wouldn't be a bit surprised if that were the outcome, but that's pretty hypothetical and looking out in the future, I don't foresee that as the likely scenario.

Ed Kelly – Credit Suisse

When you talk about the prospects for a better second half and expansion in the operating margin, is that because you are talking about the IDs [ph] continuing to get better when you get leverage on that? Is there, I guess, sort of same question, is there a possibility here the gross margin helps that in the back half of next year?

Dave Dillon

We think in the back half that the sales dollars becomes stronger because of the change in inflation from deflation. We think that we get traction on some of the programs we had in place last year and introduced this year. We think that as the market begins to improve a little bit from a customer point of view, from an economy point of view, because it looks like that's the trajectory in a way. And we think we get benefit of cost reductions, and that plays out all in a way that produces a little better outcome. So, yes to all of your examples I'd say.

Ed Kelly – Credit Suisse

Okay. And then just quickly for your last question. Now that we've seen an improvement in the credit markets, other companies have been buying back stock a bit more aggressively, and you look at over historically, I mean, you go back '06, '07',08, you go up back at least $600 million annually, and the level of your stock price was higher than where it is today. So why not get more aggressive with the share repurchase at this point?

Dave Dillon

Mike, you want to comment on it?

Mike Schlotman

As Rodney and I both said, we plan to use our free cash flow to maintain our current coverage ratios to keep the BBB flat we have, particularly as we enter a year where our credit agreement expires in November of '11, so this is a critical year. Probably we will be redoing that this year because you don’t want to go current on it. So we think it’s important to maintain the BBB flat, and we would use incremental cash to reward share – incrementally reward shareholders through a dividend or stock buyback.

Ed Kelly – Credit Suisse

Okay, thank you.

Operator

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

Meredith Adler – Barclays Capital

Thanks very much. I’d like to talk a little bit more about the deflation situation. It sounds like from what you are saying that the biggest impact on sales and profitability certainly in the fourth quarter was from dry grocery. Do you have sense of when that category, whether I should say it’s a very big category but becomes inflationary. Do you think that's going to happen even in the third quarter of 2010 because it didn’t become deflationary, I guess, but I guess it did in the third quarter of '09, right, so you could see it in the second half?

Mike Schlotman

Yes. Certainly our expectation would be as you get through the second quarter, I’d expect that it still would be slightly deflationary but the swing versus prior year won't be as painful. And then as you get to the third and fourth quarter, we would not expect to see the deflation on top of deflation to the same degree.

Meredith Adler – Barclays Capital

And would you say that's been had the biggest impact on the gross margin rather as opposed to perishable, which were also deflationary last year?

Mike Schlotman

I think it's – to me that's one of those things, but it's a good question but it's very hard to answer, because that certainly is part of it. As Dave has mentioned couple of times on the third quarter and this quarter, once you have that you also have changes in competitive reaction too. And to be able to separate the two, I don't know that we can. On perishables it's all over the Board, and sometimes the deflation helps them, sometimes it hurts, sometimes that gives you an opportunity to have a great price point, and I think on several things in 2009 that the deflation had produced in dairy and a few other categories gave all retailers opportunity to be aggressive on a price point, and it really caused everybody to react to that.

Meredith Adler – Barclays Capital

Okay. And then --

Dave Dillon

Meredith, I want to make sure everybody remembers that when we talk about grocery inflation and deflation, it's not just dry grocery, it includes our dairy department.

Meredith Adler – Barclays Capital

Okay. That's right.

Dave Dillon

Okay.

Meredith Adler – Barclays Capital

And then if you had mentioned that you're still not quite as pleased with reductions and expenses as you would like to be done a lot, but perhaps didn't hit your own internal goal, could you talk about what the obstacles have been to getting to those goals and what will be different in 2010?

Dave Dillon

Well the issue for us really is not, we have found a lot of little smaller areas to focus on, and some even big ones that if we have had got success on, but the issue for me is understanding the nature of process change, how to introduce it successfully and how to have it cause us to pull cost out of our organization. It's the kind of thing that takes, that has a long runway and it's not something that you say today I am going to save a bunch of money and then next quarter you can show the money you saved for.

And while we have been working on it for a long time and actually have a number of examples that fit that description pretty well, we have not gotten quite traction on some of the bigger areas that we would like to achieve. We think it's there, we see the opportunity there. It's teaching an old dog some new tricks, I think in my case our organization of how to do some of these things. And so, I think it's really a long-term thing that as leaders of the organization we will solve.

Rodney McMullen

And the only thing I would add to that, I mean, Dave mentioned that we found and executed a ton of incremental improvements that did help us leverage OG&A expense with tremendous tonnage growth. Now with that said, we believe there is even some bigger opportunities with fundamental process changes and those have been harder to recognize and get in place, but we think that potential is out there and that's when we talk about being pleased with the short-term, but not so pleased with the longer terms those are the things we're referring to.

Meredith Adler – Barclays Capital

Well it sounds like you are saying it's just a function of time really?

Dave Dillon

Well, it's time but it's also an organization learning how to do these things, it's both.

Meredith Adler – Barclays Capital

Okay. And then I have one final question, you made a comment, I think it was an answer to Karen's question about maybe letting up on some of this promotion and you said while the customers that used to what they have – it would be hard to take it away, but it seems like you are, to some extent, being incrementally better to them, more generous to them, and I guess I don't quite understand why you can't from a year-over-year perspective, kind of hold it here, why does it have to keep going down?

Dave Dillon

Well, let me describe it this way. The programs that you start once -- once started, customers begin to see it as who you are and your personality and why they shop with you, and to pull that away would be problematic. Now, as to whether now we need to introduce new things, the question is whether now we feel we can get sufficient growth and tonnage and in growth in loyal households without introducing anything new, we tend to think that some change-up is important to customers just simply from the point of view you being refreshed.

The main message I was describing to Karen and to you both on promotions though is -- the things we are describing are not a matter of some hot price we put on an item and then add this week, which is what I think – here the other words promotion, and sure we have promotions every week, but we are not turning that up, not making that hotter that's not the focus of our investment. And yet it is a part of our industry, and I would not expect that to go away either.

So, I don't know that I've really answered your question, except to say that I think we feel maybe it's not to the tune of the 112 basis points of gross we had in the fourth quarter but some of that in this year on a relative basis, particularly in stable cost environment, I think some of that what would be more likely than not because we think that would be what will help us in our process of gaining customer loyalty.

Meredith Adler – Barclays Capital

Okay. Thank you.

Dave Dillon

Thanks, Meredith.

Operator

Your next question comes from a line of Chuck Cerankosky with Northcoast Research. You may proceed.

Chuck Cerankosky – Northcoast Research

Good morning everyone.

Dave Dillon

Good morning.

Mike Schlotman

Good morning.

Chuck Cerankosky – Northcoast Research

Dave, you guys really are going to spend CapEx dollars this year not too far below the 2.3 billion of last year, which is different from a lot of your competitors. Can you talk about how that might be split up between remodels and infrastructure projects and give some examples of the infrastructure project. And talk about what's included in there in terms of simply buying leased properties. That might be a significant component of the number. And then also what you are doing with the convenient stores that from what I've read and seen, you have done some experimentation there such as the pharmacies and some of them that, is that a small format that has a lot of opportunity for you?

Mike Schlotman

Chuck, when you look at the CapEx guidance, it's actually very comparable to what we spent in 2009, the two three year reference is what's in the cash flow statement. There is a total of a couple of hundred million dollars roughly of some small acquisition, one store here and there as well as the lease buyouts. The $1.9 billion to $2.1 billion excludes any opportunity to buyback leases or any acquisition dollars. So the number we've talked about in the conference call, 2.15 is the number that would equate to the 19 to 21. So it's a pretty comparable number.

We do think that there will be some new stores that we deal in 2010. We gave the number of our expectation for the number of remodels. We think that’s a very healthy program and we continue to get returns above our 11.3% of hurdle rate from those investments. I won't go into specific infrastructure projects, just because of the nature of them. They are pretty important to us from what I spoke up earlier.

Some of them help improve the shopping experience that becomes a sales driver for our customers and that helps to fuel the top line, which creates incremental leverage. There are others out there that are cost savings initiatives that allows to have the dollars to execute with Rodney and David, we’re talking about to save dollars permanently to invest back in the model, where we are doing pricing or one of the other keys.

Dave Dillon

Rodney, you want to comment on the C-stores?

Rodney McMullen

On the C-stores, I’d just add that there is a couple of different things that we experiment with to say that’s going to be a major part of the growth over the next few years, I think it's too early to say. That's one of those things that you continually try to learn and see if you are going to approach it from a different perspective for the customer and see how they react to it.

Chuck Cerankosky – Northcoast Research

Okay. And then finally, Dave, when you talk about the reversal of deflation some point this year, that implies to me that we're going to some modest inflation, but it also implies increasing prices on the shelf. So how much of a rebound in inflation would be too much to pass through?

Dave Dillon

Well, we fully expect within these things we think it's very reasonable. We fully expect that inflation will be pass through, the cost inflation will be pass through and retail prices. And, I think that's the more normal approach, and I think that would be what we would expect to happen in the year. Now, whether or not you are going to have too high of inflation that could cause that to not happen, it might be a function of too high inflation and also it might be a function of what the inflation is in.

Sometimes when you have radical change too quick of change we have illustrated that on the downside this past year, and you can have the same problem on the upside, you've heard us occasionally to see that in milk, for instance, when it changed abruptly. I think you are probably refereeing to the lot of the economic forecast suggest that with the amount of money thrown into the economy that there ought to be a major inflation around the corner. Everything I have heard and read suggests that if that happens it's going to be a long way off.

Rodney McMullen

The other thing you keep in mind on inflation, Chuck is it base point on where it occurs and how it encourages the most important part of that answer. If we have flat to 1% inflation, but it's driven by a lot of inflation in products and made in deflation in grocery even though it comes out to slight inflation that's bad because you've got deflation in a very big category and a quick inflation in a perishable category is tough to manage your way through and as always, the speed of change from either direction is makes it difficult for everybody to manage their way through.

Dave Dillon

And we have always felt that the easiest to manage the business in is 3% to 4% inflation, but I wouldn't want to go from where we are to 3% to 4% in a month, but would mind 3% to 4% over time as long as we get there gradually.

Chuck Cerankosky – Northcoast Research

Thanks. That's what I want to think about as opposed to some macroeconomics forecast and say hyperinflation for the next five years, I was more thinking in terms of what you just described. Thank you very much.

Dave Dillon

Thanks, Chuck. I think we have a time for one more question.

Operator

Your next question comes from the line of Andrew Wolf with BB&T Capital. You may proceed.

Andrew Wolf – BB&T Capital Markets

Hi, good morning. Do you think the rate of deflation dwarfed in the Q4, that's my first question. Have we seen the bottom here?

Dave Dillon

Well, as we described in the quarter it certainly got in grocery particularly a little bit deeper. Mike, is going to take a look at the graphs to see if he has opinion that he wants to describe.

Mike Schlotman

I would say it's pretty difficult to say it has a trough not until we get some insight and vision in the where the first quarter is looking and our first period just closed so we don’t have where what nearly looking to what the first quarter of 2010 is looking like, but overall we had more deflation in the fourth quarter. It would be nice if it’s hit the trough but until we have more insight as we go through the first quarter it will be difficult to declare that.

Dave Dillon

I don’t expect the trough to be short either, the trough could go all the way through the quarter.

Andrew Wolf – BB&T Capital Markets

Okay. And on the branded tonnage growth, catching up to private label, can you talk a little about what’s driving that? Is that vendors the branded companies trying to get movement and passing that through to you all or is it consumer may be looking more to brand and…?

Dave Dillon

As we said, national brand tonnage was up, for it’s a positive number up about the same as where Kroger brand, tonnage was up. And as you look at that we think it's driven actually by both of the things you are referring to. First, it's driven by national vendors needing to drive more volume, and so investing in the promotional strategies of their products.

And second is, I actually take it as one sign of some glimmer of hope of improvement, Rodney described jewelry and some other discretionary categories that have improved. I think a trend up a little bit in tonnage and national brand is a similar positive sign. Now how much is due to the consumer changing and how much is due to the vendors investing? I don’t know that, I would try to judge that.

And if you remember, I guess, it was probably a year ago, or three quarters ago, Dave talked about on our corporate brands, he would expect when the economy start to getting better that you could actually have negative growth in corporate brands for a little while, and it wouldn’t surprise him. And to me one of the things that I was very pleased with is if you look at our corporate brands, we continue to have extremely strong growth there, and a year ago we had double-digit growth both in units and dollars.

So to me it's – I feel good about one the balance, and I feel good it is starting to show a little bit, the economy is getting better, but our corporate brand program has connected with customers in a different way and deeper, and they continue to reward us by buying more of that product.

Andrew Wolf – BB&T Capital Markets

Got it. Just one last question. Dave, I think you mentioned the last five weeks or the first five weeks of this quarter, the comp it sounds like it's pretty strong, is that? And the Super Bowl aspect of that, is that the calendar or are you trying to tell us you had a very strong Super Bowl? And if it is calendar, can you give us sort of what the adjusted comp is trending?

Dave Dillon

Well, first it's both. We had a very good Super Bowl, but Super Bowl this year was a year later than it was the year before.

Rodney McMullen

A week later

Dave Dillon

Yes, week, later -- yes year later, a week later and the year before and some of the players in super bowl year were still been a year later, but any way it was week later and that made it sell in the selling time and the super bowl itself fell in this year and not in last year and that’s the primary thing. We are not going to try to quantify that; we have lot of things going on at that time. We had some snow storms which also Mike referred to and first of the month, and so it's sort of a triple opportunity that with the super bowl first in the month and snow storm that was suddenly felt. But, if you try to normalize all of that, that's why we indicated that while we are a little bit above the trajectory of what we saw for the year and that certainly gives us reason for optimism we want to make sure you don't over read it because of the super bowl and snow.

Mike Schlotman

And even without that week we would still be within the range.

Dave Dillon

Yes, if you take that out we would have been.

Mike Schlotman

So it is still not – that's not the only reason why that we are pleased so far, but we would expect the quarter-to-quarter, the first quarter would certainly be tougher than the third and first quarter.

Andrew Wolf – BB&T Capital Markets

Okay. Well, that clarifies, especially the latter comments. Thanks and good job in such tough environment.

Dave Dillon

Andy, thank you. Before we end the call today, I would like to share some additional thoughts with our associates. First of all, I want to thank you for your hard work not only in the fourth quarter but throughout 2009. It was a very tough year. The economic environment was unyielding and that affected all of you and all of our customers. Still you accomplished where many others in the industry could not. You found ways to build even stronger connection with our customers through your creativity and enthusiasm for selling.

Our customers noticed, they continued to spend more in our family of stores this quarter and we thank you for making their experience with us rewarding. The challenges ahead in 2010 will be similar to the ones we faced last year. I am confident in your ability to continue to make a positive difference in the lives of our customers and your coworkers throughout your efforts every day.

Recently Katy Barclay joined Kroger to head and lead our human resource function. I want to welcome Katy to Kroger and recognize the work of our HR team, especially Katy, Della Wall and Chuck Schaeffer in improving the process of our associate tracker survey. Soon you’d be hearing more from your managers and supervisors about the results of our most recent associate tracker survey.

Thank you for taking time to complete the surveys and sharing your feedback with us. We've heard from over 246,000 associates across the US, wow. We value your input and we use it as we work to improve Kroger and make it a great place to work. Thanks for all you do. That completes the call today. Thank you all for joining us.

Operator

Ladies and gentlemen that concludes today's conference. Thank you for attending. You may now disconnect. Have a great day.