The Kroger Co. (NYSE:KR) Q1 2014 Earnings Conference Call June 19, 2014 10:00 AM ET

Executives

Cindy Holmes - Director, Investor Relations

Rodney McMullen - Chief Executive Officer

Mike Ellis - President and Chief Operating Officer

Mike Schlotman - Senior Vice President and Chief Financial Officer

Analysts

John Heinbockel - Guggenheim Securities

Ken Goldman - JPMorgan

Rupesh Parikh - Oppenheimer

Lauren Wood - Credit Suisse

Scott Mushkin - Wolfe Research

Karen Short - Deutsche Bank

Meredith Adler - Barclays

Andrew Wolf - BB&T Capital Markets

Stephen Grambling - Goldman Sachs

Jason DeRise - UBS

Chuck Cerankosky - Northcoast Research

Filippe Goossens - Mitsubishi

Kelly Bania - BMO Capital Markets

Kate Wendt - Wells Fargo Securities

Operator

Good morning and welcome to the Kroger Company First Quarter 2014 Earnings Conference Call. All participants will be in listen-only mode. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Cindy Holmes, Director of Investor Relations. Please go ahead.

Cindy Holmes

Thank you, Laura. Good morning and thank you for joining us today. 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 ir.kroger.com. After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question and one follow-up question if necessary. Thank you.

I will now turn the call over to Rodney McMullen, Chief Executive Officer of Kroger.

Rodney McMullen

Thank you, Cindy. Good morning, everyone, and thank you for joining us today. With me to review Kroger's first quarter 2014 results are Mike Ellis, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

Kroger delivered an outstanding first quarter. It is a great start to what we believe will be an another exceptional year. Our associates continue to enhance our connection with all customers and achieve key performance measures, which are allowing us to achieve our growth strategy. We also achieved our 42nd consecutive quarter of positive identical supermarket sales; exceeded our goal to slightly expand FIFO operating margin, without fuel, on a rolling four quarter basis; maintained a steady return on invested capital while increasing capital investment. We are achieving synergies from our merger with Harris Teeter. Both Mikes will have more to say about this in a few minutes. And we returned over $1 billion in cash back to our shareholders this quarter through our buyback program.

The staying power of our Customer 1st Strategy and our accelerated growth plan are generating strong momentum. We continue to lower our costs of doing business and to invest those savings both for today’s customers and for future growth. Our strong first quarter results set us up to deliver 12% to 15% net earnings per share growth rate for the year partly due to the benefit of Harris Teeter compared to our long-term growth rate of 8% to 11% plus the dividend in both cases.

I am also pleased to report that we continue to take meaningful steps to restructure and help secure our associates’ pension obligations for the future. Through two innovative agreements, we plan to move nearly 2,000 associates and retirees to more stable pension plans and 350 associates to a Kroger-sponsored 401(k) plan with a match. We intend to continue looking for opportunities to leverage our strong financial flexibility to safeguard our associates’ benefits. We are always looking for opportunities that are good for our associates, good for Kroger, and good for our shareholders.

From an economy and customer shopping behavior, we are seeing strong positive indicators in shopping behavior. Our customers have exhibited less cautious spending behavior, for example. Consistent with the rise in Consumer Confidence Index in May, our own customer research tells us that more customers perceive the economy to be in recovery. While it is obviously welcome news, the recovery remains fragile, especially for customers on a budget. We intend to keep delivering value and improving our connection with customers across the entire spectrum. Whether through our popular fuel rewards program, our Simple Truth offerings, or a more convenient shopping experience, Kroger is uniquely positioned to deliver on this promise in any economic environment. And against this backdrop and uneven economic recovery, our team's excellent first quarter performance stands out in even greater contrast.

Now, I will turn it over to Mike Ellis to outline our operational performance. Mike?

Mike Ellis

Thanks, Rodney. Good morning, everyone. I'd like to congratulate the entire Kroger team for executing our Customer 1st Strategy with precision in the first quarter, which is driving growth and improving our perception in the eyes of our customers. We are connecting better with our customers, showing them we care, and making sure they have a great shopping experience every time. Keeping cost down allowed us to invest strategically and increase customer loyalty.

During the quarter, we grew our number of loyal households at a much faster rate than total household growth, which also was up for the quarter. We saw inflation increase in the grocery category during the quarter. This, combined with higher inflation in meat, produce and pharmacy, has caused us to adjust our view of inflation for the year. We estimate inflation, excluding pharmacy, was 1.8% in the first quarter and 2.1% with pharmacy included. We expect it to be higher than originally anticipated for the rest of the year as well. Even with higher inflation, we saw strong tonnage growth during the first quarter.

I will jump to Harris Teeter. Our merger with Harris Teeter is going extremely well. We are spending time with Harris Teeter and learning a lot about how they connect with customers. Their store standards and fresh foods are world-class. And our cultures are a great fit, which makes our integration work rather easy. We are excited by what we are learning about Harris Teeter's online ordering and store pickup model. It's a program with a lot of promise.

A key driver of sustainable growth is Customer 1st Innovation. Each quarter, we are highlighting one or more of our innovations that are improving our connection with customers and growing our market share. This quarter, I will highlight some of the new, exciting work of our Corporate Brands and Kroger Technology teams.

In Corporate Brands, a strategic differentiator for Kroger's Corporate Brands portfolio is our multi-tier offering. It allows us to offer the right price points and product experiences for everyone. In the first quarter, we introduced new branding and packaging for our Value products, the good tier of our good, better, best program. The new design calls out to customers with attractive uplifting packaging and the response so far has been really terrific. For fresh products, we have replaced Kroger Value with Heritage Farm. The name better reflects the inherent quality of the brand and we are already seeing positive acceptance from our customers. Corporate Brands had a solid first quarter accelerating company sales growth and representing approximately 26.2% of total units sold and 24.5% of sales dollars, excluding fuel and pharmacy.

Kroger Technology is our team of technology innovators and inventors. They are implementing a fundamental foundational technology that we can leverage to create the Internet of Things in the retail environment. One tangible example of this is real-time temperature monitoring in our supermarkets. Today, temperature checks are performed manually by our associates. But by using interactive sensors that are connected through an in-store network, we can better ensure the freshest foods by allowing for more frequent, real-time temperature checks of meat, produce, deli and frozen food products. And we love these kinds of initiatives because they save money and they free up time for our associates to engage with customers. And most importantly, this technology will help improve our already vigorous food safety efforts. We plan to continue leading the adoption of the Internet of Things in our stores.

Now, I will give a brief update on labor negotiations – labor relations. We recently agreed to new contracts in both Atlanta and Southern California, as well as for non-food associates in Portland, Oregon. We are currently negotiating contracts with the UFCW for store associates in Cincinnati, New Mexico, Toledo, and parts of California and an agreement with the Teamsters covering several distribution and manufacturing facilities. Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality, affordable health care, and retirement benefits for our associates.

Kroger's financial results continue to be pressured by rising health care and pension costs, which some of our competitors do not face. Kroger and the local unions, which represent many of our associates, should have a shared objective knowing Kroger's business and profitability, which will help us create more jobs and career opportunities, and enhance job security for our associates.

Now, Mike Schlotman will offer more detail on Kroger's financial results and update our guidance for 2014. Mike?

Mike Schlotman

Thanks, Mike and good morning everyone. We exceeded our expectations for the quarter. Thanks to our associates performing to deliver growth. We continue to implement our long-term growth strategy, which includes targeting capital to grow our business in new and existing markets; leveraging customer insights to solve varied customer needs, through both traditional and digital channels; and continuing to deliver shareholder value through our share buyback program and dividend. When we outlined our accelerated growth strategy at our October 2012 Investor Conference, we also identified the key performance targets for shareholders to measure our progress. I'd like to spend a few minutes discussing the results in each metric.

Our first metric is identical supermarket sales without fuel. We are pleased with our first quarter ID sales growth of 4.6%. This strong performance was supported by ID sales growth in every department and every supermarket division. We continue to see outstanding, double-digit identical sales growth in our natural foods department. Our produce and general merchandise departments also posted strong ID sales growth and Kroger's pharmacy department continued its strong performance.

Rolling four quarters, FIFO operating margin, on a 52-week basis and excluding fuel and the pension agreements, increased by 12 basis points. This exceeded our commitment to grow the rate slightly over time on a rolling four quarters basis. Until we have Harris Teeter in both the current and base years, the expected increase will be higher than our long-term guidance, which is slightly expanding. Over time, we expect our FIFO operating margin growth, excluding fuel, to return to slightly expanding on a rolling four quarters basis.

The third target metric is return on invested capital. We reported a return on invested capital on a 52-week rolling four quarters basis of 13.5%, which is consistent with ROIC during the same period last year. As we increased capital investments, it will be more difficult to grow ROIC in the near-term. However, as these investments mature, we expect them to be accretive to ROIC. As Mike and Rodney have already said and our integration with Harris Teeter is well underway and we are achieving synergies in multiple fronts. One great example was combining insurance programs, which has reduced our annual premiums by $6 million already.

Now, I will share our first quarter 2014 results in more detail. Please note that this is the first period that includes Harris Teeter in Kroger's statement of operations. Year-over-year percentage comparisons are affected as a result. In the first quarter, our net earnings totaled $501 million or $0.98 per diluted share. This includes charges related to the restructuring of certain pension obligations to help stabilize associates' future benefits, as described in yesterday's press release. Excluding the effect of these charges, Kroger's adjusted net earnings were $557 million or $1.09 per diluted share for the first quarter. Net earnings in the same period last year were $481 million or $0.92 per diluted share.

As Mike Ellis said, we are seeing higher inflation than anticipated. We recorded a $28 million LIFO charge during the quarter compared to a $17 million LIFO charge in the same quarter last year. We are increasing our LIFO estimate for the year to $90 million. Our previous LIFO guidance for the fiscal year was a charge of $55 million. This affects the year by about $0.04. FIFO gross margin increased 1 basis point from the same period last year, excluding retail fuel operations. Strong identical sales and cost controls allowed Kroger to leverage operating expenses as a rate of sales in the first quarter. Operating, general and administrative costs plus the rent and depreciation, excluding retail fuel operations and pension agreements, declined 9 basis points as a percent of sales compared to the prior year's first quarter.

Now, for retail fuel operations. About half of our supermarkets have fuel centers today. In the first quarter, our cents per gallon fuel margin was approximately $0.131 compared to $0.116 in the same quarter last year. Our long-term financial strategy continues to be to maintain our current investment grade rating, repurchase shares, have an increasing dividend, and fund increasing capital investments.

Kroger remains committed to achieving a 2 to 2.2 net total debt to EBITDA ratio by mid-to-late 2015. Kroger took on debt to finance the Harris Teeter merger and realized no incremental EBITDA in fiscal 2013, because the transaction closed late in the fiscal year. This has a material effect on the company's net total debt to adjusted EBITDA ratio, which is 2.42 times compared to 1.85 during the same period last year. As we get a full year of

Harris Teeter EBITDA in the calculation, we expect to be closer to 2.2 times by the end of the year. Kroger's net total debt is $11.3 billion, an increase of $3.4 billion from a year ago. This is a result of the debt related to the Harris Teeter transaction and Kroger's share repurchase activity.

Kroger's strong financial position has allowed the company to return more than $1.9 billion to shareholders through buybacks and dividends over the last four quarters. During the first quarter, Kroger repurchased 25.7 million common shares for a total investment of $1.1 billion. Capital investments, excluding mergers, acquisitions and purchases of leased facilities, totaled $709 million for the first quarter compared to $640 million for the same period last year. We continue to expect capital investments to be in the $2.8 billion to $3.0 billion range, including Harris Teeter, for fiscal 2014.

Now, I'd like to update our growth objectives for fiscal 2014. Based on our strong first quarter results, we raised and narrowed our adjusted net earnings guidance to a range of $3.19 to $3.27 per diluted share for fiscal 2014. The original guidance was $3.14 to $3.25 per diluted share. The company's long-term net earnings per diluted share growth rate guidance remains at 8% to 11%. Shareholder return will be further enhanced by a dividend expected to increase over time. We raised our identical supermarket sales growth guidance, excluding fuel to 3% to 4% for fiscal 2014, including Harris Teeter. The original guidance was 2.5% to 3.5%.

And now, I will turn it back to Rodney.

Rodney McMullen - Chief Executive Officer

Thanks Mike. What a terrific start to our year. Our merger with Harris Teeter is going exceptionally well. We are learning a lot from Harris Teeter associates and our business is performing well. And we are even more excited about Harris Teeter's people and the opportunities today than we were when we first merged. Across our company, our associates' remarkably consistent execution continues to generate consistently remarkable results for our shareholders. We will continue building on this resilient foundation to grow aggressively into the future.

And now, we look forward to your questions.

Question-and-Answer Session

Operator

(Operator Instructions) And our first question will come from John Heinbockel of Guggenheim Securities.

John Heinbockel - Guggenheim Securities

Hey, guys. So, a couple of things. Obviously, it's a little hard to tell with Harris Teeter mixed into the numbers, but if I try to back that out and think about ex-fuel gross margin decline, it looks about what it's been running or maybe just slightly higher than it's been running? And I ask that because I am curious what you see with regard to inflation today, is that being passed along fairly quickly or given your value position, you are delaying some of that for weeks or maybe even months?

Rodney McMullen

Good morning, John. Yes, it's been on – breaking it out, you would be correct, if without Harris Teeter, the trends would be very similar to what they have been running. From an inflation standpoint, we pass it along some of it in terms of obviously how is the competitive environment going and also the inflation that we think is just a seasonal type inflation or something that's longer term. And I would say in our ability to pass it through, it's pretty much similar to what it's been running. And I don't know Mike or Mike anything you want to add to that?

Mike Schlotman

No.

John Heinbockel - Guggenheim Securities

Okay. And then as a follow-up, when I think about your price investments, right, and I don't know what inning we are in, but how do you think about it now in terms of investing by category, right. So, I know you made investments in natural foods. Are there more categories where you need that type of work, it doesn't look like there is or is it solely items? And then how do you think about private label, price investments in private label and when you think about that, do you look at the private label spread versus the brand or do you actually go out and look at what other retailers are retailing their private label products at?

Mike Ellis

Well, the first question on overall price investment, we are continuing to look at the markets we do business in and deciding where we want to be positioned. Also, we look at categories within the store and try to determine where we want to be priced relative to competition or the market, but private label, there are several ways to look at private label pricing, one would be – it would be how it's related to the branded product. And in some cases, it might be priced with the competition in a way that keeps us on our pricing strategy and keeps us relevant. And it really depends upon the item and the market.

John Heinbockel - Guggenheim Securities

But do you think we are talking about items now, most of your category adjustments have been made or you disagree with that?

Mike Ellis

We have been through most categories and made some sort of adjustments over the last several years in pricing, but we were still looking at pricing overall and where we positioned it and making decisions on where we want to be.

John Heinbockel - Guggenheim Securities

Okay, thanks.

Rodney McMullen

Thanks, John.

Operator

And the next question will come from Ken Goldman of JPMorgan.

Ken Goldman - JPMorgan

Hey, thanks for the question. Forgive me if you mentioned this, can you estimate even if it's just a rough number what weathers tailwind was on your comps in 1Q?

Mike Ellis

It's really tough. If you look at the cadence of comps during the first quarter, the first four weeks of the quarter were a little bit stronger than the rest of the quarter, but not remarkably high. And the second, third and fourth periods, the second and third were affected by the Easter shift. If you kind of normalize Easter between the two periods, they were very, very close to one another. So, I don't think there was a huge bump in the first quarter as a result of whether it certainly helped, but it's not what made the 4.6% strong, the second, third and fourth on a combined basis certainly contributed to the results as well.

Ken Goldman - JPMorgan

Okay. And then as we look at your comps into 2Q, so any particular headwinds or tailwinds we should be thinking about just a little more color on how things are progressing so far this quarter, just curious on those lines?

Rodney McMullen

Yes. We wouldn't see anything unusual versus what it's been running. And we would continue to be slightly above our guidance range in terms of so far this quarter. And it's very similar to the first quarter.

Ken Goldman - JPMorgan

One last quick one, it's a bit tricky because of the different days in the quarter in Harris Teeter, I just want to make sure, your D&A was up 12% year-on-year, your interest expense was up 14% year-on-year, are these roughly the growth rates we should be modeling for the rest of the year on a year-on-year basis?

Mike Schlotman

For the year on a year-on-year basis, yes, they will be in that kind of the range because of the Harris Teeter depreciation as well as the debt we took on for Harris Teeter. And then obviously next year, we will return to more normal level. The other one that's a little different than what we have historically reported is ramp as a rate of sales, because the large majority of the Harris Teeter stores are at least not owned like ours. So that affects that line as well and we break that line out separately.

Ken Goldman - JPMorgan

Great, thanks very much.

Rodney McMullen

Thanks Ken.

Operator

And the next question will come from Rupesh Parikh of Oppenheimer.

Rupesh Parikh - Oppenheimer

Thanks for taking my questions. I just wanted to delve a little bit more into the upside in the quarter, so you beat the high end of your guidance I think by about a few pennies, was that all driven by sales upside or are there other things in play?

Rodney McMullen

The sales piece would be by far the biggest driver of the upside.

Rupesh Parikh - Oppenheimer

Okay.

Rodney McMullen

Yes. And just to clarify we don't give quarterly guidance, so we only give an annual guidance. So, the only thing you can compare to is what the Street expectations were.

Rupesh Parikh - Oppenheimer

Okay. And then you also mentioned that you are seeing better signs of a consumer this quarter, what are you seeing more in some of your discretionary areas of the business?

Rodney McMullen

Well, we have really seen – I mean, if you look it's continuing a good solid trend. It's always hard to define what's discretionary, but certainly if you look at what areas people cutback on first we continue to see strong growth on that across the board. I don't know Mike anything you want to add to that?

Mike Ellis

No. That pretty much sums it up. There has been some mixed changes in what people are buying it looks like, but overall it's been strong all across the board.

Rupesh Parikh - Oppenheimer

Okay, thank you and good luck. Nice quarter.

Rodney McMullen

Thank you.

Operator

And our next question is from Ed Kelly of Credit Suisse.

Lauren Wood - Credit Suisse

Hi. This is actually Lauren Wood on for Ed. Just a quick question. Can you remind us what percent of your stores have heavier mix of natural and organic selection and where that number could potentially go to? And then also if you see a comp lift when you add – when you sort of bulk up that offering in your store?

Rodney McMullen

Well, I don't know if there is any particular area that has a higher mix of natural foods. We tend to – it's a strategy for the company to improve our natural foods offering across the country. So, any of our new stores or remodels we try to be more aggressive on natural foods positioning and the amount of products we carry, but – so it's pretty much throughout the country. And it is a – it's definitely a strategy of ours and it's really connecting both customers right now.

Mike Ellis

And it's not always, pretty much every store has some offering of natural and organic products, but we are finding it as much a lifestyle decision as it is a demographic driven topic. And people of all demographics are choosing a healthier lifestyle. So, we actually have the product and really, I can't think of stores I go into that don't have some. Now, the size of the store can dictate how much you have, but it's a broad appeal product.

Lauren Wood - Credit Suisse

Okay. And then just a quick one, can you update us on your total MEPP liability?

Mike Ellis

I don't remember what it is off the top of my head. It was in our 10-K and the MD&A. I don't want to guess the number, because I will be guessing wrong. You can follow-up with Cindy and I after the call.

Lauren Wood - Credit Suisse

Okay. Thanks for taking our questions.

Mike Ellis

It was in the MD&A and our 10-K.

Lauren Wood - Credit Suisse

Thanks.

Mike Ellis

Yes.

Rodney McMullen

Thank you.

Operator

And the next question comes from Scott Mushkin of Wolfe Research.

Scott Mushkin - Wolfe Research

Hey, guys. Thanks for taking my questions. I had a housekeeping item first before I got into my bigger question. The ROIC calculation you guys ran in the report, it seems like and maybe I am wrong, but basically Harris Teeter is reflected in the denominator, but the numerator is not pro forma or my – or is it?

Mike Ellis

Okay. So, you are correct, Scott. And you also noticed that we went to one decimal place instead of two decimal places. So, the way that works it's rolling four quarters calculations. So, your denominator becomes the average assets at the beginning or the end of the year. So, you effectively have half of Harris Teeter's assets in there because of that averaging, but only one quarter of their EBITDA. We will get more and more of their assets and more and more of their EBITDA as we go throughout the year. So, we did in a couple of ways. If you look at it just the way this calculation is it was about a 2 basis points down. If you pro forma Harris Teeter in there for the whole timeframe, it was about 2 basis points up. So, we just decided that rather than try to confuse it, we are going to call it the 13.5 until the end of the year and then we will go back to two decimal places, I would think.

Scott Mushkin - Wolfe Research

Okay, perfect. Thank you for that clarification. So then the second question is actually more of a strategy question. I mean, you look at the broader food landscape here and I think you guys just outcomped Whole Foods, if I am not wrong about that, but on the other side of the equation, you are clearly outcomping Wal-Mart. You have a format now and probably the best high-low operator out there, you got big data. When do we – and you just bought Harris Teeter, but when do you put this more aggressively on the road, I think you are in 34 states now, when does Kroger really start to drive even more growth? I mean, clearly you are taking enormous market share where you are either through more M&A or more aggressively venturing into places you are not?

Rodney McMullen

Scott, as you know, if you look at our fill-in markets, that is the first part of that and it's really if we look at the returns from that, the higher our market share, the higher our ROIC. So, that's really the first phase of that is we are increasingly getting aggressive on fill-in markets. And that's we are very pleased with the early result. In terms of new markets, by merging with Harris Teeter, we really view that is going into several new markets. And as I mentioned in the call, one of the things that we are really excited about is the market share opportunity, growth opportunities that Harris Teeter has. And we will aggressively partner and support growing in several of those markets as well. So, from our perspective that is going on the road with it in the context of where we think we see the highest return with the capital that we have allocated.

Scott Mushkin - Wolfe Research

Maybe a chance we get a bump in the growth rate that you have out there, 8% to 11%, I think you have been exceeding now for a while?

Mike Ellis

We are not even two years in the 8% to 11%, Scott. Let us get comfortable and used to this one for a little bit.

Rodney McMullen

But as you know, the key to our growth rate is being sales led and growing our business and then continuing to execute against our model. So, I agree with Mike give us a little time, but that's really how we are trying to drive to grow our business.

Mike Ellis

It's one thing to announce investments in October '12. It's another thing to begin making those. And then it's another thing again for them to come out of the ground and start generating sales and EBITDA. So, there is a lag from when you make the announcement until you get there. Keep in mind, our share buyback in the first quarter is very strong. That was contemplated in our guidance. And we told everybody in October '12 for the first couple of three years, a third to half of our growth was going to come from share buyback until our investments started to mature. So, we will have to wait for that tipping point happen, Scott and see where we are at that point in time.

Scott Mushkin - Wolfe Research

Alright, guys. Thanks for taking my questions.

Rodney McMullen

Thanks Scott.

Operator

And next we have a question from Karen Short of Deutsche Bank.

Karen Short - Deutsche Bank

Hi, thanks for taking my questions. Just on the comps looking at the numbers that Harris Teeter reported last year, it looks like I mean they actually had some pretty decent comps throughout last year, right up until their third quarter. So, I am kind of wondering if you could give some color on what the impact for Harris Teeter was on your comps?

Rodney McMullen

Yes. We won't give specifics. Obviously when we talked in the fourth quarter, we said we would – we gave guidance with Harris Teeter in it. We were pleased with where Harris Teeter's numbers was. It was consistent with the budget and that's true for EBITDA as well, but I won't give specifics in terms of how it affected the overall total Kroger number other than it wasn't much.

Karen Short - Deutsche Bank

Okay, that’s helpful. And then I know you obviously gave color on your inflation in the current quarter, what are your expectations on inflation for the whole year or the full year?

Mike Ellis

Yes. We are kind of expecting in the range where we saw in the first quarter to hold true for the year. I figured inflation was going to come back up again, so actually flipped to a page in our – you have seen me carry my blue book around in the conferences, Karen.

Karen Short - Deutsche Bank

Yes.

Mike Ellis

If you look at some interesting things and without fuel and pharmacy, last year’s inflation cadence was 1.7, 1.6, 1.5 and 0.8. And everybody is concerned about inflation right now in our first quarter and that same metric was 1.8. Grocery inflation in this year’s first quarter was actually lower than grocery inflation in last year’s first quarter. And pharmacy and meat and produce are basically in the same range. So, this isn’t a world we have lived in and it’s not a huge shift really from where we were about the same time last year. We are comfortable managing the business and in an inflationary environment like we have today and think we are going to see this continue, there are some grain prices out there that are favorable. Milk looks like it’s peaked and it’s going to start to come down a little bit, which will help the grocery inflation index, because that’s where we classify milk and we talk about inflation. So, we think it’s going to be pretty comparable to where it is today.

Karen Short - Deutsche Bank

The blue book came in handy. Thanks. Thanks for that color.

Mike Ellis

This is why I carry it.

Karen Short - Deutsche Bank

And then just the last question, it looks obviously you gave your dollar amounts at a buyback, but it looks like you are done, pretty much done with your authorization. So, any comments on that?

Mike Ellis

We did have our expectation and our guidance for the year contemplated a front end buyback program. It is somewhat unusual first to go without any kind of an authorization. What I would say is unless there is I wouldn’t expect significant incremental buyback activity for the rest of the year.

Karen Short - Deutsche Bank

Great, that’s helpful.

Rodney McMullen

And it’s really left up to our board on the approval.

Mike Ellis

Right.

Karen Short - Deutsche Bank

Okay, that’s helpful. Thanks.

Rodney McMullen

Thanks Karen.

Operator

And the next question is from Meredith Adler of Barclays.

Meredith Adler - Barclays

Hey, guys. Thanks. I am going to probably talk about something a little bit bigger picture. I was very intrigued by the commentary about pension and specifically that you had some employees a small number, but some employees shift to a 401(k) plan with matching and also that you moved a much larger group of employees to a different plan, could you just talk a little bit about kind of what the discussions were? Why would somebody move away from a defined benefit plan and what do you think the prospects are for other people recognizing the value of 401(k)?

Mike Ellis

Yes. There were clearly a couple of different moves here, Meredith, both of which came together in the same quarter. The folks in the Pacific Northwest, there were actually two separate moves with those folks. They are continuing, their accrued liability moved into the consolidated UFCW plan that we established a couple of years ago. So, we took their historical liability that they have already earned into that company managed UFCW plan. Their future benefits are being accrued in the sound plan and it’s not a sound plan from the financial standpoint, although it’s very well funded. It’s called the sound fund in the Pacific Northwest. So, that was a group of retail associates.

The second move was a group of King Soopers pharmacists who happen to be unionized. Same thing, we moved their obligation and it was actually through the negotiating process with them, where they have the desire to go into our 401(k) plan and be able to manage their investments themselves and accrue those dollars and move them around as they see fit. And it was – that one was really associate-driven at the negotiating table. I will tell you we have some high level talent dedicated to this effort. In fact, if you remember a year or so ago, we moved Scott Henderson, who was our Treasurer and he spends a good chunk of his time when he manages our entire pension investment program, both of the – all three of the K plan, the company plan and the UFCW plan as well as spends a lot of time with our labor negotiators trying to do this. Our view is we are trying to be proactive on this front, not reactive. And we think by being proactive, it's the best thing for our associates not only for the pension they have already earned, but for the pension that they would expect to earn going forward.

Rodney McMullen

And Scott and Mike working with our labor negotiators and the union, they understand the opportunity and need for this. And this really does improve the quality of the benefits our associates have and improves the security of their ultimate benefit. So, it's one of those things where the union is also working with us on these, but it's a lot of work and a lot of effort.

Mike Ellis

It happens slowly.

Meredith Adler - Barclays

And I guess it's fair to say that repeating what you did with the pharmacists maybe unusual because they are a unique group of employees?

Mike Ellis

Perhaps. You never know what's going to happen in the negotiation. All I know is the unions and Kroger both have the desire to continue conversations to try to come up with creative solutions to help secure the benefits they have already earned and give them a decent benefit approval going forward as well.

Meredith Adler - Barclays

That's great. And then I am going to just switch gears talking about fuels, you had – it looks like it was pretty attractive margin on fuel this quarter and I assume that's because prices were coming flat or coming down. Is that fair to say and kind of what's your outlook if you can have an outlook about fuel prices for the rest of the year? And also did it contribute to earnings per share in any kind of a meaningful way?

Mike Ellis

What we always say about fuel is one thing we will guarantee and that is it will be volatile. It was volatile inside the quarter. There were days and weeks where we were not as thrilled with our fuel results. And then there were days and weeks where we are very thrilled with our fuel results. Relative to the retail price per fuel in quarter one on a total company basis, fuel, supermarkets and convenient stores combined, the average retail price per gallon last year was 3.50 to 4 and this year was 3.45 to 6. So, it was actually a little bit lower on a combined basis between the two years. And the cost was actually about the same amount, maybe just a touch amount lower as well. So, it's – and we had very, very strong gallon growth, almost 6% gallon growth.

Rodney McMullen

It was – it helped the quarter, but it wasn't the driver for the quarter, by no means. And as you know, we always budget fuel margins kind of the same this year as the prior year. And over time that always seems to come out pretty close to right. Along the way, there is, as Mike mentioned, quite a bit of volatility.

Meredith Adler - Barclays

Right. And then I am just going to fill in one more quick question I think I just didn't hear what was said about pharmacy and what pharmacy maybe to comps and anything else about pharmacy profitability, I don't know if you made a comment, some stuff broke up when I was listening to it?

Rodney McMullen

Yes. I made a comment when I spoke about ID sales for the quarter that they continued their strong performance both from a script count and the sales count, sales basis. So, good ID sales growth in dollars and scripts.

Meredith Adler - Barclays

Okay, great. Thank you very much.

Rodney McMullen

Thanks, Meredith.

Operator

And next question we have a question from Andrew Wolf of BB&T Capital Markets.

Andrew Wolf - BB&T Capital Markets

Hi, good morning. Wanted to ask a one follow-up on the inflation questions that you have been getting, with meat rising really quite rapidly the last couple of months and the quarter coming out okay on gross margin and you guys saying your survey works looks like your customers are loosening up their pocket books. Are you seeing a lot less change in behavior in terms of trading down in proteins and into lower quality meats and stuff like that? And well, that's really the question. So, it's kind of a pass-through and are you able to pass it through in a sort of more reasonable way than you would one or two years earlier than when that type of thing happened? And how is the consumer reacting to that?

Rodney McMullen

If you look at meat specifically, you can clearly see behavior changes as prices increase. So people buying more cube steaks or buying more hamburger, those kind of things you can clearly see. The comment on the customer overall is very broadly in terms of if you look at what they are doing in total, we feel very good about and we like what we are seeing in terms of the customer in total being willing to spend a little bit more.

Andrew Wolf - BB&T Capital Markets

Okay. And I wanted to ask just a follow-up on Harris Teeter, I know you guys do a lot of survey work with customers and Harris Teeter has a pretty rich loyalty card as well? Have you been able to do any survey work with their customers? And could you reveal what it is you might have heard from them in terms of maybe in terms of the four Ts that you guys go to market with or that kind of thing? I know at a conference recently you said perishable pricing was the focus for example?

Rodney McMullen

Yes. If you look at obviously Harris Teeter has done customer research for years and before in a couple of markets, we would have our customer research on Harris Teeter just because they were somebody else in the market. Harris Teeter scores incredibly strong on people and products and freshness of products. So, when you look at produce meat, deli department, they score very well and their associates are very friendly. And that's really their strong suit. And we would expect when we start doing the combined research that, that's consistent with the research Harris Teeter has done before, we would expect to see the same.

Andrew Wolf - BB&T Capital Markets

And were they scoring well, let's say, in some of that merchandising and maybe customer interaction as well, is that something where that can be integrated into all or parts of Kroger or is it just too much of a task for given the size differential between the two companies?

Rodney McMullen

Mike Ellis on this prepared comments talked about a little bit. I can tell you that Mike Ellis and the operators are spending quite a bit of time trying to understand exactly how Harris Teeter does that. And Mike you are in the middle of all that.

Mike Ellis

Well, it's really been fun to have someone who was a competitor that you admire. And now you can actually see what they do, how they do it, but as

Rodney mentioned, they have been really strong on some of the matrix better than us in several markets. And so to learn how they do, what they do has been actually really a lot of fun and we are integrating some of that into some of our operations today throughout Kroger.

Andrew Wolf - BB&T Capital Markets

I look forward to hearing more about that. Thank you.

Rodney McMullen

Thanks Andrew.

Operator

And our next question is from Stephen Grambling of Goldman Sachs.

Stephen Grambling - Goldman Sachs

Hey, good morning and thanks for taking my questions. I guess turning back to the guidance given the big buyback upfront it looks like the year seems a bit of a change in the margin on a standalone basis even when factoring in the high LIFO charge. I know you don't like to get into this much, but can you talk qualitatively about your underlying gross margin given the OG&A assumptions in the back half and any unusual shift we should be expecting?

Rodney McMullen

Yes. I wouldn't – I won't get that granular. The closest I will come is we did make comments about operating profit and as we get a full year of Harris Teeter into the numbers, we would expect our operating profit margin to not be the 12 basis point rolling four quarters increase we had in the first quarter, but as get a full year of them in we would expect it to come closer to the slight increase that we project overall.

Stephen Grambling - Goldman Sachs

Okay, that's helpful. And then I think the other thing that I guess Kroger has been doing, it's a little bit different than other areas and retail is moving towards a few of the larger format stores, marketplace stores. As you look at general merchandise, which has been shifting online and you learn from click and collect at Harris Teeter, how are you thinking about the opportunity to offer general merchandise at a broader group of stores with the web and what are the implications for sales per square foot?

Rodney McMullen

Well, all of our large stores have some selection of general merchandise, including apparel and all of our future plans and remodels that we are working on. And we are really pleased with the results, pleased with sales per square foot and pleased with customers' reaction to the product offering. So, it is part of our strategy going forward.

Stephen Grambling - Goldman Sachs

And for the smaller stores, is there an ability right now to actually have click and collect on general merchandise?

Rodney McMullen

Not today.

Stephen Grambling - Goldman Sachs

Would it take so much?

Rodney McMullen

We would expect to take the Harris Teeter click and collect as Mike mentioned other – to do it in an another market. We like what we are seeing there.

Stephen Grambling - Goldman Sachs

Okay, great. Thanks. Best of luck.

Rodney McMullen

Thanks, Stephen.

Operator

And our next question is from Jason DeRise of UBS.

Jason DeRise - UBS

Hi, it’s Jason DeRise. Wanted to ask on natural foods obviously growing double-digits, can you share what it contributed to the 4.6% comp?

Rodney McMullen

We really wouldn’t get into that level of detail in terms of how much of the 4.6% is driven by that. Mike did mention that all departments were positive identicals.

Mike Ellis

All departments and all geographies.

Rodney McMullen

Yes. So, it’s broad-based. So that isn’t the thing that’s driving it, but obviously a nice growth.

Jason DeRise - UBS

And when you look at your customer data, do you think that this is a customer who is just entering the category in a more meaningful way now that you are offering it or do you think that you are perhaps this is sales that previously were outside of Kroger at maybe a specialty store now that shopper is deciding to that trip at Kroger solely?

Rodney McMullen

I think it’s all the above. There has been lower prices in lot of areas in natural foods, so it’s I think to bring new customers to the category, but certainly people are more health conscious for their family and the things that they consume. So, lot of our customer insights are driving lot of the decisions on what we carry and what we put into our stores. And there are customers, is shouting that this is something they are really interested in. So, it’s a big focus by us – for us.

Jason DeRise - UBS

I think it is maybe a year or two ago, there was a lot of talk about how Kroger only has half of their customers grocery spend. How has that trended since the efforts in natural foods and other categories to try to win more of that share?

Rodney McMullen

And Jason, it’s a great question and it’s one that if you could – if you were in the room you would see us smiling at each other, because it’s pretty similar to what it was, because the fortunate part we keep adding new customers. So, if you look at the loyal shoppers that have been loyal for a while we continue that 50% would probably be more like 70% to 75%, but fortunately, we keep growing our customers. So, you have new loyal customers coming in. So, when you look at the blend of existing loyals and new loyals, it’s still around the 50%.

Mike Ellis

Yes. If you look at ID loyal customers, it will be much higher than 50%, but the good news is we keep adding people that become loyal below the 50%. So, it dilutes the total back down.

Rodney McMullen

Obviously, natural foods helps on that, but it's really across the whole store that we are picking up that customer including the fresh departments produce meat, deli bakery, seafood.

Jason DeRise - UBS

Okay, great. And I guess I just wanted to see if I can put this in there on Harris Teeter, would you quantify just the EPS accretion for the quarter, just so that we can sanity check the original guidance on that?

Rodney McMullen

You should assume that our original guidance, our updated guidance would have the same base assumptions for the Harris Teeter contributions to the year.

Mike Ellis

I did mention that Harris Teeter is performing consistent, a little bit better, but not a lot in terms of the analysis that we used when we are working on the merger. So, we are pleased with where they are tracking and they would be consistent with what we shared with them.

Rodney McMullen

We are right on track with what our expectations were.

Jason DeRise - UBS

I mean, there has been in the press, I guess that part of it's your press, but that the Harris Teeter started dropping prices, similar type of press releases that you would see coming out of other Kroger banners on this. And so, that's I guess is there anything you could share about how that's gone? Is that what's driven maybe a bit more of the upside, the response to that or is that not where the incremental upside has been?

Rodney McMullen

Yes. It's really very, very early in that process. And what we are doing is the synergies as we accomplish them, Harris Teeter is taking that money and giving it back to the customers. So, it's really given the customer something back from the merger and some of the savings and Mike mentioned insurance, for example.

Jason DeRise - UBS

Okay, great. Thank you.

Rodney McMullen

Thank you.

Operator

And next we have a question from Chuck Cerankosky of Northcoast Research.

Chuck Cerankosky - Northcoast Research

Good morning, everyone. Nice quarter.

Rodney McMullen

Good morning.

Mike Ellis

Thanks, Chuck.

Rodney McMullen

Thanks, Chuck.

Chuck Cerankosky - Northcoast Research

Looking again at the pension benefit announcements you have made the other day, like I'd like to get a better idea on how the cash flows are going to look on this. You are obviously not going to pay $56 million immediately, but at the same time, how might that be broken up over the next five years or so as it moves into the funds? And is there a corresponding offset in your hourly contribution of these plans?

Mike Schlotman

Couple of questions there. So, the $56 million is the after-tax cash we will have to put in. And as we said we have up to five years to do that. We really haven't decided exactly how we are going to do it. The King Soopers pharmacist is a smaller part of that total contribution and we actually have longer than five years to do theirs, but you should expect some plan over the five years to do it. What this really does is technically what happened is assets and liabilities came attached to their already earned and accrued benefits. And that's what we are shoring up in these plans. Going forward, they will continue to earn benefits. In the pharmacist case, they will get a K plan match. In the clerk's – in the Pacific Northwest contract, they will continue to earn the benefit going forward and there will be cents per hour accrual for those benefits going forward. So, it won't reduce that.

Chuck Cerankosky - Northcoast Research

So that the $56 million is to shore up the plans and whatever is negotiated going forward is an additional pennies per hour kind of deal?

Mike Schlotman

Now, what we don't have to negotiate and we are about funding going forward is any cents prior to make up the $56 million, because we will do that separately. So, going forward, any portion of an hourly contribution that was there to make up an under funding in the plan, obviously we have already negotiated that and walled it off. So, all we have to worry about funding is future benefit accruals, not vested benefit accruals that will be separate.

Chuck Cerankosky - Northcoast Research

And announcements of this sort are likely to recur, but it’s very difficult to forecast when and how frequent, is that a fair statement?

Mike Schlotman

Predict when and how and it’s one of the reasons we had a disclosure of this kind of activity in our outlook section in the 10-K, because that’s why we dedicated some very talented resources to this, because we would love to continue to pick off opportunities like this to secure – to help secure the pension benefits of our associates going forward. And some of these under funded plans get that out of that fund, if that fund runs into trouble. We know our associates are taken care of, because we have them in a fund that we are helping manage and we do view that what we have is an obligation to do that for them.

Chuck Cerankosky - Northcoast Research

Thank you.

Rodney McMullen

Yes, thanks Chuck.

Operator

And the next question is from Filippe Goossens of Mitsubishi.

Filippe Goossens - Mitsubishi

Yes, good morning and many thanks for taking my question here. And (indiscernible) has recently indicated that they had seen a pickup in competitive activity, not only obviously in their home markets with the expansion of Albert Heijn stores, but also in some U.S. markets. Should we read into that, that you perhaps have sharpened a little bit your pricing already with Harris Teeter given that they do compete with the Food Lion stores in a number of markets?

Rodney McMullen

Yes. As I mentioned before, that is a good assumption, but it's just early in that process.

Filippe Goossens - Mitsubishi

Okay. And then just a follow-up if I may. I may have missed this, but following the announcements yesterday, have you indicated by how much your multi-employer liability will shrink on the balance sheet?

Rodney McMullen

Well, that amount we put in the MD&A is not entirely on our balance sheet. And theoretically, it would be reduced by the $56 million once we fund it. That $56 million will actually now sit as the liability in our balance sheet until we do fund it.

Filippe Goossens - Mitsubishi

Okay, great. Thanks very much for the color today.

Rodney McMullen

Yes. Thanks Filippe.

Operator

And next we have a question from Kelly Bania of BMO Capital Markets.

Kelly Bania - BMO Capital Markets

Hi, good morning. Thanks for taking my question. Just on your comp guidance, you clearly raised it, first quarter was strong, it sounds like second quarter's running strong as well. And you talked about a little bit of a less cautious consumer behavior, which I don't think I have heard you guys say for a while and upticking inflation. So, just curious if there is any conservatism in that 3 to 4 kind of outlook for the rest of the year or any other things that we should be thinking about getting back to a 3 to 4 range?

Rodney McMullen

The one thing that if you look at last year by quarter, the fourth quarter actually was a little better than the trend had been. It wasn't driven by weather, but it was helped by weather. And as we start cycling some of those things until you actually cycle them, obviously you don't know where you are. Now, we will always hope that we are a little conservative, but until you get there it is our best estimate at this point in time. Mike or Mike you want to agree completely?

Mike Ellis

I would agree completely also.

Kelly Bania - BMO Capital Markets

Great. And if I could just add another question on natural foods, clearly up strong again. Just curious as you look at your competition whether it's discount channel or supermarkets or elsewhere, do you see them investing as much as you are in natural product categories? I mean, I realize Wal-Mart has announced the Wild Oats line. We haven't really seen that show up in stores yet, but do you think some others could start to invest more in natural foods as well or what are you seeing versus your competition?

Rodney McMullen

Well, there is investment. We are seeing competitive investment in natural foods. For us, we have positioned natural foods in different parts of the store now. You will find soy milks, almond milks in the regular dairy case and things like that. So, we are just trying to answer what the customer wants and have products available at a price that they are willing to pay and in a location that they are happy to find them. So – but competitively, yes we have seen a little bit of move, but not much.

Kelly Bania - BMO Capital Markets

Great, thanks.

Rodney McMullen

We have time for one more question. Thanks Kelly.

Operator

Thank you. And that question will come from Kate Wendt of Wells Fargo Securities.

Kate Wendt - Wells Fargo Securities

Thanks for squeezing me in. So, just actually had a bigger picture question, as you look at your overall store base whether you think you will see a net increase in competitive openings against you this year or if it's consistent you think with last year or maybe offset by closures at weaker chains. Obviously, it doesn't seem to be affecting your comps this quarter, but just curious how you see that playing out this year?

Rodney McMullen

It's a good question. And you continue to see a lot of people talk about adding square footage in the space. Some of that square footage is dedicated to what we sell in the side of a different format be it inside of a Dollar General store or a drugstore or something like that. Wal-Mart is obviously building some smaller neighborhood and kind of markets. So, that's there. What kind of gets lost is competitors who are closing stores that I would call versus a small offering inside of another format, what I would call a destination store. So, when you have a destination store closing, it's 50,000 or 60,000 square feet and somebody else has added 1,200 square feet, that's really a convenient shop. It's a different kind of competitor. So, I think we will continue to see a lot of square footage open up that sells food. I think overall, the destination kind of square footage is probably flat to slightly down.

Kate Wendt - Wells Fargo Securities

Got it. That's really helpful. And then just one other quick one, I saw that you recently introduced a premium pet food assortment which sounds like it could be a nice incremental comp driver for you guys. I was wondering how many stores that's in today and maybe how many you are planning by year end? And then it also sounds like maybe along with that there has been a change in the receptivity of premium pet food brands distributing to the supermarket channel?

Rodney McMullen

Yes. We just recently introduced, I am glad you caught that, a new line of premium pet foods and it should be in every store in Kroger I would hope that was the plan and sales have started out strong and we are real pleased with it. Glad you caught that.

Kate Wendt - Wells Fargo Securities

I try. Thanks so much.

Rodney McMullen

Thanks Kate. Before we end today's call, I'd like to share some additional thoughts with our associates listening in today. Earlier this month, we introduced the Taste of México event in all our stores. We hope our associates are enjoying this fun celebration of Mexican food with our customers, including in-store sampling, creative displays and special activities. I know I have enjoyed visiting our stores across the country and seeing the creativity, passion and enthusiasm from our associates for the Taste of México. This special event is the first of a series of celebrations of foods of the world in our stores and runs through June 24.

Our associates' passion for doing good is evident in the way we serve our customers and neighbors in the communities where we live and work everyday. This month, we honor our associates' efforts in serving our communities and those in need. We are pleased to recognize in our 2013 Annual Report 28 associates across the company for their outstanding volunteer service as recipients of the Kroger's 2013 Community Service Award. These women and men give their time and talent to honor veterans, feed the homeless, raise money to fight cancer, and bring music to mentally-challenged among many other causes. We are grateful for their commitment. A big heartfelt thank you to all of our associates who volunteer. Mike and I are proud of the work you do. You make a big difference for so many others and the communities we call home. Thank you. That completes our call today. Thanks for joining us.

Operator

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