The Kroger Co. (NYSE:KR) Q1 2015 Earnings Call June 18, 2015 10:00 AM ET

Executives

Cindy Holmes - Director-Investor Relations

W. Rodney McMullen - Chairman & Chief Executive Officer

Michael L. Ellis - President & Chief Operating Officer

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

Analysts

Edward J. Kelly - Credit Suisse Securities (NYSE:USA) LLC (Broker)

Rupesh D. Parikh - Oppenheimer & Co., Inc. (Broker)

Karen F. Short - Deutsche Bank Securities, Inc.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

John Edward Heinbockel - Guggenheim Securities LLC

Meredith Adler - Barclays Capital, Inc.

Andrew P. Wolf - BB&T Capital Markets

Kenneth B. Goldman - JPMorgan Securities LLC

Alvin Caezar Concepcion - Citigroup Global Markets, Inc. (Broker)

Filippe Marcel Goossens - Mitsubishi UFJ Securities (USA), Inc.

Scott A. Mushkin - Wolfe Research LLC

Kelly A. Bania - BMO Capital Markets (United States)

Operator

Good morning and welcome to The Kroger Company first quarter earnings conference call. All participants will be in listen-only mode. After today's presentation, there will be an opportunity to ask questions. 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 - Director-Investor Relations

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

Both our first quarter press release and our prepared remarks from this conference call will be available on our website at 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.

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

W. Rodney McMullen - Chairman & Chief Executive Officer

Thank you, Cindy, and good morning, everyone, and thank you for joining our call today. With me to review Kroger's first quarter 2015 results are Mike Ellis, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

Kroger delivered strong first quarter sales and earnings results and we are pleased with our start for the year. We achieved our 46th consecutive quarter of positive identical supermarket sales growth. We exceeded our goal to slightly expand FIFO operating margin without fuel on a rolling four quarter basis, and we continue to invest and innovate to grow our business, expanding our use of technology and our digital capabilities.

Kroger has produced consistently remarkable results for so long that it might be easy to take a quarter like this for granted. But these results don't happen accidentally. They happen because we lead and drive our business towards these goals. Customer 1st and our four keys: our people, products, shopping experience and pricing, remains our fundamental strategy. We strive for balance across these four keys and each quarter we do a little better in each, and when we do that consistently for as long as we have, our results are more powerful.

Based on the strength of our first quarter results, we are raising our identical supermarket sales growth guidance for the year and we are on track to deliver our long-term net earnings per diluted share growth rate of 8% to 11%, plus the dividend in 2015.

One of the ways we continuously improve the shopping experience is by bringing new technology and digital capabilities to our business. Mike Ellis will provide an update on several digital efforts in a moment, but I wanted to mention what I think is a great example of how we're expanding our use of technology. Our recent decision to established 84.51° which replaced our previous joint venture, dunnhumbyUSA, 84.51° is helping us to continue to use data science for the benefit of our customers and to deliver a more personalized experience both in-store and online. We are so excited to welcome the talented associates at 84.51° to the Kroger team and we are already beginning to see their daily involvement in the business helping to accelerate our efforts. Just little things like 84.51°CEO, Stuart Aitken, participating in our senior officer meetings is making a big difference. We expect 84.51° to be an innovation engine and a game changer for Kroger and our customers.

We are pleased to see the economy moving in the right direction, albeit as we've mentioned for several quarters slowly. One of the important ways we are able to deliver so consistently is that we offer attractive values for all customers all the time. When you want to splurge, you can splurge. When you want to save, you can do that too. So while Murray's Cheese, Starbucks and Boar's Head, for example, are performing very well, so are our entry-level price point brands.

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

Michael L. Ellis - President & Chief Operating Officer

Thank you, Rodney. Good morning, everyone. Our associates continue to deliver an exceptional experience in ways that make a difference for our customers. Over the past year, more customers have noticed improvements in Kroger's product selection, product freshness and customer service. Our strong identical supermarket sales growth was primarily driven by an increase in the number of households shopping with us in the first quarter. We also met our goal to grow the number of loyal households at even a faster rate than total household growth again in the quarter.

We are especially proud of our loyalty and sales results when you consider the current operating environment that we're in, which has less certainty than normal. We are addressing the volatility we see out there every day. Fuel margins, for example, have returned to normal compared to where we ended last year. Another factor is product costs. Some commodities are up, some are down. We are seeing deflation in milk, produce and seafood which is driving more tonnage volume. Milk is one of our most price-elastic categories that we have. When milk prices come down, people tend to buy a lot more. We're at an advantage because we have a vertically integrated supply chain for milk. When our dairy plants run at higher volume, we become more efficient and productive. We continue to see inflation in generic pharmaceuticals and in certain commodities in the meat department.

Overall, inflation continued but at a lower rate during the first quarter which is in line with what we had expected. Tonnage growth was very strong during the first quarter. In fact, we saw the strongest first quarter tonnage performance since 2010 which is a clear indication of our ability to get pricing right for our customers. If you look back over the past several years, we've had periods of high and low inflation and we've shown that regardless of the environment we will deliver greater value and convenience for our customers.

Corporate Brands had a solid first quarter accelerating company sales growth and representing approximately 26.9% of total units sold and 25.4% of sales dollars excluding fuel and pharmacy. A key driver of sustainable growth is Customer 1st innovation and, as Rodney said, we are actively expanding Kroger's use of technology which we see as a catalyst for improving our connection with customers and growing our market share.

Kroger's digital team has developed a popular mobile app that our customers use millions of times each week. In April, we were one of the first food group retailers to release an app that is compatible with the Apple Watch and this month we reached a new milestone, more than 2 billion digital coupons have been downloaded from our digital properties since we began offering digital coupons since 2009. It took four years to reach our first billion and only 15 months to reach our second billion and the third billion will take even less time.

Also this month, our Cincinnati division began inviting local customers to try our order online, pick up in store solution we are learning from Harris Teeter which we've been beta testing for a few months and is now available in two of our Cincinnati area stores to all customers.

Our integration with Vitacost.com continues to go very well and just this week, Vitacost helped us launch a new natural and organic e-commerce website called King Soopers Live Naturally that is open to King Soopers customers who live in and around the Denver metro area. The website, which utilizes Vitacost's technology platform and fulfillment network, creates an endless aisle experience with ship-to-home service for thousands of additional health foods, vitamins, minerals and supplements that are available in our Denver area stores today. We are excited to see the results of this new pilot program.

And now, I will provide a brief update on labor relations. We recently agreed to new contracts in both Las Vegas and Louisville, and we agreed to a master agreement with the Teamsters covering several distribution and manufacturing facilities. Four or five Teamster locals have also ratified this agreement. We are currently negotiating contracts with the UFCW for store associates in Columbus, Denver, Memphis, and Portland.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality affordable healthcare and retirement benefits for our associates. Kroger's financial results continue to be pressured by rising healthcare 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: growing Kroger's business and profitably, which will help us create more jobs and career opportunities and enhance job security for our associates.

Before I turn it over to Mike Schlotman, I'd like to say a little more about the culture of opportunity we work hard to create here at Kroger. Being a Kroger associate means being part of our family, part of something bigger. Every day we hire people who come to Kroger for a job, then decide to stay for a career. In fact, two-thirds of our store managers today started as an hourly clerk stocking shelves or bagging groceries. We continue to increase our investment in training to build skills so our associates are ready for opportunities to advance and lead others. We offer so much more than a job, a chance to connect with their community, to be part of a giant team stretching from coast to coast, and to work with colleagues who want to make a difference too. We think this opportunity culture is a differentiator for us today and will continue to be into the future.

Now, Mike Schlotman will offer more detail on Kroger's financial results and update our guidance for 2015. Mike?

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

Thanks, Mike, and good morning, everyone. I'd like to spend a few minutes discussing our results for the quarter in each of the key performance target areas for our long-term growth plan.

Our first metric is identical supermarket sales without fuel. We were pleased with our first quarter identical supermarket sales growth of 5.7%. This strong performance was supported by identical supermarket 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 meat, deli and pharmacy departments also posted strong identical supermarket sales growth.

Rolling four quarters FIFO operating margin, excluding fuel, the 2014 and 2013 adjustment items, and the contributions to the pension and foundation in the third and fourth quarters of 2014 increased by 10 basis points. This exceeded our commitment to grow the rate slightly over time on a rolling four-quarter basis.

Return on invested capital on a rolling four quarters basis was 14.03%. We are not presenting the comparative number this quarter because the prior-year first quarter calculation does not include a full year of Harris Teeter assets and results. We do expect return on invested capital for fiscal 2015 to increase slightly from the fiscal 2014 result. This is an important metric as we continue to increase our capital investment to drive our future growth.

Now I'll share our first quarter 2015 results in more detail. As you know, we don't provide guidance for total sales because of the unpredictability of fuel margins on our results. Total sales in the first quarter increased 0.3% to $33.1 billion compared to $33 billion for the same period last year. Excluding fuel, total sales increased 6.4% for the first quarter compared to the same period last year.

In the first quarter, our net earnings totaled $619 million or $1.25 per diluted share. Kroger's net earnings during the first quarter last year included charges related to the restructuring of certain pension obligations to help stabilize associates' future benefits. Excluding the effect of those charges, Kroger's adjusted net earnings in the same period last year were $557 million or $1.09 per diluted share.

We recorded a $28 million LIFO charge during the first quarter, consistent with the same quarter last year. We raised our annual estimate to $90 million from $75 million, primarily due to pharmacy inflation. FIFO gross margin excluding retail fuel operations decreased seven basis points from the same period last year.

Strong identical supermarket sales growth and cost controls allowed Kroger to leverage operating expenses as a rate of sales in the first quarter. Total operating expenses, excluding retail fuel operations and pension agreements, decreased 15 basis points as a result of sales compared to the prior year. This really does demonstrate the leverage of strong ID sales as we simultaneously invested in areas other than price to provide a continually improving shopping experience for our customers, but leveraged our ID sales to drive the rate down.

Now for retail fuel operations, in the first quarter our cents per gallon fuel margin was approximately $0.116 compared to $0.131 in the same quarter last year.

Our long-term financial strategy continues to be: repurchase shares, have an increasing dividend, fund increasing capital investments and maintain our current investment-grade debt rating. Our strong financial position has allowed us to return $1.1 billion to shareholders through share buybacks and dividends over the last four quarters. During the quarter, Kroger repurchased 8 million common shares for a total investment of $585 million. Capital investments excluding mergers, acquisitions, and purchases of leased facilities totaled $915 million for the first quarter compared to $709 million for the same period last year. We continue to expect capital investments excluding mergers, acquisitions, and purchases of leased facilities to be in the $3 billion to $3.3 billion range for the year.

Our plan to increase capital investment on an annual basis remains in place. We were pleased with the early returns from these investments and we continue to have a long list of strong projects that will compete for these investments.

The company's net total debt to adjusted EBITDA ratio decreased to 2.09 compared to 2.40 during the same period last year. Kroger's net total debt is $11.3 billion, consistent with last year. It's constructive to understand that we have maintained our absolute debt level while returning $1.1 billion to shareholders through share buybacks and dividends over the last four quarters and investing $3 billion in capital on a rolling four-quarter basis, plus an additional $411 million on mergers, acquisitions, and purchases of leased facilities. In other words, we are keeping our commitments to our bondholders and our shareholders.

Now I'd like to update our growth objectives for 2015. Based on our strong first quarter results, we raised our identical supermarket sales growth guidance, excluding fuel, to a range of 3.5% to 4.5% for 2015. The original guidance was 3% to 4%. We are confirming our net earnings guidance range of $3.80 to $3.90 per diluted share for 2015. This range is within our long-term net earnings per diluted share growth guidance of 8% to 11%. Shareholder return will be further enhanced by a dividend expected to increase over time.

As we look at quarter comparisons in relation to our 8% to 11% annual growth rate, we believe that quarter two will be slightly above the range, quarter three will be at the high end of the range, and quarter four will be below the range. For the full year, we expect to be within the range and it is still somewhat dependent on where fuel margins shake out.

Now, I will turn it back to Rodney.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Mike. This is another terrific quarter. Our associates are making a difference for our customers by providing excellent service and product quality and selection. As I said earlier, results like this don't happen by accident. We create these results by connecting with our customers through our powerful Customer 1st strategy. When we take care of our customers, we create sustainable value for our shareholders.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

At this time, we will begin the question-and-answer session. And our first question will come from Ed Kelly of Credit Suisse.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

Hi. Good morning, guys, and nice quarter.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thank you. Good morning too.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

So my first question I guess is just related to the guidance, so I guess maybe more for Mike. But obviously you raised your ID guidance for the year. You had a good strong quarter but you maintained the EPS guidance. So I'm just curious at this point is it just early and you want to be conservative or are there other incremental offsets that are maybe new?

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

It's a variety of factors, Ed. One, it is early in the year. And as we said in both the release and in the prepared comments, the operating environment is a bit volatile right now. There's a lot of volatility in fuel prices. They've obviously come in very quickly to a more normal range from where the range was at the end of the year last year. We know that will be a headwind in the fourth quarter. It was baked into our original 8% to 11%. Our actual first quarter results, while ahead of the Street, were just a little bit over the 8% to 11% range and we had expected to be near the high end of the range ourselves, which was our original guidance on cadence.

And then just the volatility of inflation that's out there, while we've seen some categories with deflation, we know that pharmacy inflation is actually as high as it's been over the last several years in the first quarter. It's right at double digits. And then a little bit of concern or thought process about the avian virus with the poultry flocks and how that might affect input costs later in the year and what's going to happen with availability of those products.

So when we stepped back and thought about it, while we're pleased with the first quarter, we thought the most prudent move given the uncertainty or the volatility of some of the things out there was to maintain our guidance range. We had guided in March that if fuel margins came in, it may put us at the low end. We aren't saying we're going to be at the low end but we're maintaining the range because that actually has happened with fuel.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

And, Mike, historically you've said about $0.14 or so a gallon in fuel. Obviously, this quarter is lower but the slope of the curve was rising. Is there anything else that's changed in the marketplace or maybe it's become a bit more competitive where you're a little concerned about the $0.14?

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

I wouldn't say we focus on any one number. Our practice on fuel is to follow the market and then give our most loyal customers a really good value on fuel by our fuel rewards program, which I'll remind everybody, the cost of that reduces our ID sales. It doesn't reduce the fuel margin. And it's really just what's happening in the marketplace as we follow the marketplace and stay right on the Street price and the signs but then give that incremental reward. I wouldn't say there's anything unusual in the first quarter. Any short period of time in fuel is an interesting result but a longer period of time is what's more important.

W. Rodney McMullen - Chairman & Chief Executive Officer

Internally, we usually use a rolling four quarter number. This year, we didn't just because of how strong fuel margins were in the third quarter and fourth quarter. And as Mike mentioned, on a daily basis, we're probably never right but usually over the year, it gets pretty close.

Edward J. Kelly - Credit Suisse Securities (USA) LLC (Broker)

Okay. Thanks, guys.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Ed.

Operator

The next question will come from Rupesh Parikh of Oppenheimer.

Rupesh D. Parikh - Oppenheimer & Co., Inc. (Broker)

Good morning and thanks for taking my question. So I want to follow up a little more just on inflation. For this upcoming year, have you guys changed your inflation forecast?

W. Rodney McMullen - Chairman & Chief Executive Officer

We're still expecting it to be in the 1% to 2% range. We're actually at the high end of that range in the first quarter, a lot of that driven by the pharmaceutical inflation that Mike mentioned or we mentioned in the prepared comments, primarily in the generic arena. So that's out there. We do expect to see some potential inflation out there in the poultry flocks as the avian flu issue hits. We don't know what's going to happen with all of the input ingredients that go into products from liquid eggs and how that might affect a lot of products that contain as an ingredient. So we think 1% to 2% is right. So far that's what we're seeing.

Rupesh D. Parikh - Oppenheimer & Co., Inc. (Broker)

Okay, thanks for the color. And then switching topics maybe to competition. We hear a lot about capacity growth in the specialty grocery arena, even I guess more commentary out there on the hard discount channel. What are you seeing right now from competitor openings in – I guess from a full service grocery perspective?

W. Rodney McMullen - Chairman & Chief Executive Officer

From a full service, I guess I would say it's probably been pretty consistent over the last three or four years. Certainly not aggressive; certainly if you look at the niche merchants, there would be much higher growth there, but we consider everybody a competitor, so we wouldn't segment it as different as what probably most people would think we would.

Rupesh D. Parikh - Oppenheimer & Co., Inc. (Broker)

All right, thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Rupesh.

Operator

The next question is from Karen Short of Deutsche Bank.

Karen F. Short - Deutsche Bank Securities, Inc.

Hi, thanks for taking my question.

W. Rodney McMullen - Chairman & Chief Executive Officer

Good morning.

Karen F. Short - Deutsche Bank Securities, Inc.

Good morning. So I'm just curious on – maybe this is just semantics, Mike, and maybe I'm over-reading, but just to clarify on your guidance by quarter, you've said just now that 3Q, you expect it to be at the high end of your guidance. I think last quarter you said it would be slightly above.

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

If you look at second quarter and third quarter, actually I think second quarter we said at the high-end and third quarter above. We just flip-flopped those a little bit. It takes $8 million flipping between quarters to do that, and it's just our best thinking today. So it doesn't affect the year. I think if you look back to what we just said in March, the guidance on those two quarters is flipped between quarters, still reflects a very strong year.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay. Okay. And then on tonnage, I don't know if you guys would be willing to give an actual percent tonnage number. And then I guess following on that, I guess when I look at O&A, your O&A growth rates definitely seemed higher than what I would've expected. I know in the past you've talked about tonnage impacting that number, but maybe just some color on those too?

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

Relative to tonnage, we won't give an actual number. As Mike said in his prepared comments, it was the strongest we've had since 2010 and we haven't given a specific number, but we're very pleased with where it is. If you think about in the comments I made on OG&A, we're very pleased with the leverage we've got of 15 basis point reduction in that as a rate of sales. We did make conscious decisions to invest in other keys of our four-key strategy versus price to provide a better shopping experience to our customer, both through making sure the products are on the shelves in a timely basis, having our associates friendly and we keep our products as fresh as possible. So there was some conscious decision to invest in incremental services for our customers, which provides more jobs and hours for our associates as well.

W. Rodney McMullen - Chairman & Chief Executive Officer

The other thing on tonnage, we always try to give an outline of where we are and how it feels, but it's very hard to calculate and when a customer buys a 24-unit of something versus a 12-unit of something, internally we count that as one and one.

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

Or water, the common package for bottled water today is 32 bottles; it used to be 24. That's still a unit.

W. Rodney McMullen - Chairman & Chief Executive Officer

It's not that we're trying to avoid the question; it's just that it's very – there's an awful lot of assumptions behind that and what we try to do is give everybody a general feel for what's going on.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay. And then just on the CLICKLIST I guess in Cincinnati, I mean, obviously, I know you guys are always very conservative and want to make sure your customer is getting the best experience, but it definitely seemed like it was a pretty long test phase, so I guess maybe, can you maybe clarify or give some color on what you ironed out and what made you feel comfortable to roll it out now? And how quickly you think you could accelerate that?

W. Rodney McMullen - Chairman & Chief Executive Officer

The length of the test would seem long just because it became public a lot faster than we had intended to because somehow, one of the newspaper folks that follow us found the actual website that we were testing with our associates. So it's not that it was longer than normal, it's just that it was public longer than what we'd normally would. It's tracking – if you look at our original plan, we're tracking on exactly where we thought we would be on the original plan and feel good about it. And Mike just pointed out to me we just added our second store, I guess, it was this week or last week.

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

And again, that's in a beta test and we kind of have to know it's there. It's a new experience for us and we just want to make sure it's right.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay, Great. Thanks.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Karen.

Operator

And next, we have a question from Vincent Sinisi of Morgan Stanley.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Hi, good morning. Thanks very much for taking my questions and congrats on a nice first quarter.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks.

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

Thank you.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

I wanted to ask you, first, about really the private label, in particular, the Simple Truth. If you could just give us a quick update in terms of where that brand is today, if over the first quarter there have been any updates in terms of product expansion and how big that particular segment is for you right now?

W. Rodney McMullen - Chairman & Chief Executive Officer

The brand we're very pleased with. I think you'll find around 2,600 SKUs in our stores today and talk about connecting with the customer in a meaningful way. They have taken the brand and really embraced the brand. For us, it's been not only strategic but it's really lining up with what customers are looking for today and you can also buy it now on Vitacost.com and it's available there also so anybody who, even if you don't shop in a Kroger market, you're able to get the product today. But now, we've been totally – completely pleased with the progress we're making and there are many more new items to come.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Okay. And then maybe just as a follow-up sticking with the natural segment, as you're continuing to learn the Vitacost division and as you mentioned, you have the super site now up, have you had any further progress? I know it's still admittedly pretty early but have you had any further progress that you could share with us in terms of maybe bringing some more of those products that have historically been Vitacost into some of your other banners?

Michael L. Ellis - President & Chief Operating Officer

Today we have a pretty good selection of natural foods, supplements, bodybuilding products, healthcare products in our stores. Vitacost really just helps us fulfill that long tail of items that are smaller in some cases and on the King Soopers website now, you can pick up 25,000 to 30,000 additional SKUs than what you'd find in a typical Kroger store. So it's really helped us take Natural Foods, natural products to the customer in a much broader way. We're really pleased with where we're headed. There's a lot of work still to do. We're approaching our first anniversary of Vitacost next month and so we're actually moving pretty fast as a company and we're pleased with where we're headed.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Great, thanks very much.

Michael L. Ellis - President & Chief Operating Officer

Thank you.

Operator

The next question comes from John Heinbockel of Guggenheim Securities.

John Edward Heinbockel - Guggenheim Securities LLC

So, Rodney, I want to start with – you put up a quarter like this but I know you guys can be somewhat self-critical. When you step back and say from a skill set standpoint or a business line standpoint, where are you still not where you want to be in a significant way, not we're 90% of the way there but have a lot of work to do? And then as part of that, address maybe the issue of speed to market, and that being a more important skill set to work on over the next couple of years.

W. Rodney McMullen - Chairman & Chief Executive Officer

The shortest hard question to answer. When I did my own performance review with our board somebody asked me the same question. And you've followed Kroger for a long time and you realize when you look at our culture overall, we're always very proud of what we've accomplished. But at the same time, we feel like we have a tremendous opportunity to get better, and a lot of times we like to use the words that our to-do list is longer than our done list. And when you look at what's out in front of us, we are incredibly excited about the opportunities that we see to continue to get better. And the hardest thing that we have to do is actually make sure that we're trying not to improve on all things at once, but what are the things that are most important to the customer and put all our resources against that.

So I guess the way I would say overall is, obviously, we're delighted with the quarter, delighted with the progress we're making. We're even more excited about the opportunity to continue to get better. So I feel very good about where we are, but I feel even better about the opportunities we have in front of us.

John Edward Heinbockel - Guggenheim Securities LLC

But are there certain – there have to be, right, certain product categories. I don't want to get into geographic differences, but certain product categories, businesses, customer groups that you're not fully resonating with yet, and they have to be those. What would tie those together, if anything?

W. Rodney McMullen - Chairman & Chief Executive Officer

It's probably – I'm trying to think of the easiest way to answer your question because it's a very good question. It's more opportunity, so if you think about like apparel, we've added apparel, I think we're up to 70-some Marketplace stores. We're still learning what is the right selection of product to have that's in a Marketplace store. Obviously, the Fred Meyer group helps us get insight and procures the product for us through that channel, but we're still learning what's the right things to put in. And there's a ton of those things going on, so it's really hard to say there's one specific item or one specific customer. It's much broader than that, and it's 100 different things versus just one thing that we're really trying to get better at.

John Edward Heinbockel - Guggenheim Securities LLC

All right. And then just lastly, when you think about pricing and pricing being a journey, it looks to me like whether it's traditional competitors or mass, there has been some stabilization with regard to pricing. It's not a race to the bottom. Is that fair, and at this point, you're largely where you need to be. And the adjustments to come, do you think it's more rifled? Do you look at maybe the hard discounters and work to be done on private label pricing?

But are we stable and largely there and just selective guys you've got to address at this point?

W. Rodney McMullen - Chairman & Chief Executive Officer

If you look at longer term on pricing, as you know, over the last several years we've invested in price as we reduced OG&A to take costs out of the business. The last few quarters, we have been a little more aggressive in investing in service, so it's not just price-based. So if you look at the mix of where we invest, we have invested some of that cost reduction in additional service hours and things like that. So it's a journey that you never arrive at a destination, so you're continually making progress and you continually change based on your competitive made – competitors change as well. So we're happy where we are but we are continuing to invest, but it's really driven by as we get costs out of the business. I don't know if, Mike, anything you would want to add to that?

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

I absolutely agree. It's right in sync with the prepared remarks we had. When you think about our four keys, we're constantly asking ourselves what do we invest in to make sure that we're offering the best balance to the customer based on what the customer wants and the retail environment that we're in. So Rodney's point about investing more in our people in the last few quarters is right on.

John Edward Heinbockel - Guggenheim Securities LLC

Okay, thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, John.

Operator

The next question comes from Meredith Adler of Barclays.

Meredith Adler - Barclays Capital, Inc.

Hey, thanks for taking my question and congrats.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thank you, good morning.

Meredith Adler - Barclays Capital, Inc.

Good morning. One question would just be real quickly, you talked about what your guidance for inflation was for the year. But did you comment on what you thought inflation was for the quarter?

W. Rodney McMullen - Chairman & Chief Executive Officer

We did not, but, Mike?

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

We're at the high end of that range...

Meredith Adler - Barclays Capital, Inc.

Okay.

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

... primarily driven by pharmacy. It's about one-eighth.

Meredith Adler - Barclays Capital, Inc.

Okay.

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

If you look at it without pharmacy, it would have been lower. And the comments we had on a volatile operating environment, if you just get rid of the headline news on inflation and you start to dig into the commodities, you have things going all over the world. And one of the things I think we're most proud of this quarter is there were so many things bouncing around, and our ability to manage through that this quarter really showed up in our results.

Meredith Adler - Barclays Capital, Inc.

Great. And then I was wondering if you would talk at all about the formats that you're testing called Ruler. I think you maybe have about 30 stores. And I was just wondering what your thoughts are. And we do know that ALDI is going to be opening more stores in Southern California. It's getting a big push and Lidl is also going to be coming to the U.S. pretty soon. Just how do you feel about that format, and do you want to be a competitor in that format?

W. Rodney McMullen - Chairman & Chief Executive Officer

It's still very early and it's obviously a test for us. It's one of the things we feel good about the progress the team made. The format actually came to us through one of our mergers. When we merged with Jay C, they had the format even back then. And the team has made a lot of changes to what's inside of it, and we continue to make changes. I wouldn't say that we're ready for primetime yet, but we are making progress in the right direction.

And it really ties back to when you look at – you've heard us over the years talking a lot about how customers are bifurcating and we want to make sure that we have a format that serves all customers. And there are certain customers that living on a budget is really important because either they want to or they have to, and it's operating a store as efficient as you can to give the best prices you can. So it really ties to that. I don't know, Mike, anything you want to add to that?

Michael L. Ellis - President & Chief Operating Officer

Just what we learned from this type of format has really been helpful to better understand that value segment and how to operate in that value world, so we've really as a company learned a lot, I think.

Meredith Adler - Barclays Capital, Inc.

Great. And then just real quickly, I know you said your Natural Organic department was up double digits. Did you see any changes at all? I think there are some other retailers that have said there was a bit of a slowdown, I think, primarily in the dry grocery side, but I don't know. It doesn't sound like you saw anything, but did you?

W. Rodney McMullen - Chairman & Chief Executive Officer

Nothing that I can put my finger on it. It's still real healthy for us. Again, we have good supply, so we haven't had any issues around that. But no, customers still are as interested in the natural category, the Natural Foods world, real food, we call it, as they ever have been.

Meredith Adler - Barclays Capital, Inc.

Great, thank you for your answers.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Meredith.

Operator

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

Andrew P. Wolf - BB&T Capital Markets

Good morning. I wanted to follow up on your thinking around the guidance. I think you said the quarter came in slightly above, with fuel slightly below. So how does that – if we just isolate the stores, does that mean the stores was a little better than that versus internal expectation?

W. Rodney McMullen - Chairman & Chief Executive Officer

I think the strong IDs without fuel would demonstrate how happy we are with our core grocery performance, and that's built into our expectations for the year when we raised ID sales guidance without fuel. So we're very pleased with what's going on inside the four walls of the store.

Andrew P. Wolf - BB&T Capital Markets

Okay. And Meredith asked about, I guess, the cadence on natural, but I'd like to ask about it just across the store. It sounds like from your answer and the answer on natural that there hasn't been a big falloff of some volatility on the consumer side. I think it sounds to me like the worry is more on the supply side whether it's the fuel margins coming in or what's going to happen with some of the commodities.

W. Rodney McMullen - Chairman & Chief Executive Officer

I'm not sure I understood the last part of the question on the supply side, Andrew.

Andrew P. Wolf - BB&T Capital Markets

Well, first of all, I want to ask if you're seeing any change in your sales cadence and is that where you're seeing volatility? Or is it just the other things you mentioned such as fuel margins and potential disruptions, or whatever you're thinking about with avian flu?

W. Rodney McMullen - Chairman & Chief Executive Officer

I'll answer part of it. I'll let Mike or Mike answer the other part. If you look at the change during the quarter would be more driven by inflation, clearly. End of the quarter is slower than it started out in the quarter, so the change has been more inflation driven. Tonnage has been pretty consistent, or was pretty consistent. If you look at this quarter, quarter to date, we would still be slightly ahead of the range that we gave for the balance of the year and part of the reason for that is we expect inflation to continue to get lower as we go through the year. In terms of the avian flu and some of the other pieces, Mike...

Michael L. Ellis - President & Chief Operating Officer

When we just – Andy, when we sat back and looked at all of the factors out there and the fact that even though on the calendar, we're almost halfway through the year but for Kroger we're only a quarter of the way through the year, we just thought it was very early to change our EPS guidance for the year given the volatility in a lot of commodities inside inflation, given what could be an unknown effect of the avian virus as we go throughout the year. Volatility in fuel, again, we're very happy with where we are and we think given the 8% to 11% growth rate off of a very strong last year being able to deliver in that range and continue to produce the results on the cadence we projected, we think, will result in a very fine year.

Andrew P. Wolf - BB&T Capital Markets

Okay. Thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Andrew or Andy.

Operator

The next question is from Ken Goldman of JPMorgan.

Kenneth B. Goldman - JPMorgan Securities LLC

Hey. Good morning, everybody.

W. Rodney McMullen - Chairman & Chief Executive Officer

Good morning.

Kenneth B. Goldman - JPMorgan Securities LLC

Not sure if you answered this yet. If you did, forgive me. But in terms of ID sales into 2Q, how are they progressing quarter to date, even if just on a qualitative basis? And are there any timing issues, any items we should be aware of as we model that near-term top-line?

W. Rodney McMullen - Chairman & Chief Executive Officer

Ken, as I just mentioned, if you look at the identicals so far this quarter, we continue to be a little ahead of the range guidance we gave for the year. Part of that is driven because we believe inflation will continue to decline during the year and we would still expect that based on what we're seeing today when you look at the impact on identicals.

Kenneth B. Goldman - JPMorgan Securities LLC

Okay. I did miss it when you just said that, I apologize.

W. Rodney McMullen - Chairman & Chief Executive Officer

No problem.

Kenneth B. Goldman - JPMorgan Securities LLC

Broader question, we've seen quite a sudden market share shift in food retail in general away from specialty channels back toward, for lack of a better term, the Kroger's of the world, more traditional, I know you don't love that term, but more traditional grocers. I think the general thesis out there, which I agree with is that much of the shift is generated by you and some peers adding natural and organic products, but it seems like better-for-you isn't quite big enough to move the needle as much as what we've seen. So are there any other drivers that you are seeing out there that would sort of explain this kind of quick shift in consumer behavior or is it too vague and too hard to tell?

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

Yeah, I'm not sure – I guess I'll speak for myself a little bit here. I'm not sure I 100% agree with your thesis when you look at some of the specialty retailers just because some of them have reported lower ID sales than what their trend has been, they continue to open stores, they have a little bit of cannibalization and a lot of them continue to post ID sales above what the market would be growing at. So I wouldn't subscribe to the theory that they're necessarily a sudden shift in market share away from them, it may be a slower growth in market share gain, but I wouldn't say it's a shift away from them.

We actually – we can't ask our customers where did you shop before when our IDs go up 5.1%, we believe we're taking share and more sales dollars from our customers from a wide variety of retailers and are happy to do that and that's really what we focus on. But I think our sales strengths comes from a broad base of folks including doing a better job of offering new and unique products that they may not be able to get somewhere else like Simple Truth. But I think I wouldn't – if I we're sitting in their chairs, I wouldn't necessarily be embarrassed by some of the recent results they've had.

W. Rodney McMullen - Chairman & Chief Executive Officer

And I will answer your question a little different than how Mike did. If you look at the fresh side of our business, produce, meat and some of those departments, deli, we're having incredibly strong growth. Some of that is improving freshness, some of it is that customers wanting to eat products that's fresher and that is something that we have a huge competitive advantage versus a lot of our competitors because the variety that we offer, we offer it all plus we do still have some – there's certain products you just can't get an organic item or a natural item. So we're able to make your full shop with us. So it's really a position of strength for us and an opportunity for us to continue to deliver.

Kenneth B. Goldman - JPMorgan Securities LLC

That's a very interesting answer. Thank you very much.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Ken.

Operator

And our next question is from Alvin Concepcion of Citi.

Alvin Caezar Concepcion - Citigroup Global Markets, Inc. (Broker)

Thanks. Good morning and congratulations on a great quarter, nice way to start the year.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thank you.

Alvin Caezar Concepcion - Citigroup Global Markets, Inc. (Broker)

There's been quite a few questions about the competitive environment but I'll tack on another one. Are you seeing anything different in the promotional environment as the quarter progressed or even over the last month?

W. Rodney McMullen - Chairman & Chief Executive Officer

Well, we probably have seen different competitive pockets of activity around the country but that's not unusual. But as a company, we just tend to deal with that as things change and as our customers – try to meet our customers' needs in the most beneficial way to them. But there's nothing really specific that I can put my finger on. But again, there is promotional activity. When you have this broader geography as we have, you see just about everything throughout the course of time, so, yeah, nothing I can really put my finger on.

Alvin Caezar Concepcion - Citigroup Global Markets, Inc. (Broker)

And I guess maybe more specifically are you seeing anything different on the margin environment for your natural and organic food part of the portfolio?

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

Nothing that I would say is worth reporting but most of what we see today is just this mainstreaming of natural and organics continues but I wouldn't say there's additional retail pressure on those categories of goods.

Alvin Caezar Concepcion - Citigroup Global Markets, Inc. (Broker)

Great. And one more quick one for me. You talked a little bit about the growth in loyal households. I'm wondering if you could give us a sense of how fast that growth was and what kind of share of wallet you're getting now from those loyal customers?

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

Well, I can say we're pleased with transactions and number of households and visits per household and spend per customer. So in general, it's very healthy for us right now. I really don't want to get too specific about any of the numbers, but overall, it's been a combination of those factors that have been driving our ID sales.

Alvin Caezar Concepcion - Citigroup Global Markets, Inc. (Broker)

Great. Thank you very much.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thank you.

Operator

The next question comes from Filippe Goossens of Mitsubishi.

Filippe Marcel Goossens - Mitsubishi UFJ Securities (USA), Inc.

Good morning and thanks for taking my question here. Typically, you don't comment obviously on M&A activity, but I was wondering if you perhaps could opine a little bit on if there were to be a merger between Ahold and Delhaize, whether that would at all impact your competitive position in those markets where you do overlap with the two companies. Thanks very much.

W. Rodney McMullen - Chairman & Chief Executive Officer

You're correct when you say we don't comment on mergers, so I won't talk about the particular specifics on the one you asked about. But anytime companies merge, it creates certain opportunities, and you try to make sure that you deal with the opportunities that are created. And different ones create different kinds of opportunities. And it really is, you sit down and say what is the right strategy for this particular one. And we wouldn't look at if the two of them merge any different than whenever somebody else merges. And we believe there will be continued consolidation in our industry, and we have every intention of being a consolidator in that consolidation of the industry. And as you know, we participated in several mergers over the last year and the last several years.

Filippe Marcel Goossens - Mitsubishi UFJ Securities (USA), Inc.

Okay. And then if I perhaps may ask a derivative question, obviously, you've seen the news of CVS and Target working together right now for the operation of the pharmacy stores within the Target locations. I presume that Kroger remains fully committed to operating the respective pharmacy locations you have within your different formats yourselves going forward.

W. Rodney McMullen - Chairman & Chief Executive Officer

We love the pharmacy business and the whole offer that it offers for the customer, and we continue to see strong results there. One of the things that if you look at the average volume per location and some of that, we would have very, very strong performance on a per location basis and continue to do very well and grow. So we're making...

Filippe Marcel Goossens - Mitsubishi UFJ Securities (USA), Inc.

Okay, thank you very much.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thank you.

Filippe Marcel Goossens - Mitsubishi UFJ Securities (USA), Inc.

That's very helpful, thank you very much.

Operator

And next, we have a question from Scott Mushkin of Wolfe Research.

Scott A. Mushkin - Wolfe Research LLC

Hey, guys. Thanks for taking my questions.

W. Rodney McMullen - Chairman & Chief Executive Officer

Good morning.

Scott A. Mushkin - Wolfe Research LLC

Good morning. So, Rodney, you teed this up because you said you see yourself as a consolidator in the business. And so I know, Mike, I think you said your leverage is 2.09. Thinking about your balance sheet, what is your capacity to do further transactions?

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

I think the answer to that question isn't what my financial capacity is. It's what's the capacity of the organization to do something. It's what assets might be available and do they fit the metrics that we typically would go after when you would look at a transaction. So we wouldn't sit back and say Harris Teeter is behind us, we've delevered, let's go spend another $2.5 billion, get it back up to 2.4 and work our way back down. It's really quite the opposite.

It's one of the reasons we try to maintain the ratio where it is. If an opportunity does come up, can we take on the leverage of that correct unique opportunity, act on it, have the rating agencies continue to have the believability in us doing what we say, and that is we told them 18 months to 24 months we'd get our leverage back down? It took 12 months and it went down again this year, and I think the statistics we went through with the return of capital to shareholders as well as what we've invested back in the business, all told, when you add that up, it's about $4.5 billion we either returned or invested. And to maintain debt at a flat level really demonstrates the power of the cash that we can generate as a company.

Scott A. Mushkin - Wolfe Research LLC

Okay, thanks. The second question is, and I know we touched on some of the natural and organic guys and other things, but I was just broadly looking at the space. You guys commented tonnage growth has accelerated. It seems to me that your market share gains are accelerating. Why, I guess, what's changing? Why is more market share accreting to Kroger at an accelerating rate? And does your outlook – forget gas and inflation, but just basically is the outlook over the next 12 to 24 months that this pattern is going to continue?

W. Rodney McMullen - Chairman & Chief Executive Officer

For us, the progress that we've made overall, we really would give our hats off to our associates. It's our associates interacting one on one every time and helping make the customer's experience a little bit better is what's driving the results, and it's our ability to support our associates to deliver great service. So I don't know that there's a big magic wand that we're waving. It really is 100 small things but doing each one of those things a little bit better. And our associates continue to improve our execution and giving us feedback so we can keep getting better and then using the insights we have working with 84.51°, and then now going forward, we'll be able to work with others broader than just 84.51°. So it's all of those things together that's supporting that.

Scott A. Mushkin - Wolfe Research LLC

All right, and then if I could have one more.

W. Rodney McMullen - Chairman & Chief Executive Officer

Sure.

Scott A. Mushkin - Wolfe Research LLC

Publix continues to encroach. How do you stop that and what do you think about that? And then thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

We would say by Publix the way we would say about tons of competitors, Walmart, Costco, and on and on and on. They're a great competitor. We always learn a lot from them because they do a great job running their stores. And we don't look at it so much in terms of how do you stop a specific competitor. We're really focused on how do we make sure we keep getting better. And if they're successful in a market, they're successful at somebody else's expense, not us.

Scott A. Mushkin - Wolfe Research LLC

Thanks, guys. Nice quarter.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks. Thanks, Scott. We have time for one more question.

Operator

Sure, and that question will come from Kelly Bania of BMO Capital Markets.

Kelly A. Bania - BMO Capital Markets (United States)

Hi, good morning. Thanks for s squeezing me in. I was just curious if you could talk a little bit about 84.51°. I thought it was interesting that you – I think Rodney characterized it as a game changer. And I understand that the new structure allows you to work with outside data service providers in conjunction with 84.51°. But I was just curious if you could talk a little bit more about what are some of the priorities in terms of how you would like to expand the use of that business for Kroger.

W. Rodney McMullen - Chairman & Chief Executive Officer

How do I answer your question without competitors understanding exactly what we're trying to do? I can tell you I've had more dialogue and several of us have in terms of how do we better use the data we have for the benefit of our customers and to run our business better. And we've had more of those discussions in the last eight weeks than we had in the two years before that because we spent an awful lot of time talking about things other than Kroger. So to us and as I mentioned in my prepared comments, there are a lot of great people at 84.51° that we're just so excited for them to be part of our family and I know they're so excited because they're going to be able to even help us accelerate what we're doing.

So it's really hard to say specifics other than I can tell you we have a huge list of things that we can use our data for, for the benefit of our customers and running our business better that for whatever reason we hadn't taken advantage of and we're going to figure out a way to prioritize that and figure out a way to take advantage of that and some of those cases will involve partnering with other companies other than just 84.51°.

Kelly A. Bania - BMO Capital Markets (United States)

That's helpful. And any comments on what the strategy, or is there a strategy to grow the 84.51° business with other retailers or clients, like Kroger, so the company can grow its own profitability and growth?

W. Rodney McMullen - Chairman & Chief Executive Officer

We really won't comment on that at this point.

Kelly A. Bania - BMO Capital Markets (United States)

Okay. Thank you.

W. Rodney McMullen - Chairman & Chief Executive Officer

Thanks, Kelly.

W. Rodney McMullen - Chairman & Chief Executive Officer

Before we end today's call, I'd like to share some additional thoughts with our associates listening in today. We recently wrapped up our Red White & Barbecue celebration in stores across our company. A special thanks to each of you for making this exciting event possible, and I can tell you I personally ate way too much on the samples. Our customers loved kicking off the summer grilling season with fresh flavors and fun ideas to share with their family and friends.

I also want to thank you for helping show Kroger's gratitude to our active duty troops and our nation's 23 million veterans this summer. Through our partnership with the USO and the Honoring Our Heroes campaign, we hope to raise an additional $2 million for our military men and women. Together, Kroger's associates and customers have raised more than $11.9 million since 2010 to support USO programs. This represents the largest gift to the USO in its history. Visit the Honoring Our Heroes website for more information about how you can help. We also continue to hire our heroes. More than 29,000 veterans have joined our team since 2009, including more than 6,000 associates last year. Thank you for helping welcome them to our Kroger family.

That completes our call today and thanks for joining.

Operator

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