The Kroger Co. (NYSE:KR) Q4 2014 Earnings Call March 5, 2015 10:00 AM ET

Executives

Cindy Holmes - Director-Investor Relations

W. Rodney McMullen - Chief Executive Officer & Director

Michael L. Ellis - President & Chief Operating Officer

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

Analysts

John Edward Heinbockel - Guggenheim Securities LLC

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

Meredith Adler - Barclays Capital, Inc.

Karen F. Short - Deutsche Bank Securities, Inc.

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

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Scott A. Mushkin - Wolfe Research LLC

Robert F. Ohmes - Merrill Lynch, Pierce, Fenner & Smith, Inc.

Kenneth B. Goldman - JPMorgan Securities LLC

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

Mark G. Wiltamuth - Jefferies LLC

Operator

Good morning, and welcome to the Kroger Company Fourth 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 fourth quarter press release, which includes a reconciliation of certain non-GAAP measures discussed today, 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 Rodney McMullen, Kroger's Chairman and Chief Executive Officer. Rodney?

W. Rodney McMullen - Chief Executive Officer & Director

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

2014 was an outstanding year for Kroger. First, let me say how proud I am to work with such a great and outstanding team of associates. Each of them deserves a round of applause for improving our connection with all customers and growing our core business, right in line with our growth strategy. Second, I am pleased to report that we kept our commitments to you, our shareholders. As you know, the growth plan we first outlined in October of 2012 includes four key performance indicators: positive identical supermarket sales growth, slightly expanding non-fuel FIFO operating margin, growing return on invested capital and annual market share growth.

In 2014, we met or exceeded each of these metrics. At the end of the year, we achieved an industry-leading 45th consecutive quarter of positive identical supermarket sales growth, without fuel. We exceeded our goal to slightly expand FIFO operating margin, without fuel, on a rolling four-quarter basis. We improved return on invested capital even as we increased capital investment. And we captured incremental market share for the 10th consecutive year.

Strong performance means strong shareholder returns. We exceeded our long-term, net earnings per diluted share growth rate of 8% to 11% in fiscal 2014, and we increased our dividend for the eighth consecutive year, since we reinstated our dividend. Because we've been delivering this level, high level of performance, consistently and for so long, it can start to look easy or be taken for granted. It is important to know that our associates are committed to our continued success today and for the future.

We made progress on the other key elements of our growth strategy as well. We are innovating to grow. We expanded our digital capabilities to deepen our relationship with customers in new and exciting ways. More customers than ever before are engaging on our digital properties. The learnings from both our Vitacost and Harris Teeter mergers are allowing us to build an experience that gives the customer, our customers, the ability to interact with us when, where and how they want. Our Corporate Brand team keeps pushing the boundaries on what customers can expect from store brands. Our leading natural and organics brand, Simple Truth, hit a $1 billion in annual sales for the first time in less than two years after the introduction.

We are investing to grow in both new and existing markets. We continue to pursue our fill-in strategy and are making good progress. Our mergers with Harris Teeter and Vitacost.com have opened new markets that present meaningful growth opportunities for Kroger. We continue to create jobs. Today, we proudly employ nearly 25,000 more associates than we did last year at this time. Every day we are creating opportunities for both new and current employees.

Our strong, across-the-board results during fiscal 2014 allowed us to make a strategic and significant contribution to The Kroger Co. Foundation this year. We use our foundation dollars to support causes that our customers consistently tell us they care about, that enhances our reputation as a locally-connected retailer. We are very proud that Forbes magazine previously recognized our work by naming us the most generous company in America. This contribution will allow Kroger to continue to support our key priorities, including hunger relief, breast cancer awareness, the military and their families, and local community organizations. We are proud to make this investment to continue our efforts to support our customers and the communities that support our growth.

Kroger customers are increasingly positive about the economy since late last year through the new year. They are feeling more comfortable with their discretionary spending, in part due to the low retail price of fuel. Even so, how our customers are doing today depends on the stability of their family's finances. Customers' perceptions of the economic recovery are still very much divided. And yet, we continue to deepen loyalty with all of our customers. That is because whatever the external factors are at play at a given time, be it inflation in certain commodities, fluctuating fuel prices, or unemployment, we adjust to win with the customer.

So while inflation affected fuel costs through 2014, our personalized offers, weekly promotions and price investments helped customers stretch their dollars. We are currently investing $3.5 billion annually in lower prices. Even though natural and organic foods have been notoriously out of reach for many customers, we used our merchandising expertise, manufacturing base and buying power to make them affordable and accessible to all customers through Simple Truth, which continues to see double-digit sales growth. And while customers will always have evolving expectations for convenience, we have improved our prepared food offering to meet their changing needs as well.

Like a great meal, there is no single characteristic that makes Kroger great; rather, it is the sum of its parts. It is the combination of food and drink, people and atmosphere, surprise and delight that makes a great meal, great. And it is that combination of factors that our associates bring together, the sum of our parts that explains why Kroger is so successful.

Before I turn it over to Mike Ellis, I wanted to let you know that both the Harris Teeter and Vitacost mergers are going very well thanks to the incredible people at both companies. Mike will have more to say about these and our operational performance. Mike?

Michael L. Ellis - President & Chief Operating Officer

Thanks, Rodney. Good morning everyone. This was a great quarter, capping off a really great year. Our associates make everything happen, and they knocked it out of the park this year on several fronts.

We achieved an outstanding fourth quarter ID sales growth without fuel of 6%. As Rodney pointed out in our press release this morning, while improved fuel margins contributed significantly to our reported results in the second half of the year, our operating performance without fuel shows that our associates are continuing to deepen our relationship with customers in very meaningful ways. The better our connection with customers, the better our shareholder returns. Our identical sales performance was supported by robust performance in every department and every supermarket division. Natural foods, meat, deli and pharmacy departments all posted double-digit identical sales growth.

For the tenth year in a row, we lowered costs and reinvested those savings to improve our store experience. It's no surprise that Kroger captured more share of the massive food market also for the tenth year in a row. Our consistent market share gains drive top and bottom line growth and generate lasting shareholder value. We report on market share annually, and look at it as the customers would look at it where they spend their money.

Last year, we began using Nielsen POS+, a Kroger term for Nielsen data that includes all point-of-sale data from several competitors and includes all departments inside our stores, except for pharmacy. The data is generated by retailers who report their sales to Nielsen. This includes all major food, drug, mass and dollar competitors as well as most club competitors. It does not include C-stores. Nielsen POS+ captures roughly 85% of the items we sell, including UPC-coded items, PLU and random weight items, making it a really good and consistent source.

According to Nielsen POS+ data, Kroger's overall market share of the products we sell in the markets where we operate grew approximately 60 basis points during fiscal 2014. This data also indicates that our share increased in 18 markets of the 20 markets outlined by the Nielsen report, and was down slightly in just two markets. Walmart is one of our top competitors in 15 markets of the 20 markets outlined in the Nielsen report. Kroger share increased in all of those markets.

In addition to market share growth, we regularly measure our loyal household growth because it lets us know how well we are connecting with our best customers. During the fourth quarter, we continued to grow the number of loyal households, and at a much faster rate than total household growth, which was also up for the quarter. Customers are buying fewer units per basket but visiting our stores more frequently. This is consistent with the trend for the past several quarters. Inflation continued in pharmacy and among commodities such as meat during the fourth quarter. We estimate product inflation was 3.5%, excluding fuel, for the fourth quarter. In 2015, we expect the strong tonnage growth that we saw in the fourth quarter to continue.

We've talked a lot this year about our Corporate Brands growth and success. That trend continued in the fourth quarter, with Corporate Brands representing 28.2% of total units sold, the highest level in at least seven years and 25.8% of sales dollars, excluding fuel and pharmacy. The star, of course, has been Simple Truth. And in 2014, Simple Truth reached an amazing milestone by hitting a $1.2 billion annual sales mark. Simple Truth has been our most successful brand launch ever, reaching billion dollar brand status in less than two short years. During the year, more than 20 million households bought one or more of our 2,688 Simple Truth or Simple Truth Organic items. The brand continues to earn double-digit unit and sales growth, which we don't see ending anytime soon.

Shifting gears, we just completed our first year since merging with Harris Teeter, and our integration efforts have been fantastic. We are creating synergies both ways, and we are learning new ways to connect with our customers. The Harris Teeter team is great, and both they and our General Office teams have done an outstanding job in working together. Also we are six months into the Vitacost merger and our integration is going well. We continue to discover new ways to use Vitacost as a strategic advantage. We already have a strong Natural Foods business, and Vitacost is helping us get better in that category. A cornerstone of our ability to deliver successful mergers is partnering with businesses that share our cultures and values. This makes it easy to share ideas between each other. Harris Teeter and Vitacost both illustrate that point.

Finally, I will provide a brief update on labor relations. We are currently negotiating in Louisville and with the Teamsters covering several distribution and manufacturing facilities. During 2015, we will also negotiate agreements with the UFCW for store associates in Columbus, Denver, Las Vegas, Memphis and Portland, Oregon. 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, growing Kroger's business and profitability, which will help us create more jobs and more career opportunities, and enhance job security, for our associates. We have very positive momentum with our customers, associates and communities as we move into 2015.

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

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

Thanks, Mike and good morning everyone. Before I share our fourth quarter and fiscal 2014 results, there are a few things to keep in mind about fiscal 2014. There are two items that we are adjusting our full year results for: charges incurred in the first quarter related to the restructuring of certain pension obligations to help stabilize associates' future benefits; and certain tax benefits that we enjoyed in the third quarter.

A lot of other things happened throughout the year as well, including: low retail fuel prices and unusually-high fuel margins; a LIFO charge that was significantly higher in 2014 than in 2013; a $55 million contribution to our UFCW Consolidated Pension Plan in the fourth quarter; and, as Rodney mentioned, we contributed $85 million to the company's charitable foundation throughout the year, $60 million of which was in the fourth quarter.

Now, I'll share our fourth quarter results. Please note that Kroger's operating results include Harris Teeter in the fourth quarter and fiscal 2014, but not in the fourth quarter and fiscal 2013, which affects many year-over-year comparisons. Total sales in the fourth quarter were $25.2 billion, an increase of 8.5%. Excluding fuel, total sales increased 14.2%. Net earnings for the fourth quarter totaled $518 million, or $1.04 per diluted share. We recorded a $9 million LIFO charge during the quarter, compared to a $10 million LIFO charge in the same quarter last year. FIFO gross margin was comparable to the same period last year, excluding retail fuel operations. Total operating expenses, excluding retail fuel operations, the contributions to the pension and foundation, and the adjustment items, decreased 15 basis points as a percent of sales compared to the same period last year.

Before I move on to discuss Kroger's full-year 2014 results, I'll share some data on our fuel operations, which includes our supermarket fuel and C-store business. In the fourth quarter, our cents per gallon fuel margin was approximately $0.234 compared to $0.113 in the same quarter last year. For the full year, the cents per gallon fuel margin was roughly $0.19 compared to $0.141 last year. Going forward, we expect fuel margins to return to historical averages.

Turning now to Kroger's full-year results for 2014. Kroger reported total sales of $108.5 billion in 2014, an increase of 10.3%. Excluding fuel, total sales increased 12.9% over the prior year. Identical supermarket sales, without fuel, increased 5.2% in 2014 compared to the prior fiscal year. Net earnings for 2014 totaled $1.73 billion, or $3.44 per diluted share. Excluding the 2014 adjustment items, net earnings for 2014 totaled $1.77 billion, or $3.52 per diluted share. It is important to note that if you look at adjusted EPS excluding fuel, it was at the high end of our long-term growth rate even with the contributions to the pension and foundation included. So while fuel margins get a lot of attention, our non-fuel business had a spectacular year.

Kroger's LIFO charge for 2014 was $147 million, significantly higher than 2013 due to higher product costs. FIFO gross margin for 2014, excluding retail fuel operations, declined 3 basis points. As Mike said, strong identical supermarket sales and cost controls allowed Kroger to reduce operating expenses as a rate of sales for our tenth consecutive year. Total operating expenses for 2014, excluding retail fuel operations, the contributions to the pension and foundation, and the adjustment items, decreased 13 basis points as a percent of sales compared to the prior year. FIFO operating margin for 2014, excluding those same items, increased 10 basis points compared to the prior fiscal year. Kroger's strong EBITDA performance resulted in a return on invested capital for fiscal 2014 of 13.74%, compared to 13.43% for fiscal 2013.

For 2015, our planned uses of cash remain unchanged: maintain our current investment grade debt rating, repurchase shares, fund the dividend, and increase capital investments. In connection with our merger with Harris Teeter, we committed to getting back to a 2 times to 2.2 times net total debt-to-adjusted EBITDA ratio by mid-to-late fiscal 2015. I'm pleased to report that we achieved our objective earlier than anticipated due to strong fiscal 2014 operating results. As of the close of the fourth quarter, net total debt-to-adjusted EBITDA ratio decreased to 2.15 times, compared to 2.43 times during the same period last year, as described in Table 5 of the press release. Based on our current 2015 expectations, we should maintain a ratio below the 2.2 times target throughout the year.

Capital investments, excluding mergers, acquisitions and purchases of leased facilities, totaled $2.8 billion for the year, compared to $2.3 billion in 2013. For 2015, we expect capital investments to be in the $3 billion to $3.3 billion range. As you know, part of our long-term growth strategy is to increase capital investments over time. New store openings are meeting our expectations. We have a great pipeline of high quality projects that we expect to allow this result to continue. We will allocate more of this spend to increase square footage in our fill-in markets. We have now identified eight markets for fill-in opportunities, this is up from six. Our excitement for this activity continues to grow.

Kroger's strong financial position allowed the company to return more than $1.6 billion to shareholders through buybacks and dividends. During the year, Kroger repurchased 28.4 million common shares for a total investment of $1.3 billion. As of February 27, 2015, Kroger has approximately $432 million remaining under the $500 million share repurchase authority granted in June 2014.

Now, I would like to outline our specific growth objectives for fiscal 2015. We anticipate identical supermarket sales growth, excluding fuel, of approximately 3% to 4% for fiscal 2015. This range takes into account several factors. It is early in the year, our outlook for inflation is lower than actual inflation last year, and we expect our strong trend in unit growth to continue in 2015. Full-year net earnings for fiscal 2015 are expected to range from $3.80 to $3.90 per diluted share. This equates to Kroger's long-term net earnings per diluted share growth rate of 8% to 11%, growing off of 2014 adjusted earnings of $3.52 per diluted share. Shareholder return will be further enhanced by a dividend that is expected to increase over time.

As we think about the growth in 2015, we expect fuel margins to return to historical averages, we are not planning for similar contributions to the pension or foundation, and we expect LIFO to be lower than it was in 2014. We are anticipating inflation without fuel of 1% to 2% and the actual amount will be driven primarily by inflation in meat and pharmacy. So while fuel margins will be a headwind in 2015, we expect they will be offset by a lower LIFO charge, no planned contributions to the pension plan and our foundation, and the continued strength in our core business.

For the full year, our expectation is that we will be in the middle portion of the range. As we look at quarter comparisons in relation to our 8% to 11% annual growth rate, we believe quarter one will be in the range, quarters two and three will be slightly above the range, and quarter four will be below the range. And as we expect Kroger's full-year operating profit margin in 2015, excluding fuel, to expand slightly compared to 2014 results.

Now, I will turn it back to Rodney.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks, Mike. I'm so proud of our team. We fulfilled our commitments to our customers, associates, shareholders and bondholders in 2014. Kroger captured more share of the massive food market and continued to invest in growing our business. We created thousands of new jobs, and hired more than 6,000 veterans last year. While we are very proud of this outstanding year, we are committed to even more. As I mentioned at our Investor Day, our to-do list remains longer than our done list.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

Thank you. At this time we will begin the question-and-answer session. And our first question today will come from John Heinbockel of Guggenheim Securities.

John Edward Heinbockel - Guggenheim Securities LLC

So, guys, a few things. I think you said $3.5 billion of annual investment in price, was that right? And what do you include in there? Is that merely price reductions, promotions, or something else? Is that sustainable? Do you think you can do $3.5 billion a year? And then what happens to the elasticity of the return over time? Do the returns remain high on that investment?

W. Rodney McMullen - Chief Executive Officer & Director

Yeah, the $3.5 billion, John, that you heard us talk about, yes, that's an annual number. And that's the annual number in 2014. Now if you look at – obviously we started the journey about 10 years ago of taking costs out of the business and taking that – as we take costs out of the business, giving the customer better value both in everyday price and promotional. We would – we see it as our strategy to continue that as we take costs out of the business. We'll continue to give that to the customer in a combination of service and price based on what we see the opportunities to be. We are very satisfied with the elasticity of the demand side as we invest in price. Obviously, we have a tremendous amount of data that we have developed internally to make sure that we're investing that in the right place where we get the best return. So, we would see it sustainable, and it is part of our continued strategy. I don't know, Mike, anything you want to add?

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

No. I think that's it, Rodney.

John Edward Heinbockel - Guggenheim Securities LLC

Okay. So as far as you can tell, there's enough things to invest in that the return will remain – you think it'll remain what it's been as far as the eye can see, it sounds like.

W. Rodney McMullen - Chief Executive Officer & Director

Absolutely. And every category would have different results, and that's one of the values of our insight is, understanding that.

John Edward Heinbockel - Guggenheim Securities LLC

All right and then just one for Mike Schlotman. I know you guys have liked a front-end loaded buyback program, right, for the productivity that gives you throughout the year. Is that the idea this year? Is that sort of embedded in the guidance that a lot of it'll be done in the first half?

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

Yeah, I would say the day-to-day market conditions will wind up dictating when we make those investments, but I would point out the fact that at the end of – when we had our conference call in December, we had not used any of the $500 million buyback authorization. And from my comments today, we have used some now.

John Edward Heinbockel - Guggenheim Securities LLC

Okay. Thanks.

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

Thanks, John.

Operator

Our next question will come from Rupesh Parikh of Oppenheimer.

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

Thanks for taking my question, and congrats on a nice quarter.

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

Thanks.

W. Rodney McMullen - Chief Executive Officer & Director

Thank you. Good morning.

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

Good morning. So I just want start maybe with the center store trends. We've heard from a number of large CPG players just about challenges, and there's some in the center store categories. So, I wanted to get a sense whether you guys are seeing the same thing or any more color, what's happening there?

Michael L. Ellis - President & Chief Operating Officer

Well, actually, our center store has performed better in the fourth quarter than it had in other quarters in 2014, and we've done a lot of work in relaying our center store, getting things refreshed, new products in, and it's been a big focus of us to using customer insights and really going through our stores and doing the work that's around assortment that's really effective.

W. Rodney McMullen - Chief Executive Officer & Director

The other thing that's – a lot of the CPGs would have something different than what we would have is on a lot of the natural food items, do you include that in center store or a separate department? And it's getting increasingly complicated, because there are certain categories where natural foods, is almost as big as the historical business. So, it's a short question, but hard to answer. For us, we're completely focused on what is it that the customer wants.

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

Okay. Thank you. And then switching gears, maybe to the Simple Truth brand, you achieved your target this year for sales of more than $1 billion, do you have any new targets out there and is it getting more difficult to get the supply for that business?

Michael L. Ellis - President & Chief Operating Officer

Supply has been an issue in certain areas, but when you have over 2,600 items, we have a great base of product today, and we're going to continue to expand that. But for the most part, in some of the perishable areas, there's been a supply issue or two, but we've been able to really take care of the customer and I don't foresee anything this year and in the near future.

W. Rodney McMullen - Chief Executive Officer & Director

But certain categories will always have some tightness on supply, especially at the front end as farmers transition over to growing more of the organic or natural product.

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

Okay. Thank you.

Operator

And the next question is from Meredith Adler of Barclays.

Meredith Adler - Barclays Capital, Inc.

Thanks for taking my question. Can you hear me?

W. Rodney McMullen - Chief Executive Officer & Director

Yes.

Meredith Adler - Barclays Capital, Inc.

Okay. I have made – this is a question for Mike.

W. Rodney McMullen - Chief Executive Officer & Director

Which one?

Meredith Adler - Barclays Capital, Inc.

Oh, sorry. That's right, Mike Schlotman. Question about labor negotiations. The very strong performance of the company, do you think that makes it harder for you to get the unions to go along with what you want? Or are they, maybe the better, bigger question is, are they pushing for wage increases?

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

If you look at our average wage of our hourly associates in the store, it's nearly $14 an hour, and if you look at the total benefit package our associates enjoy, it's even stronger than that. It varies obviously by geography and particular contract. We've been on the forefront, not only with a good solid wage. We've had – we've been very upfront with the unions and have done a lot of things to protect the future pension benefits of our associates, which others aren't doing out there. It's not just the big one we did two years or three years ago, we did some more smaller ones in the first quarter this year, and it wouldn't surprise me if there will be others that we wind up doing in the future.

If you look overall, we are adding jobs. We added 25,000 jobs last year. We're up to 400,000 jobs. One of the things that we like to say around Kroger is a lot of people, particularly part-time workers that are under 18, they come to Kroger looking for a job, and they stay for a career. If you look around the ranks of our store managers, two thirds of them started out as hourly, part-time hourly associates in our store. And that really just talks to the fabric of Kroger and how well we treat our associates overall. So, it's more than just about the wages. There's a lot more behind-the-scenes of what those associates look for when they come to Kroger.

W. Rodney McMullen - Chief Executive Officer & Director

Plus, what you make today is something different than you will make as you get promoted throughout your career and take on more responsibility.

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

Right.

Meredith Adler - Barclays Capital, Inc.

And then, changing gears, maybe just talk a little bit about the tests you have of "click and collect" in Cincinnati? Maybe it's too early to say anything, but are you feeling good about how that's going?

Michael L. Ellis - President & Chief Operating Officer

Well, it is too early to say anything, Meredith, but the learnings that we have from Harris Teeter is really helping us develop our plans on how we're going to go forward. And Harris Teeter has had a very successful business for – well, they started over 10 years ago in the "click and collect" world. And we've learned a lot, and it's really helping us accelerate our learning and growth.

Meredith Adler - Barclays Capital, Inc.

Okay, great. Thank you very much.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks, Meredith.

Operator

The next question comes from Karen Short of Deutsche Bank.

Karen F. Short - Deutsche Bank Securities, Inc.

Hi. Thanks for taking my question. Great quarter.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks, Karen.

Michael L. Ellis - President & Chief Operating Officer

Thanks, Karen.

Karen F. Short - Deutsche Bank Securities, Inc.

Just a little color, I guess, following on John Heinbockel's question, in terms of share buybacks, obviously, your guidance for fiscal 2015 is very strong given the tailwind that you're going to have in gas margins. So I mean, maybe a little color on how much of this is buyback related versus core EBIT growth. I don't know if you can just elaborate a little bit on that?

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

Yeah, I won't get that granular on the model. From an expectation standpoint, you should have the expectation, we'll probably spend a little bit less on share buyback during – in terms of dollars in 2015 versus 2014. We are increasing our expectations for capital spend by a few hundred million dollars more because of the great pipeline of projects I spoke of in the prepared comments. And that's what we think we would believe is the driver for growth in the future. Keep in mind back in October of 2012, we said for the first couple of years of this new growth model, we would have 25% – a quarter to a one-third of our EPS growth may come from share buybacks, but that would decline over time as we continue to open successful stores in our fill-in markets.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay. That's helpful. And then just looking at the year in general, so when I look at obviously how strong this year was can you maybe try to frame how much of it was Harris Teeter related in terms of Harris Teeter outperforming what your original guidance was on accretion? I mean, obviously let's exclude fuel from the conversation. And then just following on that is when we start to model comps throughout the year, any color on how we should think of how Harris Teeter now that it's in the comp base, how that'll impact the comp throughout the year?

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

Well, I won't give specifics on Harris Teeter. I would say that they added a little bit more to earnings per share than our original expectations for the year. They had a phenomenal year, they also helped the core at Kroger with some ideas that they have done historically and helped the core Kroger have a very strong year as well. Relative to the comp cadence throughout the year, even though we only had Harris Teeter as a business for this year, we included them in our comp base all year using their 2013 sales, so the sales numbers we reported during 2014 actually included Harris Teeter as though we had owned them in 2013. So, there won't be a big inflection point in ID sales from, including Harris Teeter going forward.

Karen F. Short - Deutsche Bank Securities, Inc.

Even though the comps might have been pressured from investing in price?

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

They – again, their ID sales were included in our 2014 results.

Karen F. Short - Deutsche Bank Securities, Inc.

Right.

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

So going forward, they'll continue to be in there.

Karen F. Short - Deutsche Bank Securities, Inc.

Okay. Thanks. So – sorry, yeah?

W. Rodney McMullen - Chief Executive Officer & Director

I was just going to add to Mike's thing. If you look at, Harris Teeter delivered more than we were expecting, and that was driven because of their strong operations and synergies, but fuel obviously drove it, but if you look at the core Kroger even without those two items, we still exceeded as well. So it was really all three pieces that drove the strong results.

Karen F. Short - Deutsche Bank Securities, Inc.

Great. Thanks.

Operator

And next, we have a question from Ed Kelly of Credit Suisse.

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

Hi. Good morning, guys.

W. Rodney McMullen - Chief Executive Officer & Director

Good morning.

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

Again, congratulations as well on a nice quarter.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks.

Michael L. Ellis - President & Chief Operating Officer

Thank you.

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

First question just for Mike Schlotman. On the cadence of the EPS growth next year, Mike, you mentioned Q1 being in line with the range for the year. I guess I would've thought that maybe it would have been better, because the fuel comparison is obviously easier there. You still get the benefit from the repo in the first quarter and the share count, and then I would imagine that your comps are probably stronger earlier in the year than later. Could you just maybe help us understand why Q1 would just be in line?

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

At this point, that's – we had a very, very strong first quarter last year. So, we are comping off of that. I agree that there will still be some residual benefit in the first quarter from the share buyback, but that was very front-end loaded last year. And we'll – and as I said earlier, we'll buy less shares back this year than last year. So, the combination of those, the way we bought it back last year did help the first quarter a bit. It's, a lot of it lines up depending on a huge number of factors, and we just recently finalized our business plan by quarter based off of how the year wound up and what our expectations are for the various quarters, and the best answer I can give you is, we're trying to be transparent about how our operators and so forth feel about the cadence throughout the year.

And that's what our expectations are. There's a lot of factors that go into it. LIFO certainly will play a factor of how and when we get expense charges in the quarter. As you know, we increased our LIFO charge throughout the year and then it came down in the fourth quarter, so if our estimate for LIFO is accurate this year, the second quarter and third quarter will be helped a little bit by a lower LIFO charge as compared to the prior year. So there's lots of things that wind up going into building that model.

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

Okay. Okay. Thanks. And then just a follow up, and this is just on your IDs generally. Your IDs typically have outpaced the industry for a very long time, but it does seem like more recently that this gap has widened. And I guess what I'm trying to ask you is, is there anything that you can identify that you think has driven that acceleration? For instance, you saw a windfall in fuel in the back half. Have you been able to use some of those proceeds to help you around the pricing front or the other things that have maybe helped this acceleration in the outperformance to the industry?

W. Rodney McMullen - Chief Executive Officer & Director

Ed, it's a question that actually we've spent a little bit of time trying to think through internally, and probably the biggest thing is our associates, our store teams and all the people that support our stores, they continue to do a better job of helping serve our customers on a daily basis. Everything from making sure products are fresher to making sure that we treat our customers right. And we really do believe we had a great foundation in place and our associates really are taking it up to the next level in terms of how they're taking care of our customers. And we think that that's what's the thing that's really been successful and we really appreciate what our associates are doing.

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

Okay. Thank you.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks, Ed.

Operator

The next question is from Vincent Sinisi of Morgan Stanley.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Hi. Thanks for taking my question and congratulations on very nice end to the year.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks.

Michael L. Ellis - President & Chief Operating Officer

Thank you.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

I wanted to ask about natural organic, which as you mentioned, of course continues to see some nice growth, Simple Truth being the main contributor to that. But outside of Simple Truth, can you sort of give any other color in terms of maybe some other category or brand growth within and in particular maybe any early color around Vitacost? Any cross selling or expansion there?

W. Rodney McMullen - Chief Executive Officer & Director

Great question. Within Natural Foods, there's so many categories that customers are connecting with today that gets stronger and stronger, from dairy products, gluten-free, we could go on and on. And our ability to cross-merchandise some of those products throughout the store, I think has made some of those products more available in a broader way to a larger customer base. We keep talking about the blurring of departments and Natural Foods is becoming more and more mainstream for many people. So it's really broad-based when you look at where the growth is, and we're trying all kinds of new things to make these types of products more available to our customers every day. On Vitacost, we love what we have and it's a solid platform and we plan to do other things with that over time. And I think you'll be seeing some things in the near future.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Okay, all right. Fair enough. And then just as a follow-up, maybe switching over quickly to Harris Teeter. Are all Harris Teeter stores now having the "click and collect" capability? And also, I know that you started in your Harris Teeter (42:44) in one region. Any further plans for roll out that you could talk to for this year, this coming year?

Michael L. Ellis - President & Chief Operating Officer

Well, we're still at beta testing in one store here in Cincinnati. But at Harris Teeter, we're at about a 160-some stores that are currently offering that to the customer. And I'll tell you what, the growth is exciting. Customers love the service, and the numbers continue to grow. We're setting new records at Harris Teeter all the time on more customers shopping this – in this way, and it's a big part of our strategy going forward.

Vincent J. Sinisi - Morgan Stanley & Co. LLC

Okay, all right. Fair enough. Thanks very much. Best of luck.

W. Rodney McMullen - Chief Executive Officer & Director

Thank you.

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 question, and gosh, someone ate their wheaties this fourth quarter...

W. Rodney McMullen - Chief Executive Officer & Director

I hear a headline coming.

Scott A. Mushkin - Wolfe Research LLC

I just used it, maybe. But so my question is actually more strategic. As we kind of take a step back, you said a couple of things, $3.5 billion of investment in price kind of ongoing. I think, Mike Schlotman, you said you pushed up that CapEx growth rate a little bit again. So my question really goes to the top line growth of this organization. I mean is it time we accelerated it further? It seems like it's gone on a little bit but I mean is it time we continued to push? I was talking to one investor who said, Kroger is kind of the Costco with the grocery industry at this stage where they continuously reinvest. So what's your thought? I mean, is the growth rate, what should we think of as ongoing topline growth rate? Can it go higher? How do we get it higher? Is this something that the company is thinking about?

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

Well, Scott, it's a great question, and it's certain something we think about. And the investor you're talking to please pass along our appreciation for the complement, because we have a great deal of respect for Costco. We think about it a lot. In terms of, I guess, I would really say use your model to figure out how to accelerate the growth. As you know, we continue to accelerate the number of new stores, and we continue to try to make sure that our identical store sales stay strong. So I think that would automatically cause a continuation of an increasing growth rate. But we've spent a tremendous amount of energy and efforts on trying to accelerate our growth at a pace that makes sense for our organization. And one of the keys is we have to make sure we have developed associates to be able to handle the accelerated growth as well.

Scott A. Mushkin - Wolfe Research LLC

And since they are and we've talked about this before, Rodney, I appreciate that answer, there has kind of become a Kroger way, a Kroger model, driven by, I think you're just advantaged in big data. How do you get that model into more consumers' hands in markets maybe that you're not in? I mean, you really haven't expanded, I guess Harris Teeter did it for you, but, I mean, do you agree that there's a superior model now and it would be advantageous for the company to bring it to more markets?

W. Rodney McMullen - Chief Executive Officer & Director

I was going to answer the question until you said the last part.

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

We'll still let him answer, though.

W. Rodney McMullen - Chief Executive Officer & Director

We wouldn't ever think that we have a superior way, and all we're really focused on is how to get a little bit better tomorrow than we were yesterday. And, for us, that would probably be the biggest part of the Kroger way is really trying to understand what the customers' wants and needs are and trying to get a little bit better at delivering against those. And over time, numerous times, we've said anything that's available out there you should assume that we've looked at it, and it's really making sure that we find something that adds value for our shareholders and something that we think the teams fit in well with Kroger, and we can do something for the customer that they don't already have. And, when you look at Harris Teeter, it checked all those boxes, and the Harris Teeter team was just amazing. But on smaller scale, Vitacost has been the same way and on a real small scale, YOU Tech has been the same thing. So it's really, we're constantly trying to look at things that add new growth for us.

Scott A. Mushkin - Wolfe Research LLC

Perfect. Thanks for taking my questions.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks, Scott.

Operator

And next we have a question from Robert Ohmes of Bank of America Merrill Lynch.

Robert F. Ohmes - Merrill Lynch, Pierce, Fenner & Smith, Inc.

Hey. Good morning, guys. Thanks for taking my question. I was hoping you – sort of a broad follow-up question from what everybody else has been asking. 2014, you guys have characterized as somewhat unusually good year. Can you sort of walk us through some of the things that could continue? Sort of the puts and takes on 2015 and why or why not it could or could not be another unusually kind of good year, and sort of the areas what I was hoping you would cover is things like the comp contribution from natural foods. Is that slowing in 2015 versus 2014? The competitive environment seemed to maybe be a little less competitive in 2014 for a lot of food retailers. What does that feel like right now as you look out? And then maybe a little more color on the puts and takes in inflation. Is there anything that could keep inflation from decelerating sequentially as you move through the year? And then the fourth part would be customer trade up. Was that a significant support to your accelerating comps in 2014? And could that continue in 2015 as a driver? Thanks.

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

Hey, one very long question. If I ask you to repeat parts of those, I was trying to scribble them down and as everybody here at Kroger knows when I write slowly, it's hard to read my penmanship. Rodney took better notes apparently. The first point on what – the broad question, we obviously get very thoughtful and step back pretty far when we think about where we should set our expectations for a particular year. We've become very careful and protective of the overall business model that we've developed, and that focus on the customer is front and center. And as we decide what EBITDA growth rate and earnings-per-share growth rate is appropriate to ask our divisions and our different operating units to generate during a particular fiscal year, that's first and foremost. We really don't start necessarily with, here's what the answer has to be. It's what can the answer be and how do we actually build a model that winds up generating that.

From a comp standpoint, there's numbers of factors that can go into where the IDs can wind up being. One of those that you mentioned was inflation. We are expecting a little bit less inflation. That said, as you know, we have a very large and robust pharmacy business. That was a huge driver of the LIFO charge this year. Where that winds up in 2015 is purely a guess at this point. As I've said oftentimes, if we've done nothing else, the ability to predict a LIFO charge is something that is difficult at best. You mentioned competition. I don't think competition is benign by any stretch of the imagination, but I'd say it's relatively consistent. It's always highly competitive. You never know what a competitor is going to do.

We certainly assume that the current competitive condition is not going to get better than it is today. And it's always been a highly competitive industry, there's always new people trying to take part of your business that have different operating models, whether it's a Sprouts or those kinds of operators or Publix coming into Charlotte, like they have, trying to take part of Harris Teeter's business. And we build a model to defend our turf no matter where those folks try to come. When you looked at customer trade up, I would say it's somewhat – there's a lot of things out there that are affecting broad customer base.

Certainly, I think we probably would've seen some trade up from the customer who has been less affected by the downturn in the economy over the last several years, probably spending a little bit more money in a variety of outlets, certainly some of ours. I would say that customer who has been on a budget for the last several years, they probably aren't spending a whole lot more money on being big contributors to a consumer-driven economy.

They're probably able to take care of some of the bills that they manage on a monthly basis, trying to remember which one they're going to push off for a little while and they've probably been able to be a little bit more current on your bills but not a whole lot more disposable income. So it's a pretty big mixed bag out there. Certainly where fuel costs are going to wind up and a whole lot of other factors enter into it. I know I've been going on for a bit here, but it's a long and difficult – one, the question was long, but there's not a precise answer to say it's A and B and that's what drives the final answer. We take in a lot of factors as we plan a year and think about how it's going to wind up being.

Robert F. Ohmes - Merrill Lynch, Pierce, Fenner & Smith, Inc.

That's very helpful, Mike. Just the one area, just the one last area that I want to ask about, so on natural foods, you guys had big increases in square footage allocation to that space, very noticeable the last couple of years. I think that's slowed a lot. Should we expect less tailwind from natural foods to your comps in 2015 versus what you've seen in the last couple years?

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

I think you're going to continue to see great growth in natural foods. It's more of a way of life for our customer today. Okay. The other thing is that in certain categories we are starting to integrate it rather than put it in a separate space as well.

Robert F. Ohmes - Merrill Lynch, Pierce, Fenner & Smith, Inc.

Great. Thanks very much.

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

Thanks, Robert.

Operator

And next we have a question from Ken Goldman of JPMorgan.

Kenneth B. Goldman - JPMorgan Securities LLC

Hi, everyone. Thanks for the question. A couple, can you help us a bit with how QTV comp trends are proceeding, either quantitatively or qualitatively? And I guess similarly on 1Q fuel margins to date, any sort of flow-through margin help or have retail prices come down enough to maybe offset wholesale ones at this point?

W. Rodney McMullen - Chief Executive Officer & Director

If you look at our identical sales so far this quarter, and obviously, it's very early in the year because we're just a few weeks into the year. It would be slightly ahead of the guidance we gave. But it's very early in the year. On fuel margins, Mike, I'll have to let you answer that one because I don't know the answer to that one.

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

Yeah, I don't think we need to talk about weekly fuel margins. It's difficult enough to predict what a year's going to be, let alone four or five weeks, because it's such a volatile area. Just won't go down that path this morning.

Kenneth B. Goldman - JPMorgan Securities LLC

No, that's fair. And then my follow-up is you're guiding to inflation being about 1.5% lower than it was in 2014. Are you talking about maybe a roughly 1.5% deceleration in total ID sales ex-fuel? So always risky embarrassing myself by asking a simple math question, but is it fair to assume your guidance is thus implying that everything outside passing along inflation, right, sort of traffic and basket size, you are expecting that to grow at a similar rate in 2015 as 2014, roughly?

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

Yeah, as Mike Ellis said in his prepared remarks, we had great tonnage growth throughout the year and it accelerated a little bit in the fourth quarter. And we don't see any reason why that would slow down during the year, and it winds up being in our hands to continue that underlying unit growth.

Kenneth B. Goldman - JPMorgan Securities LLC

Great. Thank you very much.

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

Thanks, Ken.

Operator

The next question comes from Kelly Bania of BMO Capital Markets.

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

Hi. Good morning. Thanks for taking my questions.

W. Rodney McMullen - Chief Executive Officer & Director

Good morning.

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

Hi. Just first wanted to double-check on guidance. So I think the message for next year is you had the very strong benefit from the fuel margins in the back half, but you have lower LIFO, none of the pension, you don't cycle that pension expense again next year in the foundation expense, and so net-net you still can kind of maintain that 8% to 11% earnings growth, but it sounds like fuel still may be somewhat of a headwind. So I don't know if you can maybe parse out the net impact of those factors that were kind of swing factors this year, just to help us kind of think about how the guidance for 2015?

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

Yeah, if you look at where fuel margins benefited us, and we talked about what the fuel margins were for the year, you know roughly what our gallons are over time, so you can probably figure out the incremental benefit from a margin standpoint on fuel. So, if you think about that normalizing and then LIFO expectation being lower, not having the pension contribution or contribution to the charitable foundations, they don't perfectly offset one another, but they come close to being negating one another, and that's why we're growing off of the $3.52 at the 8% to 11%. Keep in mind, all of that information aside, our core operations without those would've been at the high end of our 8% to 11% range all by themselves last year, and it's really that underlying strength in the core business that gives us the comfort to be able to have another great year in the 8% to 11% range.

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

Perfect. That's very helpful. And then just on the comps for the quarter, I think when you were planning the comps for the quarter in Q3, you'd talked about cycling the benefit from the weather. Just curious what really came in better than expected for the fourth quarter in terms of those core ID comps? Was there a weather benefit? Or did you just kind of hang on to some of those customers that maybe were pushed into your stores last year with the weather or, just curious, thoughts there.

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

The weather would not have been as helpful this year as it was prior year. So it was really hanging on to some of those customers, and really the operating merchandising team is doing a great job of making sure that we had strong programs to cycle that weather. So it was really the team executing, doing a great job.

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

Great. Thank you.

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

Okay, Kelly.

W. Rodney McMullen - Chief Executive Officer & Director

We'll take one more question.

Operator

Okay. And that final question will come from Mark Wiltamuth of Jefferies.

Mark G. Wiltamuth - Jefferies LLC

Hi. Thank you. Wanted to get some thoughts, now that you're contemplating more of these fill-in markets, what should we be thinking about for a longer-term square footage growth rate for you? Because you have been fading off of your store closures, so I'm curious what the flow-through is going to be on actual net square footage growth?

W. Rodney McMullen - Chief Executive Officer & Director

Yeah, it's really difficult to predict exactly how many operational closings you're going to have in a particular year, and there's a wide variety of reasons those happen. But if you look at our gross, we expect it to be 2% to 2.5% next year. Our net was a little bit under 1% last year. Our store count has been down. Keep in mind sometimes when we close an under-performing store, we may be closing an under-performing store. It's under-performing because its sales per square foot are at the way low end of a range of what will make that store profitable.

And as we replace that store or open a new store, that's larger than that, the net square footage may not go up dramatically, but the sales per square foot of that new store can often be several multiples of the store we closed. So it's a little misleading just to say oh square footage growth hasn't been that much, so they can't grow sales that much. The difference between that productivity of the new store and the store we closed can be quite remarkable sometimes.

Mark G. Wiltamuth - Jefferies LLC

Okay. And were there any tax implications from the charitable contribution in the fourth quarter or anything that carries into 2015?

W. Rodney McMullen - Chief Executive Officer & Director

No. Obviously we got a tax deduction for that, but it didn't affect the tax rate in any way, shape, or form. We've just taken advantage of the opportunity of a very strong year to be able to continue to have dollars to support the efforts that we support, both that are important to us and are important to our customers.

Mark G. Wiltamuth - Jefferies LLC

Okay. Well, congratulations on a very strong core grocery performance for the quarter and the year.

W. Rodney McMullen - Chief Executive Officer & Director

Thanks, Mark.

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

Thanks, Mark.

W. Rodney McMullen - Chief Executive Officer & Director

I want to thank everybody for calling in today and listening to our call. And before we end the call, I'd like to share some additional thoughts with our associates listening in today. I'd like to thank all of our associates for their hard work and dedication in serving our customers. We finished 2014 strong thanks to your commitment in providing friendly service and fresh products to our 8 million customers every time, every day. Thank you to each and every one of you for making a difference with our customers and for each other.

As many of you know, our community service awards honor and recognize our associates who, through their widespread volunteer activity, charitable involvement and leadership, make a difference in the communities where we live, work, and raise our families. Nominations for our 2014 community service awards are now being accepted. Whether you support the hungry, veterans and active-duty military, cancer awareness, or your favorite local organization, I encourage you to apply or nominate a coworker for this prestigious award. Winners from each division will receive a donation to their charity of choice. Make sure you connect with your HR Manager for more information and nomination deadlines in your division. Thank you for all you do. Your work in our community is simply amazing. That completes our call for today. Thanks for joining.

Operator

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