Kroger Co. (NYSE:KR) Q4 2017 Earnings Conference Call March 8, 2018 10:00 AM ET

Executives

Kate Ward - Director, IR

Rodney McMullen - Chairman & CEO

Mike Schlotman - EVP & CFO

Analysts

Edward Kelly - Wells Fargo

Karen Short - Barclays

Ken Goldman - JPMorgan

Ben Bienvenu - Stevens Incorporated

John Heinbockel - Guggenheim Securities

Vincent Sinisi - Morgan Stanley

Rupesh Parikh - Oppenheimer

Operator

Good morning and welcome to The Kroger Company's Fourth Quarter 2017 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Kate Ward, Director, Investor Relations. Please go ahead.

Kate Ward

Thanks, Gary. 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, that Kroger assumes no obligation to update that information.

Both our fourth quarter press release and our prepared remarks from this conference call will be available on our website at ir.kroger.com. After our prepared remarks, we look forward to taking your questions.

In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question and one follow-up question if necessary. Thank you.

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

Rodney McMullen

Thank you, Kate, and good morning, everyone, and thank you for joining us. With me to review Kroger's fourth quarter and full year 2017 results, is Executive Vice President and Chief Financial Officer, Mike Schlotman. At our investor conference in October, we discussed the need for retail companies to constantly reinvent themselves in order to remain relevant. And Kroger is right in the middle of such a reinvention.

We are proactively addressing customer changes, and we've made strategic decisions to invest in a seamless digital experience, technology, associate wages and low prices. Combined, these efforts come together in Restock Kroger, our plan or create shareholder value by redefining how people eat. Our vision is to serve America through food inspiration and uplift.

Restock Kroger has four main drivers; redefine the grocery customer experience; expand partnerships to create customer value; develop talent;

and live our purpose. Combined, these focus areas will create shareholder value. We announced Restock Kroger six months ago while also in the middle of one of the most complicated years in our history.

Throughout 2017, we continue to challenge our team to deliver our revised identical sales and earnings guidance from June. We are proud to share today that we delivered on those revised commitments for the year, finishing 2017 with strong sales and business momentum.

In 2017, we also grew digital sales by more than 90% and expanded ClickList to more than 1,000 locations. We gained market share for the 13th consecutive year, achieved $16.7 billion in annual natural and organic sales, including $2 billion in Simple Truth sales.

We launched Zero Hunger | Zero Waste, our commitment to end hunger in the places we call home and eliminate waste across our business by 2025 and created 10,000 new American jobs in our supermarket locations across the country. All of this is encouraging as we start 2018.

Looking at 2018 and beyond, the Tax Cuts and Jobs Act is a catalyst that will enable us to accelerate investments in Restock Kroger. And as we've shared a few times since the fall, we are taking a balanced approach to ensure tax reform benefits, our associates, customers and shareholders. Shareholders will benefit from approximately one-third of the tax savings flowing through the net earnings per diluted share.

For our customers, we'll make strategic investments to continue redefining the grocery customer experience through a combination of improved services, lower prices and added convenience. And for our associates, we are developing plans now to invest in long-term benefits, including education, wages and retirement.

We are looking ways to differentiate our associate experience with the underlying philosophy that we want to provide more than a onetime award. We want to make investments in our associates' future. As an example of this, we are doing a lot of work right now to develop an industry-leading education offering for associates.

Kroger has always been a place where people can come for a job and save for a career. We believe an enhanced commitment to employee education will drive the develop talent focus area of our plan. These investments underpin and accelerate Restock Kroger, which means we fully expect a strong return from each.

Sharing the benefits with our associates and customers will create a more sustainable and stronger business model to support Kroger's future. The investments are also aligned with our purpose, our promise and our values. We look forward to sharing more details on our plans with associates in the coming weeks.

We continue to create a seamless environment where our customers can choose how to engage with us, in-store and online. Whether through ClickList or home delivery, we continue to test, learn and scale what works using our data and customer insights to make it really easy for our customers to navigate across the channels they choose when shopping with us.

In the fourth quarter, we introduced a seamless digital shopping experience that fully integrates our ClickList experiences with our other digital services, coupons, recipes, rewards and more. After just a couple of months, we already know our customers love it. Customers are making purchases on the site at a higher frequency than before and spending more per online order.

Households that participate in our seamless offerings, those who engage with our digital platforms and our physical stores spend more per week than households that do not. And households that transact with us online spend even more. These results further validate our hypothesis, which has always been that customers want to have options for how they shop with us, and that hypothesis continues to shape our strategy to further accelerate our digital and e-commerce efforts.

When you look at our customer coverage areas for seamless shopping, more than two-thirds of our customers, more than 40 million shoppers have picked up and/or delivery available from Kroger. Our goal is for every customer to have access to our convenient services.

In 2018, we will expand our digital coverage area and enhance our digital shopping experience to provide customers with relevant products, recipes, digital coupons, weekly ads, smart shopping lists and much more. To support this growth, we offer customers 1,091 pickup locations and more than 872 delivery locations across the country, and it continues to grow.

Next, I'd like to discuss how we're winning with Our Brands, and this helps Kroger redefine the customer experience. Our Brands performance this past year was extraordinary, and I'll share just a few of the highlights. In 2017, Our Brands achieved its highest ever unit share.

We reached $20.9 billion in total sales and reached $2 billion in annual Simple Truth sales, which to me is even all the more remarkable when you consider that the brand is only five years old. We also announced a partnership with Fair Trade USA. Simple Truth now offers more Fair Trade Certified products than any other private-label brand in the country.

For the fourth quarter, Our Brands made up 29.5% of unit sales and 26% of sales dollars, excluding fuel and pharmacy. I think it's incredibly easy to take this success for granted, but I've seen the energy our teams have put into creating the right items, and it's really a big deal that an independent third-party research has validated the progress that we've made.

When you look at the results, they are extraordinary, and I'm incredibly proud of our team. The data is clear. Customers love Our Brands better than the national brands and better than other private-label offerings. Our Brands outperformed even the private-label brands you immediately think of as best-in-class.

And we're going to shout about it to our customers who have yet to experience it, Our Brands, no longer will miss out. We will be particularly focused on our top brands, Kroger private selection and Simple Truth. Our customers will be treated to an amazing array of enticing our new brand product introductions throughout the year, an assortment that will add excitement and simplify – simplicity to their lives, all at amazing prices.

And Our Brands are only available at Kroger. This is why Our Brands play such a pivotal role in Restock Kroger. Restock Kroger is off to a great start. Our leadership team and associates are aligned behind that effort, which is further reinforced by our annual incentive plan. Customers are letting us know that they see, feel and appreciate our efforts to redefine the customer experience. And they continue to reward us with growing loyalty. This is the cycle that creates value for shareholders.

We are confident that we will grow identical supermarket sales and market share in 2018, and we will create shareholder value by generating incremental operating margin dollars and free cash flow over the next three years.

Now here is Mike to share more details on our fourth quarter fiscal 2017 results and discuss our 2018 guidance. Mike?

Mike Schlotman

Thanks Rodney, and good morning, everyone. Over the next three years, Restock Kroger will be fueled by cost savings that we will invest in associates, customers and infrastructure. Our goal is to continue generating shareholder value even as we make strategic investments to grow our business.

We expect Restock Kroger to generate $6.5 billion of free cash flow over the next three years. This is before dividends and considers the benefit of the tax plan. If you recall at the conference, we talked about $4 billion after dividends. This is reconverted to a more conventional free dividend free cash flow calculation. So, we're trying to be a little more conventional in the number we talk about.

As you know, we've already reprioritized the way we invest capital over the next three years by both reducing the amount we spend and optimizing our capital allocation process. We now look first for sales driving and cost-savings opportunities across brick-and-mortar and digital platforms.

Second, we will continue to make sure our logistics and technology platforms keep pace with and scale to these demands through continued investment. Finally, we will allocate capital to storing activity. This process has allowed us to use less free cash flow for capital investments.

We're aggressively managing OG&A costs and implementing new programs to reduce our cost-of-goods sold. A big focus will be on store productivity and waste. Both of these will benefit from the $9 billion in capital investment over the next three years.

For example, store productivity will improve with the scheduled launch of Scan, Bag, Go in 400 new locations this year, and we are also pleased that strength continued its steady improvement throughout the year with good results in the fourth quarter.

We plan to generate $400 million of incremental operating margin from 2018 to 2020. We are taking advantage of the lower federal taxes under the Tax Cuts and Jobs Act to pull investments forward to 2018, so we can move even faster on Restock Kroger than originally anticipated.

Turning to our results for the year. As you know, we revised our outlook in June to address the environment we're operating in. We've provided a narrow net earnings guidance range of $2 to $2.05 per diluted share, and we are pleased to have been near the top end of that range for the year. s you can imagine in a company our size, there are many moving parts in our operations.

Our goal is to manage the business on at least an annual cycle period. This can lead to quarterly fluctuations, but we always have our eye firmly on annual results and the long-term strength of the company.

We saw an opportunity at the beginning of the quarter to invest in the shopping experience and price while still delivering on our annual commitment. This is why our results reflected a gross profit rate decline of 31 basis points in the fourth quarter, but only 19 basis points for the year.

As a result of these investments, we saw growth in both households and total business, unit growth and market share growth. Since 2000, we've invested -- we've reduced prices for our customers by $4.1 billion. We intend to continue investing in price to drive unit in ID sales growth while delivering on the bottom line for shareholders.

This is the strategy we've been following for years, and it has served us well over time. It's a cornerstone of our Restock Kroger plan to invest more in redefining the shopping experience, partnering for customer value and developing talent that will be paid for by costs of good savings, strong IDs and productivity gains. This is where the incremental operating profit margin will come from over the next three years.

We continue to make investments at our associates through both higher wages and additional hours for ClickList and other services. In fact, there's two categories accounted for about half of the increase in OG&A in the quarter, and we continue to be pleased with the results we're seeing from those investments.

Despite higher inflation during the fourth quarter, LIFO turned out to be a tailwind through the lower inventory in the levels and departments most affected by higher inflation, primarily pharmacy. Speaking specifically about ID sales, we are very pleased with the result of the 1.5% growth in the fourth quarter. Several departments outperformed the company in the fourth quarter, including produce, deli fresh prepared, meat and seafood.

Our Natural Foods Department continue to generate strong double-digit growth in both the fourth quarter and full year. 18 of our 22 supermarket operating divisions had positive IDs for the year as well, demonstrating the consistency of our results across the enterprise.

Kroger's market share grew for the 13th year in a row in 2017. Our consistent market share gains drove both top and bottom line growth to generate lasting shareholder value. We report our market share annually and look at it that way customers would look at it, where do they spend their money? We use market share data as a directional measure and not a specific one. It's also worth noting that market share is calculated based on total sales and not ID sales.

According to IRI point-of-sale data, Kroger's overall market share of the products we sell in the markets where we operate grew approximately 21 basis points in 2017, a slight acceleration over last year's growth of 16 basis points based on IRI's calculations. Both our fourth quarter and full year results included several adjustment items described in table six from this morning's press release.

I want to spend a couple of minutes walking you through that table. These items are not included in our fourth quarter adjusted net earnings per diluted share result of $0.63, and they are not included in our 2017 adjusted net earnings results of $2.04. So, none of these items were included in our $0.63, I think there's a little confusion about that from some folks that some of these numbers might have been in there.

As a result of the Tax Act, we recognize the tax benefit of $922 million in the fourth quarter. This was due to the re-measurement of our deferred tax liabilities and the reduction of our statutory income tax rate for the last few weeks of the fiscal year.

As part of the company's annual review of goodwill balances in the fourth quarter, we recognized an impairment charge of approximately $110 million related to our Kroger specialty pharmacy business. This is primarily due to lower rebates and gross margins that we built into our future expectations. Kroger specialty pharmacy continues to perform well.

In the third quarter of 2017, certain assets and liabilities, primarily those related to our Convenience Store business, were classified as held for sale in the consolidated balance sheet. Through these assets being classified as held for sale, these are no longer being depreciated. We benefited from this classification in both the fourth quarter of 2017 and fiscal 2017 by not having to record the $19 million of depreciation associated with those assets.

Our results were also affected by the previously announced settlement of obligations under the company-sponsored pension plan. We also made significant headway throughout the year in fourth quarter in particular on our long-term effort to address exposure in our pension plans while, at the same time, working with unions to provide Kroger associates with a more secure pensions.

During 2017, we proactively managed future risk in several ways. Most recently in December, Kroger and the International Brotherhood Teamsters announced the ratification of the new labor agreement that provided for Kroger's withdrawal from the Central States pension plan. We recognized a $351 million charge in the fourth quarter of 2017 associated with this withdrawal and subsequently, we've negotiated a lump sum settlement for that, that I'll touch on in a moment.

This was in addition to the $292 million recognized in the first quarter of 2017 through the obligation associated with the planned withdrawal of Roundy's Associates from the same fund and a $7 million charge for a separate multi-employer pension fund. As I said a minute ago, we made a lump sum payment to Central States in the fourth quarter. This totaled $467 million pre-tax. This replaces what would have been an approximately $3 million per month pre-tax withdrawal obligation payment over the next 20 years.

In the third quarter, we announced the $1 billion contribution to our company-sponsored pension plan. This funded a $502 million settlement charge accounted for in the fourth quarter through the termination of the cash balance company-sponsored pension plan that we've previously announced. So, we funded it in the third quarter, terminated it in the fourth quarter, which is why the charge occurred in the fourth quarter.

Fuel performance was very good in the fourth quarter. Our cents per gallon fuel margin was approximately $0.198 compared to $0.172 in the same quarter last year. The average retail price of fuel was $2.46 versus $2.18 in the same quarter last year. For 2017, our cents per gallon fuel margin was $0.206 compared to $0.171 the year before. And average retail price of fuel for all of 2017 was $2.36 versus $2.10 in 2016.

In February, we announced the definitive agreement for the sale of our convenience store business to EG Group for $2.15 billion. Our convenience store business has been part of the company for many years, and I can't stress enough how important they have been to processes, both with management and the associates at the store level and in the office.

We have been impressed with EG Group's professionalism, commitment to people and understanding of the U.S. convenience, retail market. We're very pleased EG Group plans to establish their North American headquarters in Cincinnati. We continue to expect to close the transaction during the first quarter of our fiscal year, and we look forward to working with them closely to ensure a smooth transition for associates.

As we've previously announced, we plan to use the proceeds of the sale to repurchase shares and lower our net total debt-to-adjusted EBITDA ratio. Our financial strategy is to use our free cash flow to drive growth while also maintaining our current investment-grade debt rating and returning capital to shareholders. We can generally balance the use of cash flow to achieve these goals.

In 2017, we used cash to contribute an incremental $1.2 billion pre-tax to company-sponsored pension plans and $467 million pre-tax to satisfy the withdrawal obligations for the Central States' pension fund. We also repurchased 61 million common shares for $1.6 billion. We paid $444 million in dividends and invested $3 billion in capital.

At the end of the fourth quarter, our current share repurchase authorization had approximately $270 million remaining, and our return on invested capital for 2017 on a 52-week basis was 12.03%.

We have said for some time that we expect our net total debt to adjusted EBITDA ratio to grow. This is because we're bringing an off-balance sheet item on to our balance sheet, we’re funding obligation already on our balance sheet like we did with the company plan.

As a result, in the third quarter, we updated our target range for this ratio to 2.2 to 2.4 times. These obligations, whether recorded on or off Kroger's balance sheet, have generally been considered when our credit profile has been reviewed but since they weren't funded, they previously did not get picked up in the net total debt to adjusted EBITDA ratio.

The lump sum settlement negotiated with the Central States Pension Fund in the fourth quarter is the most recent example of the company taking advantage of low interest rates and more favorable tax rates to secure the benefits – the retirement benefits we promised to our associates.

Because negotiating the settlement and bringing the obligation on our balance sheet was not contemplated when we updated our target last quarter, we're again updating our target range for this ratio to 2.3 to 2.5 times. Just as in the past, this obligation was always been part of our credit profile. The funding in the fourth quarter now picks up this obligation in our net total debt amounts.

Our current result of 2.6 times on a 52-week basis is above this range due primarily to the funding of the above-mentioned pension obligations. We expect to use free cash flow and a portion of the proceeds from the sale of assets to get us back in this range. And as I said, this includes the sale of our convenience store business.

Protecting associate and retiree pensions is one significant way that we take care of our associates. Another is hiring and job creation. As we noted in this morning's press release, Kroger created 10,000 supermarket jobs in 2017. To Restock Kroger, we are investing an incremental $500 million in our associates in wages, training and development over the next three years. This will be in addition to our continued efforts to rebalance pay and benefits while also focusing on certifications and performance incentives, career opportunities and training.

Our store associates in our Cincinnati, Dayton division are currently voting on a tentative agreement between Kroger and the UFCW. This will be our first contract under Restock Kroger, and it includes an added investment in wages, raising the starting pay to at least $10 an hour and accelerating rate progression to $11 per hour after one year of service. These are the kinds of things we contemplated when we allocated $500 million to the talent portion of our Restock Kroger plan.

Looking ahead, we have several major negotiations in 2018, including contracts with the UFCW for store associates in Smith's in Albuquerque, Fred Meyer in Portland and Kroger stores in Richmond and Fort Wayne. Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and the compensation packages that provide solid wages, good quality affordable healthcare and retirement benefits for our associates. We continue to strive to make our overall benefit package relevant to today's associates.

Our financial results continue to be pressured by inefficient healthcare and pension costs which some of our competitors do not face. We continue to communicate with our local unions and the international unions, which represent many of our associates, the importance of growing our business and profitably, which will help create more jobs and create opportunities and enhance job security for our associates.

Turning now to our guidance for 2018. We expect 2019 -- 2018 identical supermarket sales growth, excluding fuel, to range from 1.5% to 2%. We expect net earnings to range from $1.95 to $2.15 per diluted share for 2018. We expect capital investments, excluding mergers, acquisitions and purchases of leased facilities, to be approximately $3 billion, and we expect our 2018 tax rate to be approximately 22%.

And now I'll turn it back to Rodney.

Rodney McMullen

Thanks Mike. We're proud of how our teams finished 2017, ending the year with positive momentum in sales in the overall business. We delivered the revised sales and earnings guidance we promised, gain market share for the 13th row -- year in a row, continued to grow our natural and organic food sales, grew digital sales by more than 90% and now offer a seamless digital experienced to more than 40 million customers in America. And of course, we relaunched Restock Kroger.

As we embark on our first full year of implementing Restock Kroger, we are committed to continuing this great momentum. And we will only accelerate our efforts to redefine the grocery customer experience through investments in digital, technology, pricing and convenience; to expand partnerships to create customer value by forming meaningful alliances with partners who share our commitment to putting the customer first; to develop talent by investing in our associate wages and education; and to live our purpose through our purpose and promise and Zero Hunger | Zero Waste commitment.

We are focused on these key drivers of Restock Kroger because we know when we execute them well, we will create shareholder value. We are encouraged at the start of 2018 and confident in our ability to deliver on both our plan for the year and our long-term vision to serve Americas through food inspiration and uplift.

Now we look forward to your questions.

Question-and-Answer Session

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Edward Kelly with Wells Fargo. Please go ahead.

Edward Kelly

Hi guys, good morning. So, Rodney and Mike, I guess, the first thing I want to start with is on the gross margin because obviously that's the point. I think that investors are -- were probably most disappointed with this quarter. Can you just provide more color on what happen here?

I mean, theoretically, you would have gotten on a full quarter of vendor initiative in Q4. Comparisons seemed a bit easier. It does seem like pockets of the country you're sort of hearing about things being at a minimum, not getting more promotional, but probably getting a little bit better.

Was the ramp in the price investment as aggressive as it looks? What's the thought process behind it? And then how do we think about all this for next year? Should we be extrapolating this gross margin down sort of like the way we saw in Q4?

Mike Schlotman

Well, relative to the last portion of your question, I think I would answer that the same way we answered the increase in the gross margin in the third quarter that you should never really take any particular quarter and extrapolate it over any period of time other than that particular quarter.

As I said in the prepared comments, yes, we were down 30-something basis points in the quarter, but only 19 basis points in the year, which is a fairly normal kind of a reduction in investment in gross margins for us. I think that's more normal. We've been very open since October with Restock Kroger.

When you look at the recent fine customer shopping experience that the investment in that is going to be more than the dollars we generate from that, and that's going to be funded by other parts of it. There's a chart back in October that delineated how we expect to invest in the business and how we expect to generate revenue or EBITDA from those investments and leading to the $400 million increase in operating profit margin.

Just giving you a little more background than you may be wanted of the journey we've been on since October. The short answer is you should expect gross margin to decline somewhat in 2018.

We aren't giving guidance on the individual amounts. We've talked about the fact that one-third of the tax savings will be invested in the business, one-third will be invested in our associates and one-third will go to our bottom line. Obviously, those are below gross margin or operating. But that benefit to EPS is below the line, if you will. But again, we always try to balance our annual expectations.

Rodney McMullen

And one other couple of things I would add to Mike. Mike mentioned it, but we really focus on the gross margin overall for the year. When you look at the year and the work that we've done on Restock Kroger, we worked – we are consistent with what we thought we would do with Restock Kroger.

As I've said before, we're not going to lose on price, but we're not out there trying to lead the market down. And as you know, as part of Restock Kroger, we committed to improving operating margin dollars by 400 million over the next three years.

And we remain, as Mike said, to that expectation of ourselves, and we would continue to expect to grow going forward. The way we will finance that is continuing to take costs out of the business through cost of goods, through process changes. Mike mentioned the improvement that we had on shrink, for example, as well.

Edward Kelly

Okay. And just a follow-up as it pertains to reinvestment in taxes on that topic. Ever since I can remember from following you guys, the narrative has always been that your cost structures uncompetitive because of your unionization. Now it appears that the nonunionized players have to catch up.

The thought process is maybe you should be spending a little bit less than what they are. But this actually doesn't seem to be the case. So, could you just help us understand why your investment around the labor side actually kind of seems to be at a similar magnitude of what we're hearing around the rest of retail?

Rodney McMullen

If you look at by far, and Mike mentioned it, the majority of our investment in labor has been in starting wages. And in the past, we've always had people very easily would come for a job and make it a career understand over time, there is wage progression.

Over time, as jobs became very plentiful, that starting wage became more important. So, we've meaningfully increased starting wages across the company, and a big chunk of the increase is there and the other huge chunk in the investment in labor that we're making on ClickList and the aggressive expansion and rollout of ClickList.

Mike, anything you want to add to?

Mike Schlotman

Yes. And those two combined to be about half of the increase in OG&A in the quarter.

Edward Kelly

Okay. Thanks guys.

Operator

The next question comes from Karen Short with Barclays. Please go ahead.

Karen Short

Hi. Thanks. I just wanted to clarify, first of all, did you give a tax dollar benefit amount before I ask my question? Because you did give one -- you didn't refute one on CNBC this morning, and it was $200 million, and I thought the dollars you were going to get was higher than that?

Mike Schlotman

Well, I will say that on CNBC this morning, that was a little bit all over the board very much in the quarter. I actually didn't have a chance to respond to their number of $200 million because it is higher than that. As we said in the prepared comments, we expect to invest one-third in the business, one-third for our associates and one-third in the bottom line.

Karen Short

Okay.

Mike Schlotman

So, in total, Karen, it's about $0.36, $0.37, somewhere in that range. So, it's -- their tax rate, it takes about $11 million to pretax to have $0.01 a share. So, it's somewhere around $400 million of benefit, and we're investing at one-third, one-third, one-third.

Rodney McMullen

And the investments we're making we've talked about in the call, we truly expect to return and what it does -- what we did was accelerate some of the key parts of Restock Kroger.

Mike Schlotman

Yes. We're moving some of them up so we can get the benefit sooner and then the latter years won't be burdened by these investments because we've already taken care of them.

Karen Short

Okay. So, I guess, that matters as it relates to your EPS. So, when you look at your EPS guidance and you back into EBIT, I guess, the numbers I get for EBIT for fiscal 2018 or calendar 2018 could be any -- down anywhere from 22 -- well, 15% to 22%. So, I guess, the first question I had on EBIT is it fair to say that you'll be much more kind of at that low-end in the first half given the accelerated D&A?

And then I guess the second half hopefully a little bit better? And then, I guess, what matters is what the core is doing because we can all take this $400 million and take two-thirds of it, right? So, two-thirds of that is part of the EBIT decline as opposed to the core decline, if that question makes sense. Is that the way you think about that?

Mike Schlotman

I'm not going to get into giving guidance on what our EBIT's going to be. If you notice in our 8-K, we didn't give guidance on our operating profit margin primarily because of the conversation you're having, Karen, trying to predict exactly where it's going to be when that's up above and I'm paying for some of my investments with tax savings dollars down below.

We are balanced to try to make the numbers we talked about at our incentive plan will only kick in a big way if we make the numbers we talked about relative to our earnings per share guidance.

We've been talking since way back in September. We said it again in November and -- in December, and I've said it multiple times when webcast since that we didn't see anything for this year that would cause us to be below $1.80 and we were striving to be equal or slightly above an adjusted 52-week year. Well, a 52-week year is the $1.95 and then above that plus the $0.12, so we did the $1.95 as the anchor rather than the $1.80.

And then the $0.10 to $0.12 from the tax savings plus being slightly above it is how we got to the $2.15. Estimates out there, it's probably the widest range I can ever remember this morning when I looked, the range of estimates for next year were from $1.84 to $2.40. So, there's clearly a confusion about exactly what that number was going to be and how the tax savings dollars were going to fall.

Karen Short

Okay. But is it fair to say though, the first half, you have much higher D&A, right? So, the decline will be greater in the first half all else equal, then it will be in the second half? And I guess, the other question is on the investments in price or wages, is any of that front-end loaded? Or is it pretty evenly distributed?

Rodney McMullen

The depreciation for book won't be affected by the immediate deduction available under the Tax Act. That would add -- we'll deduct if I -- if I buy a seven-year piece of equipment for book, I'll depreciate it over seven years. For tax, I get it immediately, so that won't grow my deferred tax liability balance back up after I reduced it. So, the D&A immediate expense unit of D&A is only for tax, not for book.

Karen Short

Okay. Thank you.

Rodney McMullen

Thanks, Karen.

Operator

The next question comes from Ken Goldman with JPMorgan.

Ken Goldman

All right. Thank you. Question on what you talked about in terms of tax-free investment. I think you mentioned that some of it will go to educating employees. And if I'm hearing you right, it sounds like the implication is that maybe you have a pool of money going toward your associates, some of it toward cash bonuses and some of it toward this education.

And I get that from a long-term perspective, right? I'm just curious in a tight labor market, do you have data that really shows the right move to sort of not spend all of that on bonuses or on wages? I'm just curious you talked about some markets being $10 or $11 per hour.

I think cost of goods so the average wages in their employees is over $22. So just thinking about that balance and any data you have that can help us understand that would be helpful?

Rodney McMullen

Yeah. In terms of our average wage, it's significantly higher than any of the numbers that we've talked about. And the other thing, I think always to remember is that in addition to our average wage, we also provide health care and pension benefits to associates after they – as a general rule full time or when they haven't been after they've been here for a little while.

We were very focused on not having something that was a one-time bonus. But what were the things that our associates told us that's important to them and one of the reasons that they come to work for us and that when you look at people earlier in their career, the ability to have flexible hours and the ability to continue with an education was something that they give us feedback that was very important to them.

So, we really view that, that is an important part of investing in our associates, and it's something that we believe is our associates gain skill, they will be more productive in terms of their day-to-day influence on Kroger, and also, I help them move from a job to a career with us.

So, for us, it was really important for not just to be a one-time headline number, but what is something that are associates view as incredible valuable and helpful over time, and that was an area where associates told us they were important. As you all of us know, people are increasingly worrying about college debt and the debt they take on and a small way will be helpful for associates as well.

Mike Schlotman

So, Ken, to be clear, none of our differed of the tax-saving investment in our associates will be in the form of a bonus. We just don't think that's long lasting and drives retention or drives employee morale over the long term. We think that's temporary, it gets a big headline and is somewhat fleeting, and we're trying to make our investment in things that will drive retention and morale over the longer term.

Ken Goldman

That's very helpful. Can I just ask a quick follow-up? Mike, I appreciate you're not wanting to give some of the guidance items that you typically in the past would have given. But there are certain items that maybe are unaffected by tax, fuel, gross profit per gallon assumption, LIFO assumption, maybe some color on the current quarter. Any help you could give with that would be appreciated.

Mike Schlotman

Yeah. I don't think we've typically given -- I guess, we've given a range of margin per gallon. It's one of those things, Ken, we did make a conscious decision to skinny down the individual items we give guidance on.

Because every time the results a little different than what you expect, that becomes the only talking point versus our promise is to deliver on Restock Kroger over the three years, to deliver the $6.5 billion of free cash flow, to deliver the $400 million in operating profit growth over the next three years and as it relates to 2018 specifically, to have ID sales between 1.5% and 2% and earnings per share from $1.95 to $2.15. and it's – every time we have to change in those numbers 8-K, it becomes the talking point and sometimes the forest gets lost for the trees.

Ken Goldman

I understand. And thanks, Mike.

Mike Schlotman

Yeah.

Operator

The next question comes from Ben Bienvenu with Stevens Incorporated. Please go ahead.

Ben Bienvenu

Hi. Good morning. Thanks for taking my questions.

Rodney McMullen

Good morning, Ben.

Ben Bienvenu

Mike, I want to follow up on some comments or could have been Rodney some comments you made on the pull-forward of investments as it relates to Restock Kroger. My inference from the comment is that there is not also an associated pull-forward of the operating margin growth benefits that you would see as a result of those investments.

So, is it correct interpretation of what you said to think that those benefits would accrue in years two and three of the plan versus concurrent with the pull-forward of investments in 2018? And to what extent that's still reflected in your guidance?

Rodney McMullen

Yeah. If you look at they way we even started talking about Restock Kroger back in October, it was always designed when you start looking at the numbers that, and we have been given guidance that our 2018 way back in September when we talked about not less than $1.80.

And hopefully, we would stride to be flat to slightly above this year, the report of 2017 numbers, it's pretty easy to assume that we weren't expecting operating margin dollar expansion with an earnings per share range like that. We've obviously updated it with the final results for this year, the final business plan for 2018 now completed as well as really good clarity on exactly how we're going to invest the tax savings dollars.

The short answer is, yes, operating profit margin dollars will likely be down in 2018, and we're going to pull dollars forward out of 2019 and 2020 where the margin dollars should be higher. And we will pay for that for known, the known been the tax savings that are real dollars.

And we are working diligently to deliver the savings dollars. We're pulling these dollars forward with real savings dollars that we effectively already have in the bank because of the lower tax dollars we're going to have to spend. This isn't designing the plan that's going to reduce shrink by 10 basis points in 2018 and hope that.

I hate use the word hope. I always quickly trying to find different one, but believing that we're going to be able to do that 10 basis point reduction and that was going to pay for our investments.

From a cash flow standpoint, from after-tax cash flow standpoint, we were absolutely neutral doing it this way, and it's going to benefit 2019 and 2020 when we make some of those investments this year can still deliver the earnings per share growth and after-tax cash flow that we think we can deliver out of the plan.

Mike Schlotman

Ben, I don't know if this helps you but from one of the numbers Mike outlined in October was we expect cost reductions and savings of $4.450 billion over the next three years. That savings is what we would still expect. We have not included tax savings in that $4.450 billion.

And then if you look at what we plan to invest, the $4.050 billion that Mike talked about in October, our investment plan would still be the $4.050 billion. We’ve just accelerated some of that into – or 2008 where before, it was 2009 or 2010.

Rodney McMullen

2018 and 2019. Move forward to 2018 instead of 2019 and 2020. And still – we're still targeting the same numbers. We're still targeting the same operating profit margin growth at the end of three years, and we're still expecting the same free cash flow.

And if you remember, on free cash flow, in fact, I talked about $6.5 billion. If you take what I talked about in October was $4.5 billion, but that was reduced for $1.5 billion of dividends over the three years, so we’ve increase that by $500 million for some of the tax savings falling into free cash flow.

Ben Bienvenu

Okay. So just to summarize that, there's a pull-forward of the operating margin investments into this year versus what had been over – more steadily over three years, there's not a pull-forward of the operating growth, but it will be heavier in years two and three and paired with less operating margin investment in years two and three? Is that the right way to think about it?

Mike Schlotman

Correct. And from an earnings per share standpoint, we're paying for that with a known increase in earnings per share from a lower tax rate.

Ben Bienvenu

Got it.

Rodney McMullen

So, you have to go out and figure out a way to say, we know we're going to be able to pay for that from an earnings per share standpoint and a cash flow standpoint, because these are real cash dollars with a lower tax payment.

Ben Bienvenu

Awesome. Thank you so much for that. And then a quick follow-up on freight, I didn't hear it mentioned in your comments. It's been a thematic touch point across the retail landscape over the last reporting period. To what extent is that impacting your gross margins? And how do you think about that cost pressure going forward? Thank you so much.

Rodney McMullen

Yeah. We're pretty well protected on freight. Obviously, we have our own captive fleet that delivers products from our warehouses to our stores. We have a little bit of third-party there, but they're under contracts. A lot of our inbound freight is under contracts that are being honored, and those folks typically have a good supply of drivers.

There is a little bit we do in the spot market and we're subject to some of the disruptions in a somewhat minor way on that. Relative to third party, the CPG companies, there are a few of them that are having disruptions in some of their freight.

We've been pretty firm and pretty much still invest. It's their issue, not our issue, because we agreed to pay a certain price for the product and their obligation is to get it to us for that price, and we'll see how that evolves over the rest of this year.

Ben Bienvenu

Thanks so much.

Rodney McMullen

Thanks, Ben.

Operator

The next question comes from John Heinbockel with Guggenheim Securities. Please go ahead.

John Heinbockel

So, Rodney, question. Tactically, the third that you're going to invest in people, how do you do that in the context of the unionized business and contracts, right? So, contracts that might be up next year, the year after, are – is most of the investment in contracts coming up this year? How do you deal with the contracts that are yet to expire in terms of wages or benefits?

Rodney McMullen

In some cases, you may end up doing a contract early. But as Mike mentioned like in the Cincinnati contract, that was part of what was negotiated was to increase starting wages and increase the progression during the first year. And we've been doing that as contracts have been coming up during 2017.

But it's a -- your question is a great one, and it's one of those where you actually sit down with each local and have that conversation. And you target those conversations with places where your starting wage needs to be adjusted. We don't have starting wage needs to be adjusted across every part of the country, just parts of the country.

John Heinbockel

And the one-third that you would invest in the business, how much of that is price or promotion? And when you think about the draw forward of right of some of these investments, is the comp outlook -- I mean in your mind, is the comp outlook better in '19 and '20 versus what it would have been if you hadn't done this? And you probably want to quantify that, but how much better?

Rodney McMullen

If you look -- I'm going to broaden my answer a little broader than just your question. Certainly, as we look out to 2019 and 2020, we increasingly see opportunities for the business to grow in a reasonable way.

And if you think about our investments that we've been making in our digital and seamless experiences on a year-on-year basis that continues to be a headwind at some point, late next year or early 2020, that will end up becoming something that's a tailwind because of process changes that we've made on reducing the costs of doing stuff and the growth in the customer in terms of what they spend with us.

So, when you look at all the pieces that we have together, we really see that we're positioning the company to start growing again as you start looking out to '19 and '20 and starting it out proactively doing it in a position of strength as well.

John Heinbockel

Okay. Thank you.

Rodney McMullen

Thanks John.

Operator

The next question comes from Vincent Sinisi with Morgan Stanley. Please go ahead.

Vincent Sinisi

Hey great, good morning guys. Thanks very much for taking my questions. Wanted to ask in just in terms of margins for 2018, just to be sure, in terms of freight, what level? Or do you have some cushion baked in for I know you said you're relatively protected with what you own and a lot contract it's not so much on the spot market. But do you have some level of an increase in freight costs baked in there?

And then also just on the vendor negotiations, which was obviously more of a topic last quarter, should we look at that as a potential for ongoing opportunities? Or was it just because maybe more it kind of came to it once last quarter and over time, you really haven't seen any notable changes there?

Mike Schlotman

Yes. I would say the performance -- the on-time performance hasn't moved dramatically. The fine amount was about the same in the fourth quarter as the third quarter. Relative to -- I won't get specific on transportation as a subset of my margin number. But as you can imagine and accompany our side, pretty much everything we do is talked about in ranges.

And then when we go to do our internal business plan, we pick a point estimates somewhere within that range. So pretty much everything has a range around it just like transportation would be and then you make a point estimate and put that into the model.

You build everything else around it and you move and tweak things to get to what we think is the right answer to strive for as a point estimate for the year. It's the reason we do earnings per share in a range. All of those kinds of things would result in the kind of range you see.

Rodney McMullen

Yeah. In terms of our team and the way we're partnering with our CPG partners on the vendor negotiation, there wouldn't have been any change in the fourth quarter versus the third quarter.

And from a talent standpoint and the way we've – what we're negotiating, we've supplemented our team by some talent that we recruited from outside of the company. So, feel really good about where we are.

We really do continue to view our CPG relationships as partnerships, but we will use our data to make sure that we understand the strength of each brand and each brand within a category and as we’re renegotiating, use that part of the negotiation. And all the backdrop is our own brands, the strength of them continued – continues to improve, and we have very high ratings on that promotability in tax line as well.

Vincent Sinisi

Okay. All right. That's helpful. And then just one quick follow-up if I can. For the C-store sale, I'm guessing at this point, there's nothing's really kind of specifically incorporated into your 2018 outlook.

But, of course, we do know as you said kind of repurchases and debt pay-down are the main priorities with sort of the proceeds. Should we think of it as more of kind of all right both kind of begin in 2Q and kind of incrementally are spread, let's say, evenly across the future quarters, or should we expect kind of more early on? Just any comments on that would be helpful.

Rodney McMullen

I know it would be helpful, but I won't to explain exactly what our strategy is for repurchasing shares. I did have the opportunity to read a couple of the quick analyst reports that came out as the release crossed the wire.

And one thing I want to clear up is our guidance range that's out there, the $1.95 to 2.15, is with or without the C-Store sale. We will use the proceeds to reduce shares, to replace the EBITDA that goes away without transaction. I'm not going to talk about EBITDA level right now, and we will use a portion of those proceeds to reduce debt to balance our net total debt EBITDA ratio out.

So, we built the plan, so that whether we kept the C-Store's or sell the C-Store's, we will offset the lost EBITDA from the year by buying in shares, and then we'll use the rest and other free cash flow to reduce debt to get our net total debt-to-EBITDA ratio in balance.

Vincent Sinisi

Okay, all right. That’s helpful. We will now stay tune. Thanks a lot, guys. Good luck.

Rodney McMullen

Thank you.

Kate Ward

We have time for one more question.

Operator

And that question will come from Rupesh Parikh with Oppenheimer. Please go ahead.

Rupesh Parikh

Good morning, and thanks for taking my question, fitting me in. May be first on the guidance, I'm guessing you probably won't answer, but we're getting a lot of questions in terms of how to think about the seasonality of EPS growth this year. So, anything you could qualitatively give us color in terms of how you think first half or second half EPS growth.

Rodney McMullen

Yeah, it's – I would go back to the earlier question on margin per gallon of fuel on where we think that might be and things like that. We really do run our business over the course of a year.

And frankly, we try to run it a little bit – over a little bit longer time frame than a year. But we do try to make sure that we have guidance out there that's relevant and meaningful to investors. My long-winded answer is I'm not going to give you quarterly cadence. We are in this for the long haul. A quarter is 12 weeks long most times. The first quarter, 16 weeks long.

And trying to say every quarter is going to exactly X or exactly Y. I can tell you they're rarely wind up exactly at X, exactly Y and that's why we make modifications throughout the year. We sometimes we meet a little more sometimes, we have a little extra, and do we take some of the bottom line?

Do we invest more? And we're constantly balancing that throughout the year and really try to do that on a rolling year basis, not just when I get midway through the year. I'm only worried about the second half, we're already thinking about the first half and next year.

Rupesh Parikh

Okay, great. Then I guess, my real question for the call. So, as you look out home delivery I know you guys recently expanded a partnership with Instacart. So, I was curious how that was going.

And just given some of their competitive developments out there, do you feel as you look at where you guys are currently doing home delivery that you need to accelerate your investment in this area going forward?

Rodney McMullen

Well, as you know, if you go back a little over a year ago, we did home delivery almost to no stores and now we're up to almost 900 stores. We would continue to look at home delivery as part of our offering.

What we find is some customers like delivery. Some customers like pickup, and some customers like to go in-store. And probably the most common thing is we find customers actually do all three.

And it just depends on what's going on in their life and whether they have a soccer practice to get to or from or whatever. So, for us, you should expect to see us continually expanding the way customers can engage with us and do that digitally and with the mobile app. And we'll continue to make investments in those areas.

Rupesh Parikh

Okay. Great. Thank you.

Rodney McMullen

Thanks, Rupesh.

Rodney McMullen

Hopefully, from Mike's and my comments and stuff, you could tell that we're incredibly excited about the future of Kroger. And when you look at Restock Kroger, the pieces of Restock Kroger are coming together exactly the way we would have hoped and get excited about.

Our customers continue to tell us we're doing a better job and our associates tell us that they are having more fun serving our customers. So, all those pieces are coming together, and we continue to invest for the future in terms of the way we think customers will want to engage in a retailer five years from now, not just today. So hopefully, you could feel that excitement from our comments.

The other thing I'd like to do is just share a few additional comments with our associates listening in. Today, it's very fitting that its International Women's Day. Kroger is proud to join organizations across the world to support and celebrate the social, economic, cultural and political achievements of women. This day is a great opportunity to live our purpose and demonstrate our values and diversity and inclusion by uplifting the women in our workplace.

At our headquarters building in Cincinnati, we're joining with several other downtown companies in lighting up our building with a female symbol to celebrate women in business. And last night, we had it lit up and it looked fabulous.

I'd also want to encourage you to check out a video that we're sharing online both internally and externally that highlights several of our women executives. We are proud to be a workplace that works for women and to support their career aspirations and goals.

This is what it really means to live our purpose; to Feed the Human Spirit. With St. Patrick's Day and a pretty big basketball tournament right around the corner, March is always fun and a fabulous celebration time of the year.

I encourage you to take advantage of the opportunities we have to uplift our customers and each other every day and to help our customers have great celebrations, great parties and a great experience in our stores and through our digitally experiences.

Thank you for what you do each and every day. That completes our call today. Thanks for joining.

Operator

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