The Kroger (NYSE:KR) Q3 2013 Earnings Call December 5, 2013 10:00 AM ET

Executives

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

David B. Dillon - Chairman, Chief Executive Officer and Member of Proxy Committee

W. Rodney McMullen - President, Chief Operating Officer and Director

Michael L. Ellis - Senior Vice President of Retail Division

Analysts

Edward J. Kelly - Crédit Suisse AG, Research Division

Steven Forbes - Guggenheim Securities, LLC, Research Division

Charles Edward Cerankosky - Northcoast Research

Scott Andrew Mushkin - Wolfe Research, LLC

Mark Wiltamuth - Jefferies LLC, Research Division

Andrew P. Wolf - BB&T Capital Markets, Research Division

Karen F. Short - Deutsche Bank AG, Research Division

Jack Mohr – Barclays, Research Division

Operator

Good day, ladies and gentlemen, and welcome to the Q3 2013 The Kroger Co. Earnings Conference Call. My name is Kim, and I will be your operator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to your host for today, Mr. Mike Schlotman, Chief Financial Officer. Please proceed.

J. Michael Schlotman

Thank you, and good morning. Thanks for joining us today. Cindy can't join us today, so I'm going to do the introductory comments. Her daughter, Grace, is actually having an emergency appendectomy as we speak, and I haven't violated any HIPAA rules by disclosing that. Cindy was okay with me telling you why she couldn't be here.

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 third 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. [Operator Instructions]

Thanks again to those of you who are able to join us for our 2000 (sic) Investor Conference in New York on October 30. I will now turn the call over to Dave Dillon, Chairman and Chief Executive Officer of Kroger.

David B. Dillon

Thank you, Mike, and good morning, everyone. Thank you for joining us today. With me to review Kroger's third quarter 2013 results are Rodney McMullen, Kroger's President and Chief Operating Officer and soon-to-be CEO; and as you've already heard, Mike Schlotman, Senior Vice President and Chief Financial Officer. Also joining us for the call today is Mike Ellis, Kroger's Senior Vice President and soon-to-be President and Chief Operating Officer.

Our third quarter results were quite strong and helped ensure that 2013 will be another great year. Team Kroger continues to fuel our accelerated growth by performing with consistency and discipline. The resiliency of our Customer 1st Strategy to deliver for shareholders and customers was on full display during the quarter even as our internal research shows that customers remain uncertain about the economy.

We expanded rolling 4-quarter FIFO operating margin, excluding fuel and adjustment items. We increased return on invested capital while increasing capital investment, and we lowered operating costs as a percent of sales. And once again, this quarter, our associates' disciplined performance resulted in positive identical sales in every operating division and every store department.

Overall, our quarterly results show once again that Kroger is uniquely positioned to grow and win in the U.S. food retail industry.

I am most proud, however, of another distinctive achievement, team Kroger's 40th consecutive quarter of positive identical sales. It is not simply the scorecard that makes this meaningful, although 10 full years without skipping a beat is extraordinary. What makes 40 consecutive quarters of positive identical sales so remarkable is the underlying importance of the metric.

For retailers, identical sales are the strongest indication of whether or not we are connecting with our customers over time. Every one of our 343,000 associates deserves recognition for their individual work to achieve this unprecedented milestone. Congratulations. I know our entire team is hard at work to achieve the 41st.

We are pleased with where our business is trending, pleased with the growth of our loyal households and pleased with our business during the Halloween and important Thanksgiving holiday, all of which give us confidence that we will achieve our full year earnings per share and identical supermarket sales guidance.

Looking forward to 2014, we expect our earnings per share growth rate to be 8% to 11%, excluding the effect of the Harris Teeter merger and tax benefits, which is consistent with our long-term growth objective. I'll now hand off to Rodney for more details on the third quarter performance and consumer sentiment. Rodney?

W. Rodney McMullen

Thank you, Dave, and good morning, everyone. Our associates did a terrific job executing our Customer 1st Strategy in the third quarter. We improved our connection with customers, especially our most loyal shoppers and are receiving more credit from our customers because of our strong progress to improve our fresh products and customer service. As you know, these areas are important aspects of our 4 keys.

Before we discuss our loyal customer growth for the quarter, I want to highlight that Kroger has consistently grown loyal households for the last -- the past 10 years. We estimate that since 2003, loyal households have increased by an outstanding 83%. That means today, compared to a decade ago, 83% more households are shopping with greater print [ph], purchasing more items from our stores. Focusing on our most loyal customers has been a real key to reaching 40 consecutive quarters of positive identical sales.

In the third quarter, we continued to grow the number of loyal households, and our loyal household count grew at a much faster rate than total household growth, which was also up for the quarter. We have a tremendous opportunity to increase their spending across our family of stores because on average, we only capture $0.50 of every $1 loyal customer spend on products we sell. In the third quarter, loyal customers drove total sales gains in line with our strategy.

Our strong identical sales in the quarter were largely driven by the increases in total and loyal households. Total units in the quarter were up compared to last year, although items per trip continues to trend down as it has for the last couple of years. We believe this is a reflection of changes in shopping patterns that began with the economic downturn and have now become the norm. We estimate the rate of product cost inflation at 1.5%, excluding fuel and pharmacy.

As Dave mentioned earlier, we had positive identical sales in every department. These sales were exceptionally strong in produce and natural foods. These gains confirm that our Customer 1st investments in our products are working as intended and creating sustainable competitive advantages for Kroger.

We continue to invest to meet our customers' health and wellness needs, and this is evident in our pharmacy and the Little Clinic businesses. We are very pleased with the strong gains we've made when our pharmacy team seized the opportunity created by the dispute between Walgreens and Express Scripts, and even more pleased with the scripts that we've retained. By nearly every measure, our pharmacy team took advantage of that opportunity and ran with it. The Little Clinic likewise continues to see strong growth.

Many of our customers are feeling the stress of an economy that is only slowly improving, and they are not immune to the episodic ups and downs that create uncertainty. There are a number of factors impacting an already fragile consumer sentiment, including government gridlock, various concerns about health care, and it remains to be seen how the reduction in SNAP benefits will impact the entire U.S. retail industry. We continue to see high variability in sales comparisons between days and weeks.

What little economic recovery there is remains bifurcated. For some of our customers, the economy is markedly improved. But for others, there are no -- there has been no noticeable improvement at all. While these factors are creating more uncertainty than we normally have, we have never been more confident in our business model and we continue to gain market share. This is because of the remarkable consistency of our Customer 1st Strategy. No matter the environment, our customers and shareholders can depend on

Kroger to deliver value. Our ability to make constant adjustments based on what we see in the environment and what our customers are facing has defined Kroger, in our customer's eyes, as a place they can rely on in good times and in tough times.

We continue to personalize and merchandise in ways that solve for the needs of all of our customers. For the customer under stress, we are offering low entry price point on key items and special low prices on seasonal items, especially in corporate brands. And for all our customers are -- and all our customers are benefiting from better service and more value through lower prices on organic and natural foods, including Simple Truth, as well as our digital promotions, fuel rewards and health and wellness offerings.

Corporate brands continued to gain market share during the third quarter as well, with corporate brands representing approximately 26.1% of total units sold, and sales dollars were 24.1%, excluding fuel and pharmacy.

Kroger leveraged operating expenses in the third quarter, as associates did a good job controlling costs and driving positive identical sales. Our OG&A costs are -- costs plus rent and depreciation without fuel and the adjustment items for 2012 and '13 decreased 27 basis points as a percent of sales compared to the prior year. We are on track to deliver our ninth consecutive year of leveraging operating costs.

Before I turn it over to Mike, I want to provide a brief update on labor relations. Our store associate ratified new labor agreements covering stores in Little Rock, Dallas and Seattle. We are currently negotiating our contract in Cincinnati, which is on extension until March 1. 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 career opportunities, plus enhance job security for all associates. In fact, over the last 5 years, we have added 33,000 jobs.

Now Mike will offer more detail on Kroger's third quarter financial results and our guidance for the year. Mike?

J. Michael Schlotman

Thanks, Rodney, and once again, good morning, everyone. Total sales increased 3.2% to $22.5 billion in the quarter compared to $21.8 billion for the same period last year. We know there are estimates out there that are higher than our total sales, but it's important to keep in mind that the retail price per gallon of fuel was down 8% for the quarter. This is why we look at sales excluding fuel, which increased 4.7% in the third quarter over the same period last year.

Net earnings for the third quarter totaled $299 million or $0.57 per diluted share. Both the current and prior year quarters benefited from certain adjustments. This year's third quarter includes a net $0.04 per diluted share benefit that is comprised of $0.05 from certain tax items, partially offset by expenses related to Kroger's pending merger with Harris Teeter.

Last year's third quarter included a $0.14 per share benefit from a settlement with Visa and MasterCard and from a reduction in the company's obligation to fund the UFCW consolidated pension fund created in January of 2012. Excluding these adjustments, earnings per share would have been $0.53 per diluted share in the third quarter this year and $0.46 per diluted share in the third quarter last year.

FIFO gross margin, including fuel, was 20.57% of sales in the third quarter. Excluding retail fuel operations, FIFO gross margin decreased 25 basis points from the same period last year. The company recorded a $13 million LIFO charge during the quarter compared to a $15 million LIFO charge in the same quarter last year. The company continues to estimate its full year LIFO charge at $55 million.

FIFO operating profit margin, excluding fuel, the 53rd week last year and the adjustment items in fiscal 2012 and 2013 on a rolling 4-quarters basis increased 11 basis points. On this basis and for the full year, we can continue to expect our non-fuel FIFO operating margin to expand slightly.

Turning now to retail fuel operations. We disclosed many items with and without fuel due to its effect on operating cost and gross rates, but we view fuel as a core department that is expected to contribute to earnings per share growth. About 1/2 of our supermarkets have fuel centers today. In the third quarter, our supermarket fuel centers' rolling 4-quarter margin per gallon was approximately $0.141 compared to $0.133 a year ago. Total gallons sold showed solid growth.

We increased our return on invested capital on a rolling 4-quarter 52-week basis, recording a 13.42% return on invested capital this year compared to 13.34% during the same period last year. As we increase capital, it will be more difficult to grow ROIC in the near term. However, as these investments mature, we expect them to be accretive to ROIC.

Our planned uses of cash remain unchanged: maintain our current investment grade debt rating; repurchase shares; have a growing dividend; and fund increasing capital investments. Net total debt was $8.2 billion, a decrease of $525 million from a year ago. On a rolling 4-quarter 52-week basis, Kroger's net total-debt-to-adjusted-EBITDA ratio was 1.86 compared to 2.08 during the same period last year.

During the quarter, Kroger repurchased 3.6 million common shares for a total investment of $148 million. Over the last 4 quarters, Kroger has returned more than $752 million to shareholders through share buybacks and dividends as a result of our strong financial position.

Capital investment, excluding purchases of leased property, totaled $641 million for the third quarter compared to $474 million for the same period last year. Year-to-date, we have spent $1.8 billion. We expect full year capital investments to be approximately $2.4 billion.

As you know, we plan to continue increasing capital investment over time. This will take the form of adding square footage in markets where we believe our business model is already resonating with customers. With a better presence, we can grow our market share and ROIC. This fill-in strategy is a continuation of efforts that have been underway for some time and include a new focus on markets such as Dallas, Texas and the state of Michigan.

Stores we have opened in the earlier fill-in markets are producing results in line with our expectations, giving us the confidence to add new fill-in markets. Additionally, we will continue to narrow our focus on markets where we do not currently operate, with the intention of selecting one to enter organically.

Next, I would like to update you on our pending merger with Harris Teeter. To say we are excited about the prospects of our companies joining together would be an understatement. We know this is going to be an outstanding combination that will benefit our customers, associates and shareholders.

The merger is proceeding as planned. Both Kroger and Harris Teeter are having productive conversations with the FTC staff. We believe we are still on track to close the transaction before the end of Kroger's fiscal 2013.

Now I'll update you on our guidance for the remainder of the fiscal year. For the fourth quarter of 2013, Kroger expects identical supermarket sales growth, excluding fuel, of approximately 3% to 3.5%. Excluding certain tax items and expenses related to our pending merger with Harris Teeter and assuming a LIFO charge consistent with our current estimate, we expect EPS to be up -- for the year, to be up in the range of $2.73 to $2.80. That's our current range. This is consistent with our long-term growth rate guidance of 8% to 11% based on our fiscal 2012 adjusted earnings per share of $2.52, and shareholder return will be further enhanced by a dividend that we expect to grow over time.

While these are fairly large ranges with one quarter to go, several factors, including the reduced SNAP benefits, a shorter holiday selling season and slow economic recovery, make it a little more difficult to precisely predict the fourth quarter. Regardless of where we finish in the range, it will be a very strong year, demonstrating the strength of our Customer 1st Strategy. I want to echo Dave and Rodney's thanks to all of our associates for your hard work to deliver what will turn out to be a very good year.

We do realize such a wide range of potential earnings per share results this late in the year can be somewhat confusing. It could also raise questions about where our trends are going into next year. We remain very confident in our ability to deliver 2014 results in line with our 8% to 11% earnings per share growth targets. This is why Dave discussed 2014 expectations. Normally we would not talk about this until our year end release in March, but felt it was important to be clear about the underlying confidence we have in our team and the future.

Now I'll turn it back to Dave.

David B. Dillon

Thank you, Mike. As you can see, Kroger delivered strong across-the-board performance in the third quarter. More importantly, we demonstrated the consistency of our Customer 1st Strategy to deliver for customers and shareholders alike.

Before we turn to your questions, I'd like to take a moment to thank our investors. As you know, Rodney will become CEO on January 1. While I will continue to serve as Chairman through the end of next year, Rodney will take the lead on the call next quarter.

I've appreciated our dialogue through the years. You have made me a better retailer as we envisioned our future. I hope you will continue to invest in

Kroger in the years to come. I know I will. I could not be more confident in Kroger's future, knowing that our entire leadership team and Rodney McMullen will guide Kroger to even higher levels of performance. Now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from the line of Edward Kelly with Credit Suisse.

Edward J. Kelly - Crédit Suisse AG, Research Division

Maybe just the first question to start out. Mike, you talked about the wider range in the fourth quarter. There's not really a wide range around the ID expectation. So is that more around gross margin? And does that say anything about competitive environment and what you're sort of thinking about there? Maybe just a little bit of help on that front.

J. Michael Schlotman

Yes, I don't think it's really -- that it's necessarily an increase in the competitive environment out there. It's always been a competitive industry. I think it's really -- the thing that's a little difficult to read at this point in time is exactly what the effect of the SNAP reduction will be. It's early in that process. While it's been a full month with November behind us, it's a little difficult to extrapolate November. With the Thanksgiving and holiday selling season in that month, it's always a big selling season and people always find ways to have a good holiday celebration. That, coupled with the shorter holiday selling season of between Thanksgiving and Christmas, as well as just the slow economic recovery, it's just really difficult to predict. As Rodney had mentioned, we see great volatility of sales by day and by week, and it's just a little difficult to predict exactly where we're going to fall in the range. But again, wherever we fall -- wind up falling inside that range for the year on EPS, it's going to be a very solid year and one within our 8% to 11% guidance.

Edward J. Kelly - Crédit Suisse AG, Research Division

And to the extent the economy -- I mean, you sort of hinted that it's harder, but how do IDs look so far in Q4?

David B. Dillon

Let me answer that, Ed, because I'd like to actually give you a little perspective. I want to look at how they flowed through the third quarter and then bring you up-to-date in the current quarter. In the third quarter, they were stronger earlier in the quarter, a little less strong near the end. However, so far in the fourth quarter, we are running slightly higher than the sales guidance that we've just given. But I want to add, I wouldn't read an awful lot into where we are currently because of the unpredictable nature of the things that Mike just described, the calendar, SNAP benefits and the impact of health care. Uncertainty has -- all of those create uncertainty for the consumer, and as a result, create some unpredictability. So we're optimistic, as you can see. That's why I wanted to give you that perspective on how the sales have emerged so far this quarter.

Edward J. Kelly - Crédit Suisse AG, Research Division

Is there any way to sort of quantify what you think SNAP has done so far?

W. Rodney McMullen

So far, in November, you can see where SNAP dollars are down, but customers are substituting and buying with cash that shortfall. So the trend so far for that customer hasn't changed, but the way they're paying for their product has changed. How much of that is at the expense of other consumption items would be pure speculation. As you know, the other thing that's helping the economy and everyone is fuel prices are lower this year than a year ago, so some of that savings or benefit or whatever you want to call, is probably coming from there as well.

Operator

Your next question comes from the line of John Heinbockel from Guggenheim Securities.

Steven Forbes - Guggenheim Securities, LLC, Research Division

It's actually Steve Forbes on for John today. If we take a look at natural and organic foods, you mentioned the strength this quarter. And I guess, we're just hoping if you can provide some additional color on the current size of that business today.

W. Rodney McMullen

How do I do this in a way that is helpful for you, but not gives up competitive advantages? It's a meaningful part of our business. And it would be, I don't know, probably our sixth or seventh largest department. But it's by far the fastest-growing department on a percentage basis, and sometimes even on a dollar basis it's one of the bigger departments. I don't know, Dave or Mike, if you can think of any other way to give a little bit better insight.

David B. Dillon

I think the interesting thing to me is we're such a big company and seeing the growth of that inside our company, you hardly are able to see it the way we do. But it's been a fabulous part of our business. We are pleased. It certainly indicates where customers are headed and have suggested that what we're offering, they really like.

W. Rodney McMullen

If you look at our natural -- the competitors out there that focus purely on natural foods, we would be the second-largest retailer out there on a standalone basis by a pretty large margin. We would not be bigger than the largest in that space.

Steven Forbes - Guggenheim Securities, LLC, Research Division

Okay. Then I guess, if we could just talk generally about, I mean, how you view the market share opportunity, I mean, maybe taking a brand like Simple Truth, I guess, the mature share or how the share develops over time, do you see the ability to get to, say, double the nonorganic categories of overall market share? And then just lastly, if you could just briefly touch on the margin structure and how did that look compared to the more conventional categories as well?

W. Rodney McMullen

If you look at the market share opportunities, for us, we can easily see how that business could double from where we are today. And if I understood the question right, you were direct at just Simple Truth, but that comment is, when I look at natural foods and organics overall when I make that comment. But we don't see it as something that's a dream to double our business. We actually have a pretty good plan in place that will get us significantly along the way on getting there in a reasonable period of time. The margins on the business, it's still -- it's a little bit better than the margins on the conventional business, but it's not hugely different. And like in produce, you'll see us more and more pricing a lot of the organic items at the same price as conventional certainly in certain markets. So we're driven because that's where our customer's headed. We think the growth there is because customers overall, our existing customers continue to buy more and more organic and natural foods, plus the younger generation buys a higher share in those categories. So we see a huge opportunity and we see it exciting and we have some great products to offer there.

Operator

Your next question comes from the line of Jack Mohr – Barclays, Research Division.

Jack Mohr – Barclays, Research Division

This is actually Jack Mohr calling on behalf of Meredith. I guess, I wanted to see what your strategy is more broadly around the new markets that you have recently announced investments in, including the Dallas market, the Michigan and Detroit and then also in Cincinnati. And how would you prioritize the kind of acceleration of investment in those markets? And where do you see the expansion going forward?

W. Rodney McMullen

It's really a combination of several things. It's markets where we see, from a competitive standpoint, an opportunity to gain share because there are certain things that we offer in the market that our competitors may not be offering. We have a good relationship with our associates. And we have a competitive cost structure where we can afford to invest and give the customer a good value and be very strong in the marketplace. So it's a combination of all those things together. It isn't necessarily driven by the economic growth in the market, but we do see, like in Dallas, a great -- that economy there in Dallas/Fort Worth has a huge growth in front of it.

Jack Mohr – Barclays, Research Division

And the second question would be, would you consider your strategy to be an aggressive offensive type of strategy in these markets or more of a defensive market share protection? How would you characterize and I guess, maybe more granularly by each of those 3 to 4 new markets that are expanding?

W. Rodney McMullen

Yes, if you look at the markets you've identified, I feel very comfortable to call all of them offensive. We see great opportunities to get a good return on our investment and grow the business there. So I would characterize as all of them offense in nature. I don't know, if Dave, would you...

David B. Dillon

I not only would characterize it that way, I would even think about it from the point of view of we look at market share more as we can grow our connection with the customer better. I would, and Rodney did the same, is I wouldn't use your term aggressive because that sort of implies you're going to come in and try to stomp on competitors, and that's not the idea. The idea is we attract our customers better, we serve our customers better. That they like what they're having, and that's the relevancy. The customers that we've talked about for so many years. And that's the essence of really of our strategy. So it is definitely offensive and it works exactly like Rodney described.

W. Rodney McMullen

And the other thing is we have a great foundation of associates in these markets. And by -- as you're building new stores, you create a lot of job opportunities for people to get promoted. And what we're finding is we have a lot of associates that are ready to continue to grow to take on more responsibilities. So it's a double win and our shareholders get a good return because we find there's a high correlation between the higher our market share, the higher our return on investment.

Operator

Your next question comes from the line of Chuck Cerankosky from Northcoast Research.

Charles Edward Cerankosky - Northcoast Research

If we're looking at the gasoline business, thanks for the data on that, but as gas prices have come down, what has been the customer response to it? Is it still looking as an important reward? Are they buying more gallons because it's cheaper at a better margin? Can you talk about that a little bit?

David B. Dillon

I'll just mention on gas, as we've said, and Mike or Rodney may want to add to that, but we've said gas is -- fuel is an important part of our business for a variety of reasons. Our gallons were up nicely. We feel -- we continue to feel really good about where we're positioned. But gasoline being a large purchase out of a family's budget, even at these lower prices, is still significant to -- and important to them to have the fuel rewards that we offer. And it's important to have a convenient place to refuel at a really competitive price. I just filled up the last 2 weeks twice at getting $1.05 off a gallon. And I can tell you that even in my case, I smile when I'm driving away from the gas pump. So it makes a difference. Rodney or Mike, do you want to add anything? Okay.

Charles Edward Cerankosky - Northcoast Research

Can you quantify what the gallon lift was in the quarter?

David B. Dillon

Mike, do you want to give any color to that?

J. Michael Schlotman

It was mid-single-digit gallon growth. That's total, not IDs because, as you know, we continue to add a lot of supermarket fuel centers in existing markets that cannibalizes the existing stores a little bit. But it's -- we are very pleased with the direction of the gallons that we're selling in a market that's not growing anywhere near that much.

W. Rodney McMullen

And identicals were positive.

J. Michael Schlotman

Identicals were positive as well.

W. Rodney McMullen

Correct.

Charles Edward Cerankosky - Northcoast Research

Okay. How about the mix of gallons at full price versus the reward price?

David B. Dillon

I don't think we give that out ever, do we?

J. Michael Schlotman

We haven't.

David B. Dillon

And I don't think we're going to start now.

J. Michael Schlotman

The good news is I'm not even tempted to give it to you because I don't know the number off the top of my head.

David B. Dillon

But thank you for asking.

Charles Edward Cerankosky - Northcoast Research

Yes, I try. On the convenience stores, can you give us a little update on how that business is tracking and some of the, call them, experimental formats, you've been looking at, have been trending?

W. Rodney McMullen

Well, if you look at the core business, that continues to grow and their consecutive identical sales growth quarters is actually longer than the 40 that Kroger has achieved overall, and they continued with their streak. On the experimental formats, I would say right now, we're continuing to learn a lot. And it's still early in the process and Mike Ellis and Chris Hjelm have actually been heading it up, and we've actually recently restructured some of our internal operation structure to get more focus on it. I could tell you we still remain excited about the opportunity, but we haven't found something that I think our shareholders would be excited about the opportunity yet. But we think there's something there and we continue to learn a lot.

Charles Edward Cerankosky - Northcoast Research

Comment on general merchandise sales during the quarter and what that might be telling you about where the customer is headed. And I'm not trying to get in a prediction of holiday sales, but the sort of quarter year-over-year third quarter and how the general merch sales are tracking?

J. Michael Schlotman

One of the important metrics would be, as you look at general merchandise, probably the best metric would be the Fred Meyer Group had an outstanding Black Friday. By the end of that day, they were very pleased with the ID sales growth they had, not important holiday for the general merchandise merchants. And they feel like they're set up very well to have a strong holiday season.

Operator

Your next question comes from the line of Scott Mushkin from Wolfe Research.

Scott Andrew Mushkin - Wolfe Research, LLC

And Dave, congratulations.

David B. Dillon

Thank you.

Scott Andrew Mushkin - Wolfe Research, LLC

We're going to miss you on the calls.

David B. Dillon

Thank you.

Scott Andrew Mushkin - Wolfe Research, LLC

But enjoy your retirement and your grandkids. So I guess, I want to go back to what Ed was focused in on in the first question. Because if I -- and I really appreciate, Mike, you giving us some kind of thought process on the fourth quarter. But I guess what pops into my head is kind of what's changed? In other words, kind of new about SNAP. And I mean, when we were at your Analyst Day, we also -- I think I asked about the days that were going to go missing and we kind of knew about it. So I guess, what I'm trying to understand, it seems like you're a little bit more cautious about the fourth quarter, generally. I just wanted to understand what's kind of maybe changed in your -- even though your sales are running, I guess, over 3.5% right now. So what's changed?

David B. Dillon

Let me add a comment or 2 and then Mike can add to that, Scott. The thing I think I want to emphasize is that we see the world as a little more unpredictable than it generally is. And the SNAP change that occurred, certainly, we knew at the investor conference what was going to happen but we didn't know what the outcome would be and we still don't actually know the outcome, and that's what makes it unpredictable. And the more we think about it, we think it's -- there's a lot of ways in which it could be played out. We still believe, as we did in the investor conference, that customers' eating is a high priority, and so customers will tend to substitute other forms. So they'll pay in cash or credit card if they didn't have the food stamps and then they will give up on something else. And at the moment, as I think Rodney mentioned, they've been able to give up on fuel because the price of fuel is so low. But you don't know where that will lie in the longer term and we also don't know how the Christmas holiday plays out. The holiday calendar, of course, we knew that before, too. Now that it's right upon us and we're reflecting on it, we're not quite sure what it means. And then we watch every day the amount of uncertainty that our customers have generally, not just with SNAP and not just with holiday, but you look at the health care and some of those areas that we've discussed. It just created enough unpredictability for us that we felt we needed to take a little more cautious position.

J. Michael Schlotman

Okay.

David B. Dillon

Okay. Now, Mike doesn't want to add anything more to that. So I think that's the only reason we felt that way. I don't want you to over-interpret what we've said because I'm actually quite optimistic.

Scott Andrew Mushkin - Wolfe Research, LLC

Dave, I appreciate that. Is it something that -- because like you said, your business is running pretty strong right now. Is it behavior inside your stores where the week-to-week and what the consumer is buying? Or is it more of even though you guys are taking maybe even more share now, what's going on with some of your competitors...

David B. Dillon

It's actually that when you look at the data, it's a little, it's more unpredictable, more variable than what we're used to. We've talked about this actually for quarters, where we've seen wider swings from week-to-week, especially first of the month and last of the month kind of swings.

We've talked a lot about that. But we're even seeing now, in addition to the week-to-week, the daily kind of swings that are surprising. But still in the end, as you can see in the third quarter, in the end, it came out terrific. So maybe I'm over-reading it, but I just think that variability creates unpredictability, and unpredictability means we need to be a little bit more cautious.

Scott Andrew Mushkin - Wolfe Research, LLC

That's terrific. And then if I could ask one about gross margins and kind of what your thought process vis-a-vis inflation, so I guess, kind of a 2-part question. I think you guys said about 1.5%. Where do you think that's going? And do you think we've had deflation before and people freak out thinking that something is wrong and tend to overinvest in price on top of it? Is that a concern and where do you think the inflation is going? And then I'll yield.

J. Michael Schlotman

Yes, you bet, Scott. Thanks. From an inflation standpoint, when you look at where -- let's just talk about the grocery categories since that's just such a big percentage of our sales. It's fairly remarkably consistent in the first, second and third quarter, all a little bit above 1% inflation. You look at individual periods inside there, and there's a little bit of variability, but it's been fairly consistent inflation in that grocery category. Some of the perishable categories have had a little bit more inflation during the year, causing that overall index to be a little bit higher. We really haven't experienced deflation and aren't predicting a deflationary environment for next year. Our expectation as we end this year and go into next year is probably inflationary pressure is about the same where we are today, a very low inflationary kind of period, which is a period we operated in for a very long period of time. There was a very long period of time until the last 3 or 4 years where there is virtually no inflation, and in some of those years actually had deflation. So we're comfortable with our ability to continue to execute and operate in this environment. One of the things that does cause us frustration when you see problems with inflation is when there's big variability in an inflation from inside every year from high inflation to deflation and swinging back. Those have been the periods of time where it's been difficult to manage through. But a consistent, little more than 1% in grocery. Yes, life's a little better with a little more. But when it's consistent, it's significantly easier to operate in that inconsistent environment.

Operator

Your next question comes from the line of Mark Wiltamuth from Jefferies.

Mark Wiltamuth - Jefferies LLC, Research Division

Wanted to get into a little bit what categories are working because it seems like if you look at Nielsen data and some of the other areas out there, the center of the store seems weak for the rest of the industry, yet you're saying all of your categories were still showing good IDs. So maybe if you could tell us color on the center of store versus the perimeter?

David B. Dillon

Well, Rodney may want to add some color to this, but we've identified some of the strong growth areas that we have better than our average sales, places like produce, natural food. I don't think we've mentioned. Well, we did mention pharmacy. It's also true in deli and seafood. But -- and natural food has a number of items that are within the center of the store so that would be partially part of your answer. We're also seeing a really strong or improved trends anyway and very strong in some, but the categories that are more discretionary, which illustrates the bifurcated nature of the economic recovery, things like Starbucks and sushi and Boar's Head and some of the upscale cheese. Greeting cards are doing reasonably well and toys are too, both of which are in the center of the store. And Rodney, you may want to add some more color to where you see that.

W. Rodney McMullen

No, I would agree. If you look at -- it's kind of hard how you define center store anymore. Dave's comment about natural foods is one where I always struggle with because technically, it probably is center of store. That would be -- the center store is the weaker part of our business, but it has been for a long period of time because people are buying more and more -- they want dinner prepared and they just come in and pick something up. So there's all kinds of shifts going on, but we continue to gain good share in what business is there. And it really is just moving -- adapting as the market changes. And Mike reminded me that grocery units continue to grow, so it's still positive. Don't take too much into what I said.

David B. Dillon

Yes, and the important note is that we sell both.

W. Rodney McMullen

Well, it's really important to be positioned to take advantage of both because it's left up to the customer what they want versus us trying to force them.

Mark Wiltamuth - Jefferies LLC, Research Division

And if you dig in a little bit on that natural food category, are you still adding aisle space and SKUs to that area or is it really just more higher turns of existing products?

W. Rodney McMullen

It's a good question and it's really both. We continue to -- there's a lot of product innovation in those areas, so you find a lot of good new products that you can add that customers like. We continue to find subcategories within it that we haven't had in the past that's doing very well that we continue to add. Plus if you look at the base business, it just continues to grow. So you have all those things happening. We are continuing to add space to those, to that department when you look across the company.

Mark Wiltamuth - Jefferies LLC, Research Division

And are those more focused on your upscale stores or is this actually creeping more into some of the core stores also?

W. Rodney McMullen

This would be all stores. The amount of it would be different. But a value store would have changes as well. It isn't focused just on upscale by no means.

Operator

Your next question comes from the line of Andrew Wolf from BB&T Capital Markets.

Andrew P. Wolf - BB&T Capital Markets, Research Division

Dave, I just want to add my congratulations on everything you've achieved in the last 10 years or so at Kroger.

David B. Dillon

Thanks, Andrew.

Andrew P. Wolf - BB&T Capital Markets, Research Division

A couple of follow-ups. First, at the end of the quarter, when things got weak, could you tie that or would you tie that to using focus groups or your own intuition or whatever, to the uncertainty around the government shutdown? Do you think that was the primary reason October sort of softened for your business?

David B. Dillon

Well, my intuition says it was a variety of things. There was a modest change in the calendar in such a way that, that might have affected it a little bit. I think that there was some differences in our own merchandising from last year to this year, not a lot, but enough that you could maybe see a little difference in it. And then third is the point you raised is I think there were a lot of unpredictable things going on and causing people to be uncertain. I know for sure that in some retailers, you could see a clear change in sales performance when the government was shut down because of the wildly uncertain market that created for some people. And the categories that were within that retailer would have been within our store, and we didn't see quite [indiscernible] and we certainly didn't see that kind of a variation in our total sales or even any one department. But I think each of those things go together, conspire together to create what I think is probably going to be an anomaly. But it illustrated to me how unpredictable some of these events may be. And that's probably what makes me a little cautious. It doesn't make me negative, it makes me cautious about predicting, not cautious about what the future will actually be. That's why I emphasized I'm actually quite optimistic.

Andrew P. Wolf - BB&T Capital Markets, Research Division

Yes, I think that's a good segue into my real -- my primary question, which is around the sort of ongoing implementation of the Affordable Care Act and the kind of machinations it's changing and as it's going -- the rules that are coming out and all that's going on. So we've had our conference recently. It seems to be, especially from the corporate viewpoints, creating a lot of consternation about the consumer, about take-home checks, are those going to change January 1 materially, and really about corporate cost structure. So sure you guys have put a lot of time and energy into this. I know there's a lot of uncertainty around it. But I wonder if you could just share with us right now and I know this will change over time kind of your best thinking around the consumer, what it's going to mean for the consumer and what it could mean for Kroger's cost structure. Maybe it's a positive thing relative to nonunion businesses, but I'd just like to hear what you think about that.

David B. Dillon

Well, I have a couple of thoughts and recognizing it's early and as you point out, it makes things a little hard to know for sure. But the first thing is that everyone will be affected in a similar kind of a way. I don't think Kroger will be singled out in any particular way either in advantage or disadvantage. And as a result, if it ends up being worse than I'm mentally thinking, then it's worse for everybody than it is -- it's just not Kroger. But also what we're seeing early on so far is our estimates and the way we've played out the future is consistent with what we have been thinking and what we've been feeling, meaning our cost will go up a little bit, it's going to be manageable, it's within the context of what we see as our long-term earnings guidance. And it doesn't change our confidence level at all about what our future looks like and our ability to perform. The short-term effect, the effect on uncertainty and unpredictability for the customer and whether that changes their behavior, that actually could be a short-term issue, it certainly could be a long-term issue too, if I'm wrong. But the short-term issue is more because of the unpredictable nature, does that cause the customer to be more cautious themselves and their behavior. That's what many people felt happened with the government shutdown. And then, of course, once that got back to normal, then a lot of the business looks like it kind of recovered and came back to normal, too. Rodney, I don't know. You and I have talked a little bit about that. You want to add any...

W. Rodney McMullen

No. No, there are some customers that will probably end up saving money as well. If you were in one of the groups where you were paying more for premiums than under the new structure, so there's some people that's on the other side of that as well. So I think Dave's point on unpredictable in terms of how the customers are going to react, I think the customer doesn't even know how they're going to react yet, because they're still trying to understand what does it mean.

David B. Dillon

Yes. Now, you did mention the union, nonunion picture and of course, we have a number of collective bargaining agreements. And in those, it does create a little, I want to say a little bigger pressure on both parties, on the union bargainers and on the company bargainers, because there's certain changes you have to make because of the law. And when you make those, then that has cost implications and then that puts pressure on the rest of the contract to make whatever other changes you have to make to adjust for that. And I could see the argument that might put a union operator at a competitive disadvantage. I don't happen to feel that way but I can certainly see the argument. Because I think what it really does is it causes the parties at the bargaining table to try to face reality and say, "How are we going to collectively negotiate this out and compromise this out in a way that works for the law and works for our associates and works for the company?" And that's been our objective and so far, we've been pleased with being able to do that.

Andrew P. Wolf - BB&T Capital Markets, Research Division

I just want to get one follow-up on a question a few folks, including Mark Wiltamuth, I think asked on where the natural food growth is coming, velocity versus expansion. And really, Rodney, I think you said the business could double and I clearly see that that's more than likely. But would you -- could you put a time frame around that, bracket it? Would it be closer to 10 years, closer to 5 years, within which you predict, I know not to the year, but what -- would it be closer to one or the other?

W. Rodney McMullen

I would say it's closer to 5. Now Mike Ellis is over there cringing because if you -- I would be pushing him to maybe get there a little faster.

Michael L. Ellis

True.

W. Rodney McMullen

But definitely, I would see it in the next 5 years' time frame.

Operator

And your last question comes from the line of Karen Short from Deutsche Bank.

Karen F. Short - Deutsche Bank AG, Research Division

;

I just wanted to ask a couple more housekeeping-related questions. On your comp this quarter and also on your gross margin, what was the impact of generics this quarter? Have we finally cycled that completely or are there still some impact on the comps?

J. Michael Schlotman

With and without pharmacy numbers, without pharmacy, we were a little bit stronger without it when you take pharmacy out of our sales along with fuel so there was still a slight impact on the ID sales as a result of the pharmacy department. It wasn't [indiscernible] certainly declining.

Karen F. Short - Deutsche Bank AG, Research Division

So it should be fully cycled by '14?

J. Michael Schlotman

It's not meaningful. It's not meaningful anymore, it's so small.

Karen F. Short - Deutsche Bank AG, Research Division

Okay. So the gross margin deterioration that we saw this quarter, now that we've more or less cycled the generic benefit on the gross, is that kind of -- is that our I should think about the gross margin deterioration this quarter? Like it was obviously less in the first and second and then now it's just taking a little bit of a step up, not that meaningful, but it's [indiscernible]

J. Michael Schlotman

I would characterize where our gross wound up a little different than deterioration when you look at the cost savings, the total operating cost savings that Rodney spoke of when we look at OG&A plus rent and depreciation, we clearly paid for our investments in gross. And we continue to strive the balance on our rolling 4-quarters basis, the investments we make in gross and the reductions in our cost. And as we've always said, individual quarters can have different results than the full year happens to have. And I wouldn't take one quarter and try to extrapolate that. I would look more where we've been on a rolling 4-quarters basis or on an annual basis so far this year.

Karen F. Short - Deutsche Bank AG, Research Division

Okay, that's helpful. And then looking at your CapEx, you brought your CapEx spend up to the high -- well, to the high end of the range, but it seems like the projects that you have, have kind of remained unchanged. Anything to point to there because it was $2.1 billion to $2.4 billion?

J. Michael Schlotman

Well, just that we -- where we sit today, having spent $1.8 billion year-to-date, it's more likely than not that we're going to be in that $2.4 billion range. When you look at the number of projects, the major projects may not be appreciably different as a result of that. We're doing a lot of smaller remodels that don't fall into the major project category. Plus we're having a lot of spending in 2013 on 2014 projects, so we can get them opened earlier in the year. And that is something we continually work on, is to not look at those budgets necessarily that you budgeted to open in '14. So spend all your dollars in '14. So there is quite a bit of pre-spend on 2014 openings.

Karen F. Short - Deutsche Bank AG, Research Division

Okay. And then last question is when you actually close on Harris Teeter, will you provide updated guidance at that time or are you going to wait until you report your fourth quarter?

J. Michael Schlotman

My view is that considering that it will be by the end of our fiscal year, which means by the end of January, we'll probably take February to sit down with them. It's a little difficult today to have even conversations with them about what their business plans should look like next year relative to the FTC will be concerned. We're trying to run their business and we haven't closed on the merger. So my expectation is we'll take the month of February to sit down with the management team at Harris Teeter to solidify jointly what their business plan should look like for 2014 and then give combined guidance when we release earnings for the full year in March.

W. Rodney McMullen

But the accretion for the first full year would be consistent with what we talked about before.

J. Michael Schlotman

Absolutely, there's nothing that we know of or would expect to know of that would cause the $0.06 to $0.09 to be different.

David B. Dillon

Yes, great, Karen. Thank you very much. And before we end the call today, I would like to share some additional brief thoughts with our associates, who we encourage to listen. 10 years of positive identical sales growth is simply amazing, and I'm proud to be a part of an organization that is committed to serving our customers and enriching the lives of others. As I've said earlier, each of us had a role to play in reaching this milestone. It is one you should each be proud of. And thank you all for what you do to make our stores the best place in which to shop during the holidays. Remember the little things like a smile and a friendly greeting always make a customer's day better. And actually, they make our day better, too. I hope each of you celebrate the holidays with family and friends. We wish you Merry Christmas and Happy New Year. That completes the call today. Thank you all for joining us.

Operator

This concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.