Kroger Co. (NYSE:KR) Q2 2016 Earnings Conference Call September 9, 2016 10:00 AM ET

Executives

Kate Ward - Director of IR

Rodney McMullen - Chairman and CEO

Mike Schlotman - EVP and CFO

Analysts

John Heinbockel - Guggenheim Securities

Edward Kelly - Crédit Suisse

Shane Higgins - Deutsche Bank

Rupesh Parikh - Oppenheimer

Stephen Tanal - Goldman Sachs

Ken Goldman - JPMorgan

Vincent Sinisi - Morgan Stanley

Scott Mushkin - Wolfe Research

Robby Ohmes - Bank of America Merrill Lynch

Alvin Concepcion - Citi

Operator

Good morning, and welcome to The Kroger Co. Second Quarter Earnings Conference Call. [Operator Instructions] Please note, this event is being recorded. I would now like to turn the conference over to Kate Ward, Director of Investor Relations. Please go ahead.

Kate Ward

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

Both our second 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. Please save the date for our 2016 Investor Conference, which will be held in Cincinnati on November one and 2. Details will be coming soon, and we hope that you can join us.

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

Rodney McMullen

Thank you, Kate. Good morning, everyone, and thank you for joining us today. With me to review Kroger's second quarter results is Executive Vice President and Chief Financial Officer, Mike Schlotman. Our core business remains strong in the second quarter as we continue to increase market share, improve tonnage and grow loyal households. As we often say, we are focused on the long-term performance over a three to five year horizon. We have the right strategy, the right people and the financial flexibility to execute our strategy, which allows us to continue investing in our associates, our business and grow market share.

By remaining focused on our strategy, we create long-term value for our shareholders. An example of staying on our strategy is continuing to add hours to support tonnage growth in a deflationary environment. This increases our cost as a rate of sales, but without this investment, the shopping experience, an important element of our Customer 1st Strategy, would be negatively affected. The transition from inflation to deflation creates a difficult operating environment. We estimate that we had deflation without pharmacy of 1.25%, including 1.5% deflation in the grocery category. I want to stress that we've been through economic environments like this before. In 2009, we transitioned from inflation to deflation in a very similar way. Of course, in 2009, we also had a much more difficult macroeconomic backdrop. Even though the current environment is volatile, we are confident that we will navigate today's challenges and continue to deliver value for our customers and shareholders.

While we've revised our identical supermarket sales growth and net earnings per diluted share guidance for the year, our growth objectives are on a three to five-year rolling cycle, and we remain confident in those targets. We are in this long-term range run and not a 12-week cycle or particular year. We have demonstrated our ability to invest at the appropriate times to create momentum when the environment improves. While we expect continued deflation and tough year-over-year comparisons for the remainder of the year and even into early next year, as we know from past experience, the environment won't be deflationary forever. Kroger's long-term focus is one of the reasons why our business continues to generate healthy free cash flow, which allow us to invest for the future and maintain financial flexibility to create shareholder value.

To this end, we have decided to allocate approximately $500 million less to capital investments for 2016 and for 2017, which will allow us the flexibility to return value in the near term. This could include utilizing our current board-authorized $500 million share repurchase authority as market conditions provide the opportunity. We often say that the only certain thing in retail is that it is always changing. This is certainly true for an evershifting customer preferences as well as the overall competitive environment. We believe one of the reasons for our continued success, regardless of the operating conditions or competition, is our ability to generate increasingly sophisticated customer insights.

Our team at 84.51° helps us figure out what customers want so we can provide highly informed strategic investments based on rigorous data analytics rather than simply reacting to competitors. Customer insights give us a big advantage in challenging environments like this one. A lot of what we are seeing suggests a gradual tightening of budgets. Our customers tell us they are less confident about the economy now than they were three months ago, and they expect the economy to get worse in the next three months. We are as committed as ever to doing what is right for the customer. Our team's execution of our Customer 1st Strategy helped deliver growth in loyal and total households, units and market share compared to last year. Customers continue to vote with their dollar, and on that basis, Kroger continues to win.

We believe that it is easier to steer a big ship when the waters are smooth. But when the water gets rough, the right people and the right strategy make all the difference. These are some of the same reasons why you should continue to believe in Kroger. We are focused on the long term. We have the financial flexibility to execute our strategy, and we have the right people and the right strategy to weather any storm. Our merchandisers and operators are the best in the business. Our senior management team brings a great mix of new ideas and long tenure, propelling innovation while remaining steady at the helm. Like any of the high-performance teams, the mindset of our leaders is agility and responsiveness to changing customer and economic dynamics. We remain focused on growing market share, and we'll continue to invest in our associates and our business, providing value to our customers, both today and for the future.

One example of our long-term focus is our recent merger between our specialty drug pharmacy, Axiom, and ModernHEALTH. The merger, which closed last Friday, further expands our presence in the high-growth specialty pharmacy area and connects nicely with our retail pharmacies and broader health and wellness strategy. We are excited to welcome ModernHEALTH's 500 associates to the Kroger family. A second example of a long - of our long-term focus is our progress integrating sustainable practices into our business operations. We believe that customers and associates increasingly make decisions based on how well companies take care of their people, their communities and the planet. So we are very pleased to share that Kroger has earned a spot on the Dow Jones Sustainability Index for the fourth consecutive year. More than 600 companies in North America are evaluated each year, and only the top 20% are listed on the index. This recognition, of course, is only possible, thanks to the thousands of individual activities our associates do on a daily basis in our stores, manufacturing and distribution facilities and offices.

Through all our growth initiatives, we strive for balance between our core business, beyond the core and innovation. This fundamental approach is how we'll continue to win with customers and create sustainable long-term value for shareholders. I noted earlier that we operate our business on a 3- to 5-year rolling cycle. Over both time horizons, we have been performing consistently above our long-term net earnings per diluted share growth guidance of 8% to 11%, plus a growing dividend.

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

Mike Schlotman

Thanks, Rodney, and good morning, everyone. As Rodney said, we've been through periods like this before, and we have the leaders and the strategy to continue delivering value to our customers, associates and shareholders. While the quarter and the year aren't shaping up the way we expected, we continue to be well positioned for the long term. We continue to see a strong flow of capital projects. We've tried to be very clear about our deliberate ramp-up of capital spending since 2012. As the management team, we recognize the environment and believe it is prudent to reduce capital investments, excluding mergers, acquisitions and purchases of leased facilities, to $3.6 billion to $3.9 billion for 2016 and 2017. This is still a substantial investment in the business.

Consistent with our long-term financial strategy, we're maintaining flexibility with our cash flow to invest in the business, repurchase shares and maintain a growing dividend. Our philosophy is to always create value for shareholders. And while our Customer 1st approach remains our distinctive business strategy, we implement multiple approaches to deliver shareholder value.

There are many gives and takes in any quarter and year, and we view our ability to adjust to return value to shareholders as the core strength of our financial strategy. Identical supermarket sales without fuel came in at 1.7%, impacted by deflation across most departments, with the exception of produce and pharmacy. We are seeing significant deflation in milk, eggs and cheese. We will continue to focus on growing households, growing units and making sure we are delivering the right value proposition for our customers.

As Rodney pointed out, we continue to do all three of these things during the second quarter. That. Our team accomplished this in such a deflationary environment is no small feat and demonstrates that our associates continue to connect with customers in a personal and meaningful way. As you know, a strength of our Customer 1st model is that we make regular investments in our people, products, shopping experience and price. As Rodney said, we added hours to keep up with unit growth, and we also continued our price investments as evidenced by our lower gross margin. We balance these investments based on the needs we see in the business to drive sustainable results over time.

Operating costs, excluding fuel, Roundy's and the pension agreements, were better by 6 basis points in the second quarter. A lower expected bonus is one driver of these results. We'll continue to focus on cost controls and use those savings to provide additional value to customers.

Now for an update on retail fuel. In the second quarter, the average retail price of a gallon of gas declined by $0.47 compared to last year. Our cents per gallon fuel margin was approximately $0.198 compared to $0.19 in the same quarter last year. On a rolling four quarters basis, we are at $0.184 this year compared to $0.186 last year. We expect this rolling four-quarter comparison to further decline as we cycle some very strong margins for the rest of the year. A variety of factors contributed to our net earnings per diluted share results in the second quarter. Deflation was clearly a headwind, and that was offset by our lower-than-expected effective income tax rate due to the adoption of a new accounting standard.

Our second quarter net earnings per diluted share on a GAAP basis was $0.40 compared to $0.44 during the same period last year. Our net earnings per diluted share results included charges related to the restructuring of certain pension obligations to help stabilize associates' future benefits. Excluding the effects of these charges, Kroger's adjusted net earnings were $454 million or $0.47 per diluted share. Our integration with Roundy's continues to be on plan. We have two dedicated management teams, one for Roundy's in Wisconsin and one for Mariano's in Illinois, to take into account the uniqueness of the formats in each location. These leadership teams have a mix of Kroger and Roundy's experience. We are pleased with the early results of our Roundy's investments in Wisconsin, and we remain excited about this opportunity.

During the second quarter, corporate brands represented approximately 27% of total units sold and 26% of sales dollars, excluding fuel and pharmacy. Our corporate brands team continues to drive innovation in important categories. Earlier this week, we launched a new, more affordable corporate brand line of cage-free eggs. As you may know that earlier this year, we committed to a 100% cage-free eggs supply chain by 2025. In order to reach that goal, we want to help customers shift from conventional eggs to the cage-free category. By offering a lower-price alternative to most other cage-free eggs on the market today, we believe our mainstream customers will begin to migrate to the cage-free category.

Our net total debt to adjusted EBITDA ratio increased to 2.11 compared to 2.02 during the second - the same period last year. This result illustrates our commitment to use free cash flow to both grow our business and return cash to shareholders while maintaining an appropriate level of leverage for our credit rating. Over time, we would expect our net total debt to EBITDA ratio to grow if we continue to successfully negotiate restructuring of troubled multiemployer pension plan obligations to help stabilize associates' future benefits. We would not expect this increase to adversely affect our credit rating as the rating agencies already contemplate our multiemployer pension plan obligations, and the additional debt we would take on to fund these plans will be offset in a reduction of our off-balance sheet multiemployer pension plan obligations.

Over the last year, Kroger's used free cash flow to repurchase $1.1 billion of common shares, pay $406 million in dividends, invest $3.8 billion in capital and merge with Roundy's for $866 million. Return on invested capital for the second quarter was 13.95%, excluding Roundy's, compared to 14.24% for the second quarter of 2015. Our balance sheet is as strong as ever. I will now provide a brief update on labor relations. We recently agreed to new contracts covering store associates in Little Rock, Nashville and Southern California. We are currently negotiating contracts with the UFCW for Fry's associates in Arizona and store associates in Michigan and Atlanta. We also negotiated a new contract with the Teamsters for our Roundy's distribution center.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages to 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, have a shared objective, growing Kroger's business and profitably, which will help us create more jobs, incur opportunities and enhance job security for our associates. I'd like to take a moment to highlight our $111 million commitment to the UFCW consolidated pension plan. This is part of an agreement to transfer the liabilities of two troubled multiemployer pension plans, which protects pensions already earned and will provide greater stability for future benefits of more than 6,500 Kroger associates and retirees. This is the latest in a series of steps we've taken during the last four years to provide greater stability of current and future benefits for Kroger associates and enhance the prospects for future returns while continuing to deliver strong shareholder value.

In 2012, we agreed to establish the UFCW consolidated pension plan by working with the unions to consolidate four multiemployer pension funds into one. That agreement protected benefits - that agreement protected earned benefits and provide a greater stability of the future benefits of more than 65,000 Kroger associates. In 2014, we announced similar agreements with two additional multiemployer pension funds. And in 2015, we accelerated contributions to the consolidated plan. We are proud of our ability to do this even in a tough operating environment. We intend to continue looking for opportunities to leverage our strong financial flexibility to safeguard associates' benefits, increase certainty and control over future benefit obligations and continuing to deliver strong shareholder value. Turning now to our 2016 guidance. As a result of continued deflation, we lowered our net earnings guidance to a range of $2.03 to $2.13 per diluted share for 2016. Kroger's adjusted net earnings guidance range per share - per diluted share for 2016 is $2.10 to $2.20, which excludes the $0.07 charge from the company's commitment to restructure certain pension obligations. The previous guidance range was $2.19 to $2.28, which did not anticipate the $0.07 charge from the company's commitment to restructure the pension obligations.

Shareholder return will be enhanced by a dividend that is expected to increase over time. For identical supermarket sales growth, excluding fuel, we expect the remainder of 2016 to be in the 50 basis point to 1.5% range, which is 1.4% to 1.8% for the full year. Finally, we now expect Kroger's full year FIFO operating margin in 2016, excluding fuel, to decline slightly compared to 2015 results.

Now I will turn it back to Rodney.

Rodney McMullen

Thanks, Mike. We are in this for the long term whether it is our sustainability initiatives, job creation or return to shareholders. None of these are short-term ventures or quick fixes. We've been through business cycles like this before, and we know the best and right thing to do is to deliver on our promise today while investing for the future. We are as committed as ever to our Customer 1st Strategy, and we are confident that we will continue to deliver long-term value for shareholders.

Now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question will come from John Heinbockel of Guggenheim Securities.

John Heinbockel

So maybe you can talk about how you guys **-** and obviously you've got a lot of data, how you think about the analytics around price elasticity in a deflationary environment versus inflationary, right, in trying to get a decent, at least short-term ROIC. And then **-** and contrast that with maybe what you're seeing in the marketplace competitively. Because it always struck me that, right, when you have a deflationary environment and your costs are going down, people can be a little more irrational and make poor decisions, right, because their COGS are going down. So curious how you look at that and what you're seeing from your competition.

Rodney McMullen

Well, the - thanks. The - it's a great question, and it's a little hard to answer because each category would be a little different. And if you look at some of the beef and pork categories, people are moving back into those categories in a very, very strong way, and we have incredible tonnage growth in those areas. So the elasticity, you have tons. Other categories where people kind of buy what they need all the time anyway, you don't see as much. So if you think about eggs, for an example, people only eat a certain number of eggs. But some of the other categories would be a little different. The other thing that's always hard is getting your message out because - it's fascinating. In a research, most people are saying their basket of goods cost more money, but we, in fact, know that it isn't. So helping the customer see that is always a challenge for us and our competitors as well. Go ahead, John.

John Heinbockel

No, that's good.

Rodney McMullen

And when you look at the competition, it's kind of the same as what we've always had in each - one of the - what they say in each short statement in economics is wrong because if you look across the country, you have competitors doing all kinds of different things depending on what's going on in their business and what's going on in that part of the country. So there really isn't a consistency to it that I would say it's completely different today than before.

John Heinbockel

Yes. Well, [indiscernible] because you guys always talked about - you felt competition has not changed. It was rigorous but not irrational. I mean, it just looks like there are pockets of irrationality. And I wondered, is that true? And particularly in protein, is that made worse in the Memorial Day to Labor Day time period because that's kind of prime beef season? And then so post Labor Day, that should come down or no?

Rodney McMullen

The - I guess, I'm a little - I wouldn't be quite as aggressive on saying people are being irrational because I don't see anything that is different today than when you go back and look at it over the last year or three years or 5 years. And you always have certain pockets where people are doing something different than overall. I'm just trying to think from a Labor Day standpoint and some of the ads, I wouldn't say that there was something drastically different than what...

Mike Schlotman

Like the holiday ad.

Rodney McMullen

Yes. And you're going to put in the ad the things that the customers want for that period of time. And to your comment, certainly, people grow out a lot more on that weekend just because it's kind of the last major weekend of summer.

Operator

The next question will come from Edward Kelly of Crédit Suisse.

Edward Kelly

So Rodney, I just wanted to follow-up on John's question because there has been, I guess, a fair amount of talk now from, I guess, food retailing competitors about conventional grocery stores getting much more aggressive from a promotional standpoint. We - there's also been plenty of talk about Walmart being more aggressive within the marketplace as well.

You're kind of suggesting that you don't see as much of that. So I'm just wondering where that disconnect maybe would come from. And then as part of all that, could you just talk about what you are seeing so far in your third quarter, both from the perspective of your ID growth and the general promotional cadence of your business?

Rodney McMullen

Well, if you look at competitors, the thing that you really have to look at is you have to look at across the whole country. You can't just look at one particular area. So to say that there's something drastically different, I wouldn't define it as that. As you know, we have a basket of goods that we look at on almost a weekly basis in terms of how is our pricing relative to our strategy and relative to our competition. And we really haven't seen drastic changes in that relative pricing in those basket of goods, and we haven't for a long period of time. The other thing, I think it's always incredibly important for us to remember, and this is as much inside the company as external, is the customer decides where to shop, and price is only one element of that decision on where to price. They also look at the fresh - the quality of the fresh departments. What are the products that are being offered, what's the variety there.

And then really a critical part is how do the associates engage and how are they treated and how long does it take to - when you're in line and those elements. And we continue to make great progress on those elements, and our customers continue to tell us it's really important for them as they decide where to shop. And that's - as you know, years ago, that's the reason we started the Customer 1st Strategy. It's also the reason why we continue to execute the Customer 1st Strategy. If you look at what's within it though, it has changed over time as customers change. So if you look at natural and organics, when we started the journey, natural and organics really wasn't a critical part of the product strategy. Today, it's incredibly important. And I don't know, Mike, it's probably, what, 10% or a little over 10% of our business when you look at it in total.

Mike Schlotman

Yes, definitely over 10%.

Rodney McMullen

So those are - elements, I think, are equally important. When you look at where we are so far in the third quarter, obviously, we're early in the quarter. We would be at the low end of the range on identical sales growth, but we're still very early in the quarter.

Edward Kelly

I think it's - right, let me ask a question...

Mike Schlotman

And also keep in mind, the third quarter is a tough compare for us with the - in the face of deflationary pressures on the top line. It was a mid-5s quarter last year in the third quarter. So combination of a very strong ID sales quarter last year and deflation last year is certainly a factor on where we are and where we'll wind up.

Edward Kelly

Let me just ask the question maybe a different way. Like if we look back at the last period of meaningful deflation, it was obviously a tough period for the industry from a promotional standpoint. If I look at your guidance, it seems to imply there is probably not much deterioration in the gross margin baked in. We sort of look at your numbers historically over a long period of time. I don't think I've ever seen ID growth as low as it's now going to be in the back half of the year without seeing that. We're hearing sort of pockets of more aggressive promotions. I guess, what I'm really trying to understand, Rodney, is why this period is going to be different, why the movie that we saw in 2009 doesn't play out the same way. Because I think just from looking at your numbers and what I'm hearing from you, that's what you're anticipating..

Rodney McMullen

Yes. And when you look at from most of the elements we can see at this moment, we would expect it to look pretty similar to '09. If you look at back in '09, the identicals would be similar. I think we were at 1.3% and 1.8% or something like that. I don't remember for sure.

Mike Schlotman

1.3% and 1.2% in the third and fourth quarter.

Rodney McMullen

Yes. So both of those would be within the range where we've given for the balance of the year. We would certainly expect - typically, you do see a little bit more promotional activity early in inflation cycles just because the competitors think they're losing share versus the it's a fact that it's deflation. And we would certainly include some of those elements in terms of where we expected things to be for the balance of the year. But everything that we can see, '09 would be the most similar. And if you look at '09, there were three quarters of deflation. If you go back and actually look at 2002, there are four quarters of deflation. So those are kind of the points that we're using for references.

Operator

And the next question is from Shane Higgins of Deutsche Bank.

Shane Higgins

And actually, just following a little bit on Ed's question. The deflation that we're seeing today, do you think we're really in a similar situation as in 2009? I mean, at that time, I recall we were cycling some pretty high inflation in '08. That's not really the situation today. Just inflation wasn't very high last year. The economy today is expanding, albeit slowly. So this environment does feel a little bit different. I mean, do you think if we stay in a more sustained deflationary environment that the promotional environment could intensify from here? I don't know, any thoughts you guys have on that would be great.

Rodney McMullen

Yeah. It’s kind of fascinating, your question. I mean, if you look at over the last 8 or 9 years, if you look at inflation on a rolling 5-year basis, the range is 2% to 3% on a rolling 5 years. Now, if you look at it in terms of swings, we had deflation of basically 1% or so, and this includes pharmacy, I should add, up to inflation of 6%. And that the high inflation actually happened, as you referenced, in '08, and it also happened in '11. So to say that it's different this time, I mean, each one of us would have our own opinions. An awful lot of deflation/inflation is driven by what's going on in commodity markets, and most of the commodity markets are incredibly benign at the moment.

And historically, I always like to say high prices solve high prices and low prices solve low prices, because capacity will start changing. And if you look at farmers, they're very smart, and they'll start producing less of the things where they don't make money. So historically, that's what’s caused inflations to swing. And still an awful lot of our business is driven by the commodity markets. If you look at produce, that's just going to be driven by what's the growing season and what's the growing season like. We continue to see good demand. We still continue to see tonnage growth in those elements and those are the things that we're looking at to see, do we think it's different this time.

Shane Higgins

All right. Thanks for that color. And just a quick follow-up, I mean, given that you guys have such a strong private-label portfolio, I believe, Rodney, you said it was 27% of units during the quarter. Does this give you guys some additional flexibility in periods of inflation and deflation in terms of maybe being able to pass along some of the lower costs more quickly? Any color that you guys could give there will be great. Thanks.

Rodney McMullen

Yeah. I'm going to broaden your question a little bit, Shane. For us, corporate brands is a huge, important critical part of our strategy and a very important competitive advantage. And it starts with what products are we offering and what's the quality of those products and the value for those products. We find it always an advantage from a competitive standpoint, because if national brands do something that's non-economic, our corporate brands pick up share. So we find them -- our customers love them and they vote by buying a lot of them. We also find that it's a way of keeping the market honest. We certainly would have an advantage in terms of understanding the true economic cost to produce something, and retail pricing would be based on that true economic cost.

Shane Higgins

And then actually just a -- I'd like to squeeze just one more in. Are you guys working pretty closely with your vendor partners in this period to try to, since you guys understand the costs so well, to try to get the best prices? And how are those conversations going?

Rodney McMullen

Yeah, always. And then as you know, we always look at the CPG companies as partners. And I obviously go to a quite a few meetings where the CPG partners and Kroger meet. And a lot of times, it's hard to figure out who works for who, which I view as a positive. Both of us are trying to drive volume and trying to drive profitability, and most of the CPG teams have a responsibility for part of our profit as well. So I don't see those discussions changing. There are healthy respect, but there are also healthy negotiations that go on. And I don't sense a change in that basic approach. And the other thing that we always feel that we are able to provide the best insights for CPG companies on introducing new items, what's the success, what customers are buying, and we try to work with those partners to grow their business as well.

Shane Higgins

Great. Thanks. I'll get back in the queue.

Rodney McMullen

Thanks, Shane.

Operator

And next, we have a question from Rupesh Parikh of Oppenheimer.

Rupesh Parikh

Thanks. Thanks for taking my question. So I just want to go back to your comments, Rodney, on the U.S. consumer. It sounded more down deep to me versus prior quarters. Just want to get a sense, if you look at your business, are you actually seeing consumers pull back on discretionary spending? Or is that just based on the surveys that you believe the consumer is more cautious?

Rodney McMullen

Yeah. If you look at the areas that we would consider discretionary like high-value wine, Boar's Head, Starbucks, Murray's Cheese, all of those areas, they continue to have nice growth. The comments I made are more based on the surveys that we -- where we survey customers almost every day and the changes in terms of what the customers tell us they anticipate will happen.

Rupesh Parikh

Okay, great. And then switching topics to inflation and deflation. What are you building in for the balance of the year on the deflation front? And is it fair to say that at this point, you're assuming that deflation will continue through at least the early part of next year?

Mike Schlotman

Yeah. We did not provide a point estimate or a range in our 8-K that we filed this morning. We only talked about the fact that we expect to see product cost deflation for the balance of the year. And as Rodney said, it could extend into early next year as well in his prepared comments.

Rupesh Parikh

Okay, great. I'm going to sneak in one last one. From a tonnage perspective, has your tonnage growth been consistent with prior quarters? Or has it -- or did you see any change this period?

Mike Schlotman

We continue to be very pleased with our tonnage growth. It's positive. There's a lot of things that go on inside tonnage growth. There's mixed pack changes. There are certain categories where we've gone to multipack units, bigger selling units of multiple items in the same package. We continue to be very, very bullish about our ability to grow tonnage. Rather, we try to avoid giving an exact measure because it's much as an art, as a science, but it's something we're fundamentally focused on. We had nice tonnage growth, and we continue to have market share growth in the quarter as well.

Rupesh Parikh

Thank you for all the color.

Operator

The next question is from Stephen Tanal of Goldman Sachs.

Stephen Tanal

Thanks so much for taking the question. Good morning. Just a follow-up on that last question a little bit. So the data that we're looking at, I guess, would suggest that input cost deflation should be moderating a bit into the back half. Do you think that that's accurate at all? And how do you see the retail side of this playing out from here? Do you have any expectations for how long this typically -- this kind of thing typically would last?

Rodney McMullen

Well, if you look at how long it lasts, the only insight that I could provide is the comment I made a little earlier. If you go back and look at 2009, it was three quarters. If you go back to 2002, it was four quarters. We've had inflation every quarter other than those since the first quarter of 2002 as how far back we went. On terms of moderating, as you get toward the latter part of the year and early next year, you're starting to cycle the deflation.

So I would -- certainly, we would guess that it would start to moderate just because you're starting to cycle some of the deflation. And an awful lot of the deflation is driven because of commodity pricing. And that would be the reason why that we would believe that it would start moderating. And then when you start cycling, it would -- we don't expect it to be negative for a long period of time.

Stephen Tanal

Got it. Okay, that makes sense. Now is that at all part of sort of the guide here? As you say, you're sort of tracking toward the lower end of the back half guide. Or do you -- would you say that that dynamic reflects your expectation of improvement in retail? Or would you say it's more about the compare? Or how would you describe that?

Rodney McMullen

Yeah, why don't you say it --?

Mike Schlotman

There's a little distraction here in the room.

Rodney McMullen

Yeah. Stephen, if you don't mind asking the question again because all of a sudden, we had extra voice in the room.

Stephen Tanal

Yes, of course. The guidance for IDs, being at the low end now versus obviously a bit of a higher range or a higher midpoint, is that more reflective of your expectation of improvement in retail prices or more about just the compares from a year ago?

Rodney McMullen

I would certainly say a big piece of that is the compare to last year. Last year, in the third quarter, we had 5.4% ID sales. So when you look at the deflation we've had since then compared to that compare, it's really a little bit of a compounding effect as we begin the third quarter here. Keep in mind, last year's fourth quarter was 3.7% IDs, so the compare starts to moderate a little bit as well. And that just -- it's the range we feel that, at this point, where we think we would wind up in.

Stephen Tanal

Great. And if I could just sneak one last one in. If you could comment on the health and wellness side. Obviously, with the Axium date, it seems like you do have some interest in the pharmacy business. Any thoughts on that business, building it out maybe longer term?

Rodney McMullen

Well, it's -- when you look at the total health and wellness strategy, we are very excited about the opportunities there. Obviously, all of us, baby boomers, keep getting older and the new generations as well, and it creates higher demand for pharmaceuticals and other things. So it's an area that we like. It's an area where we believe we have a unique competitive advantage just because we can start helping customers eat healthier as well, and that's something that's a positive in terms of the overall connection with the customer.

And when you look at all the pieces together, we think it's a great opportunity to create sum of all parts where a customer can engage with us in a physical facility, online or through the specialty drug channel and then we can leverage across and then the Little Clinic helps as well. So we really get excited about the opportunities. And the other thing that we really like is that customer is very loyal as well.

Stephen Tanal

Okay. Thanks a lot.

Operator

The next question comes from Ken Goldman of JPMorgan.

Ken Goldman

Hi. A couple of quick clarification questions. The statement about quarter-to-date comps being near the lower end of the range, was that the annual range or the back half range?

Rodney McMullen

It's the back half range. And remember Mike's comment about as you go to this -- first of all, we're cycling incredibly strong identicals a year ago, and then as you get to the fourth quarter, you start cycling identicals that were lower than where they were in the third quarter. I don't know, Mike, anything you're going to add?

Mike Schlotman

I would agree with that.

Ken Goldman

Okay. My other clarification, there were a few deflation numbers that were mentioned this morning. I just wanted to make sure we're on the same page of it with those. I think what you said, and correct me if I'm wrong, total company deflation was minus 1%. Total deflation ex-pharma was minus about 1.25% and perishable deflation was minus 1.5%. Do I have those right?

Mike Schlotman

So yeah, a little less than 1%, including pharmacy; 1.25%, excluding pharmacy; and grocery was about 1.5% negative.

Rodney McMullen

And that's grocery only. And it's the way we define grocery.

Mike Schlotman

Which includes the dairy complex. Not everybody has the dairy complex in grocery, but we do.

Ken Goldman

Okay. I had heard that can be perishables. I guess it was grocery. Okay. Thank you. One quick one here. Sprouts said this week, and if you've addressed this, forgive me, but most of the more extreme pricing actions they're seeing in the marketplace were promo driven, not really list price reductions. Do you agree with that? And if so, is that one of the reasons you have hope that maybe some of the irrationality you're seeing out there will be short lived?

Mike Schlotman

Well, we see a little bit of everything out there. And as Rodney said a few minutes ago, our -- over the breadth of the geographies we have, you see a variety of everything. You see people in certain -- even if they're a broad-based retailer, you see them doing things in one geography and not other geographies, and then you see regionals doing particular things in and out of different promotions and then other people continuing to make investments in price. And we did a little bit of all those as well.

We put out a circular, sometimes weekly, sometimes for a couple of weeks, and we continue to invest in everyday price as well, so it's really no different. I think the thing to keep in mind is, we don't always necessarily just react to what particular competitors are doing with our relationship with 84.51°. We put significantly more science behind how and when we make price investments, whether it's promotional activity or a permanent price reduction.

Ken Goldman

Great. Thanks so much.

Operator

And next, we have Vincent Sinisi of Morgan Stanley.

Vincent Sinisi

Hey, great. Good morning, guys. Thanks very much for taking my questions. Just going back to the comments from the macro perspective, first, on the consumer with the surveys. Wondering if you're seeing anything different kind of sequentially in terms of snap that's being used in the stores or in terms of the items in the basket.

And then secondly, just on the competitive commentary that you gave, I understand that varies by geography. But just wondering just kind of if overall, are you seeing some of the heavier pockets of competition coming from particular segments of the market, whether that be more of the larger conventionals, the big boxes or some of the smaller regionals discount, that type of thing?

Rodney McMullen

Yeah. When you look at the surveys overall, first of all, snap continues to decline and it has for the last, I'm going off of memory, and then Mike, if you remember the exact number, but I want to say like a year-and-a-half or so that it's been declining.

Mike Schlotman

That's about right.

Rodney McMullen

Some of the decline is driven because of changes in terms of what is in snap in terms of programs that get renewed or don't get renewed. If you look at the items in the basket, that's always a tough one to answer because if you look at the items in the basket, we've been flat or up slightly or down slightly for a long period of time. The thing that's important to note is if you look at customers over a month, how do they spend with us, and they continue to spend five more items from us. And as we get better and better in our fresh departments, customers come in and shop our stores more often because on fresh products, people want to buy it. It's not quite to the European standards where people buy daily, but you'll see people increasingly coming into the store every two or three days to pick up their fresh items and that affects the items in the basket.

So I think it's always difficult to overlook it, to look too much at items in the basket, and we would focus much more in terms of, over a month, how our customer is behaving. In terms of the competitors, I don't know that there's too much I can add from what I -- Mike and I mentioned before. Overall, I wouldn't say that we're seeing a huge difference. If you go back and look, you have competitors that had gone out of business that now stores have been reopened in some parts of the country. You have all kinds of different things going on. And to make a blanket statement or -- a blanket statement toward a specific competitor, that, I don't think it would be helpful because I really don't see it changing massively when you look at big groups. I don't know, Mike, anything you would want to add to that?

Mike Schlotman

Yeah. I would agree with you.

Vincent Sinisi

Okay. That's helpful. And if I could just slide one more fast one in here. Just with the kind of the next two years or so of annual CapEx kind of getting back to that sub-4 mark, just any other color that you can give us all in terms of where versus what you have been planning when it was over the 4 range, kind of where some differences may lie?

Mike Schlotman

Well, we've obviously done a lot of work at this point in the year to pare back capital spending in the current fiscal year because you have projects in the pipeline. There are certain projects that will slide into the next fiscal year and then projects from '17 that will slide into '18 probably. And I'll remind you that our -- a few of the $500 million reduction is for this year and next year. Well, for this year and then keeping next year in the same range as this year, we just think it's prudent in this environment to maintain and increase our financial flexibility to respond to the environment that's out there and to have that incremental cash to be able to spend.

Our view is there will always be a significant number of projects in the pipeline, and we're comfortable we're going to be able to do the projects we have the highest level of confidence in and get those built, while maintaining as much financial flexibility as we can. It's not concentrated in any one geography, particularly this year. Frankly, some of it was where did we have stores we're not legally committed to open or start projects on and we feel very good about, that level of spending will still be a record year for spending. So it's not an -- it's a very substantial investment in the business.

Rodney McMullen

The biggest effect will probably be in terms of net new stores. If you just make blanket statements in terms of where will it, but it'll be a little of everything, but that's probably the biggest bucket.

Mike Schlotman

I would agree with that.

Vincent Sinisi

Okay. Very helpful. Best of luck.

Operator

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

Scott Mushkin

Hey, guys. Thanks for taking my question. So I'm kind of just sitting back and listening to the call and trying to compare it to what we're seeing out in the marketplace and there's definitely just a little bit of a disconnect. I mean, you have your biggest competitor, Walmart, that's on the record. They were just at the Goldman Sachs conference, and I'm sure you guys see the research. I mean, they're clearly moving on price in certain geographies and have said that they are going to continue to do that. And we can also see the market share moving pretty quickly towards them.

Then we saw Albertsons, your second biggest competitor, lowering price pretty aggressively, not in all geographies but in several of yours. But you guys say you don't see anything different. So I mean, are you hoping they just don't keep coming at you? I mean, we do see your comps now at about 0.5% and it seems like the market share has -- your market share gains have ebbed. So I'm just trying to understand the strategy a little bit better.

Rodney McMullen

Well, if you look at our market, we continue to gain market share in the second quarter. If you look at it from a competitive standpoint, our second biggest competitor would actually be somebody other than Albertsons. I don't remember where Albertsons is right now, but Costco would be the second largest competitor. I always think it's important to look across the whole country and what's going on, and I made the comment before about all short statement. All short statements in economics are wrong. And there, you can see behavior, all kinds of different behavior across the country, what competitors are going to do. Your guess is as good as ours would be in terms of whether that's something they're going to do everywhere or if that's something they're testing or -- and what speed does it take for them to do it everywhere. I don't know, Mike, anything you'd want to add?

Mike Schlotman

I agree. And keep in mind, when you think about what competitors are doing, it's not like our prices have remained stable or increased. We continue to invest in price as well.

Scott Mushkin

So I mean, I guess, last quarter, I asked Rodney that if Walmart did follow through, what would you do, would you continue to keep your gap where it's gone, which is lower. It's been lower over the last several years, it's pretty narrow in the mid-single digits in a lot of markets, not every market. It seems like now, you seem okay at least in certain markets with that gap to move up maybe back into the mid-teens, and I'm just again, I would push on why.

Rodney McMullen

I would challenge your comment because first of all, we would not publicly say what we're going to do from a competitive standpoint in advance of doing it because I think the FTC would probably get a little upset with us along with, I know, our general counsel would be. And I did not say that we would be comfortable with any specific number, and you were the -- and you gave the specific numbers that you speculate what that is. I would go back to the comments that Mike and I made before. We continue to execute our strategy. There's parts of the strategy that's more important than just price. It really is everything all together. To say, to react to specific comments, I think, would be very difficult. And how you look at a basket of goods may be different than now a customer looks at a basket of goods as well.

Mike Schlotman

One of the other things that continues to fascinate me with all the conversation about investing in price or not investing in price, 18 months ago, all the questions I was getting is, why do you guys continue to invest in price, why don't you let your gross margins go up? You've closed the gap everywhere and now you can reap the benefits of what you've sown. And we've staunchly said for years we're going to continue to invest in price because if you look at any segment of retailing, over any period of time, gross margins always decline, and we'll continue to maintain our financial flexibility and execute our customer first strategy and invest not only in price, but the three other elements of it as well.

Scott Mushkin

And then just one last quick one. Are you guys happy with where your market share gains are so far in the third quarter? And then I'll yield. Thanks.

Rodney McMullen

Well, looking at market share gains, I don't think it's -- the data isn't quick enough to be able to answer where we are so far in the third quarter on market share gains. And I actually couldn't answer the question because we wouldn't have the data yet from the market. And we look at market share by looking at Nielsen data, IRI data and other sources. Thanks, Scott.

Scott Mushkin

All right, guys. Good luck. Thanks.

Operator

And the next question is from Robby Ohmes of Bank of America Merrill Lynch.

Robby Ohmes

Good morning, guys. Thanks for taking my question. I apologize ahead of time. I'm going to ask a couple of quick clarifications. I hope you answer them. On the deflation, can you give us some insight on -- I get the meat deflation and the commodity-driven deflation. But can you give us some insight, as you rolled from the first quarter and into the second quarter, did the deflation spread out significantly in the center of store? And are you seeing and expecting deflation in sort of the CPG-driven part of your business? That's one clarification I'm looking for.

Mike Schlotman

It certainly did pick up in the grocery category in the second quarter as far as more deflation. The other thing that's happened, and I said this actually earlier today when I was on CNBC, if you look at produce, it wasn't deflationary in the quarter, but it was -- there was this inflation in produce in the second quarter. So it was less inflationary in the second quarter than the first quarter, so we were -- it's fairly broad based.

Rodney McMullen

Yeah, but if you look within grocery, it's heavily driven by the dairy category, which is obviously mostly milk. Eggs is a huge part of that. So if you look at the acceleration, it's really being driven by a few select items within it.

Mike Schlotman

Fair point.

Robby Ohmes

And then my second clarification is if you look at the natural organic category within your store, whether it's looking at it at Simple Truth or looking at the natural organic brands that you've now been carrying for a while, is natural organic deflating right now?

Rodney McMullen

It would only be in terms of the areas that are commodity driven. So if you look at eggs, eggs is kind of fascinating because there wasn't as much inflation a year ago in eggs that were organic eggs. So the deflation there isn't as much. It's because they didn't inflate as much. Milk would be a little bit. But if you look at the alternatives in terms of grain-based milks, really not so much there. I don't know, Mike, any --

Mike Schlotman

I agree with you.

Robby Ohmes

That's great. And just last one, not a deflation question. Can you just give us a sense of Simple Truth momentum and penetration and remind us where that's at?

Mike Schlotman

We continue to be thrilled with Simple Truth. It continues to grow as a brand. More and more households continue to enter into the category and just stay in the category. Our corporate brand folks continue to do a great job of expanding the category with incremental products in the category as well. It's really the cornerstone of our natural and organic program.

Rodney McMullen

And it would continue to be growing at close to double digits, especially if you don't include chicken because there's quite a bit of deflation in chicken.

Robby Ohmes

Got it. Terrific. Thanks, guys.

Rodney McMullen

We have time for one more question.

Operator

And the next question will come from Alvin Concepcion of Citi.

Alvin Concepcion

Good morning. Thanks for squeezing me in. Just in regards to your 8% to 11% long-term earnings guidance, would you expect to return to that range in 2017? And the follow-up to that is, what gives you comfort in that level of earnings growth, especially since many folks are worried that the promotional environment will intensify down the road?

Rodney McMullen

I wouldn't feel comfortable telling you the specific time until we give 2017 guidance. So -- and I don't want to think we want to go ahead and give '17 guidance now. And we really look at it over a rolling three to five-year period of time. And if you look at it historically, we've actually grown in -- well in excess of the 11% over a three-year period of time and a five-year period of time, both on the quarter and the annual basis. So it really is -- when you look at the overall ability to connect with the customers, that's why we feel comfortable with that 8% to 11%. We still see tremendous opportunities to improve the way we connect with customers and the way we run our business.

And you guys hear me say often that our to-do list remains bigger than our done list, and that certainly remains the case. And that's the reason why we remain confident in the 8% to 11% plus a dividend that's increasing over time, is that we still see plenty of opportunities to grow the business, connect with a customer in a deeper way and to continue to run our business better. And it's one of the things that's exciting every time you figure out something that you could do better and you do it, it helps you learn how to do something else better. So that's the reason why we get excited. At this point, I wouldn't feel comfortable to give you the specific period of time and obviously, at some point, we'll give some guidance on '17, but it's really too early at this point.

Alvin Concepcion

Great. Just a couple of quick clarifications as well. On the taxes, the employee share-based payment, is that a onetime thing? I mean, should we expect the 35% tax rate going forward into '17?

Mike Schlotman

Yeah. It's purely driven by how many stock options wind up getting exercised in any time frame and a reclassification from an accounting standpoint where the benefit of that goes in the financial statements.

Alvin Concepcion

Great. And last one for me. Just you've given guidance on fuel gross margins in the past. I think you've previously said it would be at or below the 5-year average. Is that still your view for this year?

Mike Schlotman

Our view for the rest of the year is it will continue to -- on a rolling four quarters basis, it will continue to trend down from where we finished the quarter, and I wouldn't see that expectation any different. We had a very, very strong fuel quarter last year. It's actually held up better so far this year than we thought. We finished the rolling four quarters at the end of the second quarter at $0.184. That was down $0.002 from last year. We would expect that downward trend to continue a little.

Alvin Concepcion

Great. Thank you very much.

Rodney McMullen

Thanks, Alvin. Before we end today's call, I'd like to share some additional thoughts with our associates listening in today. I want to thank the many associates sharing in the Kroger journey. We have six generations working with us today. Each associate makes a unique contribution. You bring your energy and ideas, your experiences and expertise. We are a better company because you've made Kroger the place where you want to be and work. Even as we've grown and gotten bigger as a company, I know that when the doors open and the lights go on at our stores, offices, distribution centers and manufacturing facilities, everyone is giving their best to our customers, our company and each other. That means a lot and that will make all the difference. Thank you for everything that you do for our customers 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.