The Kroger Company (NYSE:KR) Q4 2019 Earnings Conference Call March 5, 2020 10:00 AM ET

Company Participants

Rebekah Manis – Director-Investor Relations

Rodney McMullen – Chairman and Chief Executive Officer

Gary Millerchip – Chief Financial Officer

Conference Call Participants

Robby Ohmes – Bank of America Global Research

Ken Goldman – JPMorgan

Rupesh Parikh – Oppenheimer

Kelly Bania – BMO Capital Markets

Edward Kelly – Wells Fargo

Christopher Mandeville – Jefferies

Simeon Gutman – Morgan Stanley

John Heinbockel – Guggenheim Securities

Operator

Good morning and welcome to the Kroger Company Fourth Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note this event is being recorded.

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

Rebekah Manis

Thank you, Gary. Good morning, and thank you for joining us. Before we begin, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions, and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings, but Kroger assumes no obligation to update that information. Both our fourth quarter press release and our prepared remarks from this conference call will be available on our website at ir.kroger.com. After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question and one follow-up question, if necessary.

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

Rodney McMullen

Thank you, Rebekah. Good morning, everyone, and thank you for joining us. With me to review Kroger's fourth quarter and 2019 fiscal year results is Chief Financial Officer, Gary Millerchip. We were pleased with our 2019 results and improving trends in our supermarket business. As a result of our customer obsession and renewed intensity around operational excellence, we delivered on our commitments for identical sales without fuel, adjusted FIFO operating profit, cost savings and delivered over $100 million of incremental operating profit through alternative profit streams in 2019.

For the full year 2019, we delivered on the total shareholder return, or TSR, model that we outlined at our Investor Day, and are positioned to deliver on our TSR model of the future, where you're using the power of Kroger's stable and growing supermarket business to create meaningful incremental operating profit through the alternative profit stream businesses, positioning our business for long-term growth that generates consistently attractive total shareholder returns. We continue to generate strong and durable free cash flow as reflected by the fact that the company has reduced debt by $1.1 billion over the prior four quarters and continues to increase the dividend to create value for shareholders.

In total, we returned $951 million to shareholders in 2019. Our confidence that we can deliver even stronger TSR in the future is guided by our strong free cash flow and sustainable net earnings growth. By executing against the Restock Kroger framework, we are repositioning our business by widening and deepening our competitive moats. The four main areas of Restock Kroger framework redefine the customer experience, partner to create value, develop talent, and live our purpose continue to be a top strategic priority for us.

We are continuing to enhance the customer connection with investments in our competitive moats today, which are product freshness and quality, Our Brands and personalize rewards, and our competitive moat of tomorrow, the seamless ecosystem we are building. Fresh continues to be an important driver of sales for Kroger. Our fresh departments drive trips, loyalty and gross margin. Again, our produce department's strong identical sales for the quarter demonstrated how our store teams are focused on improving everyday execution in ways that are highly relevant to our customers.

Our Fresh for Everyone campaign has been well received and is driving significant improvements in marketing effectiveness. It is also driving more trips to our seamless ecosystem in-store and online. Our Brands achieved its best year ever, exceeding $23.1 billion in sales. We introduced 758 new Our Brand items in 2019, which helped drive strong year-over-year sales lift across our portfolio of brands. Since its launch in 2023, Simple Truth has become the leading natural and organic brand in the country with annual sales exceeding $2.5 billion in 2019.

After identifying plant-based foods as a key food trend well before 2019, we introduced the Simple Truth plant-based collection in 2019, and that launches off to a strong start. The Simple Truth brand expanded into plant-based meats with Emerge grinds and patties in January. And in only one month, these products ranked third in the category for the entire fourth quarter.

Our Private Selection brand eclipsed $2 billion in sales for the first time. The Kroger brand exceeded $13.7 billion in sales, capitalizing on product development around key customer trends like global and regional flavors.

Kroger continues to invest in digital as we build a seamless ecosystem that combines the best of the physical store experience with the digital customer experience for our customers. This is where customers are increasingly going to meet their needs. We know our customers value the greater convenience this provides, and our data shows it's an essential component of driving overall loyalty. Digitally engaged customers not only drive growth through our digital modalities, they also help drive brick-and-mortar sales growth and share of wallet as well. Providing our customers with the ability to have anything, anywhere, anytime from Kroger sets us apart from a large segment of our competitors and will drive loyalty, as well as our long-term growth and margin expansion.

Our approach to partnerships is simple, but not simplistic. We think they work best when the two of us can do things together that neither of us could have done alone. We are roughly a year away from our first fully functional customer fulfillment center with Ocado in Monroe, Ohio. These facilities will accelerate our ability to provide customers with a seamless experience in a much more cost-effective way. We continue to be excited about the partnership. As we shared previously, we believe Ocado's value as a partner is not just on its current capabilities, but also how quickly the company is able to innovate and serve rapidly changing consumer market.

We continue to roll out our plan, and you should not assume just large facilities. We are designing a flexible distribution network combining disaggregated demand and proximity of our stores, medium-size facilities and large facilities. Our network will flex as demand matures and the optionality will allow us to fulfill same day or next day delivery or pickup, and the customer or store replenishment.

As America's grocer, we continue to invest in our associates as part of Restock Kroger and have made significant investments in our associate wages. The investments Kroger is making in human capital is putting more money in our associates' product – pockets today. Our investments in associate wages has increased Kroger's average hourly rate to $15 an hour in 2019. And with our comprehensive benefits factored in, our average hourly rate is over $20, benefits that many of our competitors don't offer. We are working hard to ensure that we have the right talent, teams and structure in the right focus areas in our core supermarket business and our alternative profit businesses.

Our focus is on developing, training and promoting internal talent while at the same time hiring seasoned food industry executives to drive our retail supermarket business. In addition to investing in American workers and communities, Kroger is also leading the effort to end hunger in the places we call home, and eliminate always across the company through our award-winning Zero Hunger | Zero Waste social impact plan. We made this bold commitment rooted in our purpose because we fundamentally believe that customers, associates and investors are increasingly choosing where to shop, work for and invest in companies that are purpose-driven and are actively making the world a better place.

In these ways, Restock Kroger is the right framework to reposition our business to create value for all of our stakeholders both today and in the future. Our focus on the strategic drivers is expanding Kroger's competitive moats and will drive total shareholder return in 2020 and beyond.

And now, I will turn it over to Gary for more details in the quarter financials. Gary?

Gary Millerchip

Thanks, Rodney, and good morning, everyone. As I get started, I'd like to remind you of the key things we shared during our Investor Day. Our model is built upon a strong and durable base, driven by our retail supermarket, fuel and health and wellness businesses. It begins with the customer and our obsession with increasing customer loyalty. Our intensified focus on execution and continued improvements in the value and experience we deliver for our customers drive increased identical sales of our fuel across our store and digital ecosystem.

To drive sustainable sales growth, we continue to invest in areas of the business that are important to our customers. This includes ongoing investments in talent, price, digital, and store experience, with an even greater emphasis on our competitive moats: Fresh, Our Brands and Personalization, plus the moat we are in the process of building a seamless ecosystem. We also committed to be very deliberate in balancing these investments with disciplined execution of cost savings that simplify our business.

Our full year 2019 results demonstrated clear progress toward delivering on this model and generating consistently strong and attractive total shareholder returns. Identical sales without fuel grew 2% in 2019. While first quarter results came in below our identical sales guidance range, the balance of the year came in at the top end of our guidance at 2.25%.

Adjusted FIFO operating profit of $3 billion came in at the top end of our guidance range and demonstrated the strength of our multifaceted business model with industry-wide retail pharmacy gross margin headwinds offset by strong fuel results. We demonstrated financial discipline by balancing investments in our customers, associates and the development of our seamless ecosystem with significant cost savings. This was evidenced by our improvement in OG&A rate of 29 basis points, more than offsetting our investments in gross margin rate of 23 basis points during 2019.

We achieved over $1 billion of cost savings in 2019 on top of the $1 billion of savings in 2018. We also have clear line of sight to $1 billion of incremental savings in 2020. These savings are being achieved through improved productivity and automation, elimination of waste, improved sourcing of goods to sale and could not for resale, and administrative efficiencies. We also achieved over $100 million of incremental operating profit through alternative profit streams in 2019 and delivered FIFO net operating profit growth within our 3% to 5% target range shared at Investor Day. Adjusted earnings per share came in at $2.19, the middle of our guidance range.

Finally, we generated strong adjusted free cash flow, which we have used to pay down debt and bring our leverage ratio within our target range and reintroduce share repurchasing in the fourth quarter.

Now, I'd like to provide commentary on Kroger's fourth quarter results. We delivered fourth quarter adjusted EPS of $0.57 per diluted share, up 18.8%. LIFO charge for the quarter was $36 million compared to a LIFO credit of $10 million for the same period last year. This increase was driven by higher inflation in dry grocery, pharmacy and dairy.

Our corporate tax rate for the fourth quarter was 18.2% compared to 20.8% for the same period last year. This decrease resulted from an increase in tax deductions. Adjusted FIFO operating profit for the fourth quarter was $758 million, up 20.7% compared to $628 million in the fourth quarter in 2018.

Kroger reported identical sales without fuel of 2% during the fourth quarter. Several departments outperformed in our supermarket business, including produce, key beverage categories, pharmacy and natural foods. The underlying trends in the business were strong. November and December identical sales were consistent with third quarter performance. As expected, January was negatively impacted as we lapped incremental SNAP dollars in the market in January 2019 and we experienced milder weather this year. February bounced back nicely and performed in line with our expectations and slightly ahead of the trend in the third quarter and November and December.

As a reminder, we do expect SNAP to positively impact the first quarter of 2020 as we lap a 15 basis point headwind from prior year. We expect identical sales in 2020 to improve over 2019 as we drive increased customer loyalty through Fresh, Our Brands, Personalization and Seamless.

Digital contributed approximately 75 basis points to identical sales without fuel. Kroger pickup and delivery continue to grow in a faster pace than our overall digital growth. During the 2019 holiday season, we offered a limited time free pickup promotion in select markets. Customers responded positively to the promotion and we were pleased with our fourth quarter digital sales growth of 22%.

Gross margin was 22.1% of sales for the fourth quarter. The FIFO gross margin rate excluding fuel increased six basis points. This increase resulted from improvements in cost of goods, accelerated alternatives in profit streams and cycling of investments in the fourth quarter of 2018, partially offset by investments in price and personalization, continued industry-wide lower gross margin rates in pharmacy and growth in the specialty pharmacy business.

Our Associates continue to do an impressive job managing shrink, which improved in the fourth quarter compared to last year. This represents the 10th consecutive quarter of year-over-year shrink rate improvement.

While retail pharmacy gross margin continued to be a headwind in the fourth quarter, retail pharmacy remains an important part of our strategy and continues to generate good returns and strong customer loyalty. OG&A cost as a rate of sales excluding fuel and adjustment items decreased 79 basis points in the quarter. Part of this was due to cycling of investments in OG&A made in the fourth quarter of 2018, plus broad-based improvements in Restock Kroger savings initiatives. We were pleased with our ability to deliver OG&A improvements above the level of gross margin investment as a rate of sales in 2019, and we expect that balance to continue in 2020.

Fuel is an important part of our strategy to drive customer engagement. Our loyal customers received hundreds of millions of dollars in fuel rewards in 2019 in the form of price discounts at the pump. The average retail price of fuel was $2.58 this quarter versus $2.34 in the same quarter last year. Our cents per gallon fuel margin in the fourth quarter was $0.33 compared to $0.34 in the same quarter last year. Fuel is a great example of Kroger's sourcing teams continuing to improve buying practices. This allowed us to achieve improvements in fuel cost of goods in the fourth quarter.

Alternative profit streams contributed an incremental operating profit of more than $100 million in 2019. Media and Kroger Personal Finance continued to be the primary drivers of growth. Brands continue to invest in Kroger Precision Marketing because we close the loop between media exposure and store and digital sales to make brand advertising more addressable, actionable and accountable. An annual survey by the Path to Purchase Institute gave us strong ratings for effective targeting, measurement, sales growth and ROI.

Most recently, we became the first retail media platform to be awarded Platinum certification by the Trustworthy Accountability Group for meeting guidelines to improve transparency and prevent ad fraud, malware and piracy. We're committed to being the most transparent media organization and making the entire digital media ecosystem a safe and effective investment for CPG brands.

As Rodney mentioned, we continue to invest in our associates as a key part of Restock Kroger in a variety of ways, including investments in wages, training and development. We ratified new labor agreements with the UFCW covering associates in Memphis during the fourth quarter. We are currently negotiating with the UFCW for contracts covering store associates in Las Vegas and Houston.

Looking ahead, we have several major negotiations in 2020, including contracts with UFCW for store associates in Dallas, Food 4 Less associates in Southern California, and Fry's associates in Arizona. Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality affordable healthcare and retirement benefits for our associates. We strive to make our overall benefit package relevant to today's associates.

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

We continue to generate strong free cash flow and are being very disciplined in how we deploy it to deliver strong and attractive total shareholder returns. We are committed to investing in the business to drive profitable growth, maintain our current investment grade debt rating and return excess free cash to investors via share repurchases and a growing dividend.

In 2019, Kroger reduced our net total debt by $1.1 billion, bringing our net total debt to adjusted EDITDA within our target range. We also returned $486 million to shareholders in dividends and repurchased $400 million of shares in the fourth quarter of 2019 under our $1 billion Board authorization.

At our Investor Day, we committed to continue to apply a rigorous and disciplined approach to capital management and we are focused on ensuring our capital projects deliver strong returns. Consistent with our approach in 2019, the majority of our investments in 2020 will be allocated to driving profitable sales growth, improving productivity and building out our supply chain and seamless ecosystem. We also committed to effectively manage our portfolio of assets to improve ROIC over time.

As part of our review process in the fourth quarter, we recognized an impairment charge relating to the planned closing of 35 stores across the footprint in 2020. This is reflected in the $52 million of transformation costs recognized during the fourth quarter.

As we have shared with you previously, Kroger made the decision to divest our interest in Lucky's Market in the third quarter of 2019, and we took the appropriate impairment charge based on the information available at that time. Subsequently, the decision was made by Lucky's Market to file for bankruptcy in January, which led us to fully write-off the value of our investment and deconsolidate Lucky's Market from our consolidated financial statements. This resulted in a non-cash charge of $174 million in the fourth quarter. Kroger maintains liabilities associated with certain property-related guarantees that will result in Kroger making payments to settle these over time. These items have no effect on net earnings per diluted share or adjusted free cash flow guidance for 2020.

Turning now to guidance for 2020, building on our momentum in 2019, we continue to expect identical sales without fuel of greater than 2.25%. We also continue to expect adjusted FIFO operating profit of $3 billion to $3.1 billion and adjusted net earnings per diluted share to range between $2.30 and $2.40. Looking at the cadence of EPS growth in 2020, we expect the first quarter to be below our annual EPS growth range of 5% to 10% as we cycle real estate gains in the fourth quarter of 2019.

Overall, I'm encouraged with the momentum created in 2019, which provides a solid platform from which to deliver on our commitments in 2020.

Now, I'll turn it back to Rodney.

Rodney McMullen

Thanks, Gary. Before we invite your questions, I'd like to say a few words about the coronavirus. From a financial standpoint, it is too early to tell the effect on our business. It is not included in our guidance, and while it is obviously very early for this public health event in the United States, we are not seeing anything so far that would cause us to change our guidance.

From a business preparedness standpoint, we've established an internal task force that has activated our pandemic preparedness plan with a focus on our customers, associates and supply chain. We generally believe that we have limited supply chain exposure in China as the majority of the products we source is domestic. We certainly feel for those in America and around the world who have been affected. The health and well-being of our associates, our customers and our communities is Kroger's top priority. Always being there for our communities is part of our heritage, and especially in times of uncertainty. We believe everyone deserves to have access to affordable fresh food.

Returning now to our business results, I want to stress that Restock Kroger is the right strategic framework to deliver both on our 2020 guidance and to position Kroger for sustainable growth and total shareholder return.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from Robby Ohmes with Bank of America Global Research. Please go ahead.

Robby Ohmes

Thanks for taking my question. Good morning.

Rodney McMullen

Good morning.

Robby Ohmes

A couple of quick ones. First, just on ClickList, with the kind of fee waiver and the response to that, maybe some color what happens after you put the fee back in? And also, what are your sort of intermediate term thoughts on keeping a fee versus getting rid of it like some of your competitors seem to have? That would be one. And then, just two other quick ones. Just the pharmacy expectations for 2020 and the fuel profit assumptions in your guidance for 2020, maybe just give us some color so we can think about those things in our modeling. Thanks.

Rodney McMullen

Thanks, Robby. As Gary mentioned, when you look at the digital promotional offer on the waived fee, overall we're happy with what we learned. We did engage with some new customers. I think it's important to remember that this was a test among many, many tests that we continue to do. And overall, what we're focused on is really how to create a seamless experience.

In terms of going forward, I wouldn't be comfortable sharing our exact plans because obviously that will tell our customers – our competitors – excuse me – what we're planning to do. And the customer behavior was consistent with what we expected. They were happy, and the results since then have been consistent with what we expected as well. And overall, I think it's always important to remember what we're really trying to do is build out a seamless experience, and what we find is the better job we do on creating that seamless experience, creates a deeper and deeper loyalty strategy.

In terms of pharmacy expectations and fuel, Gary, I'll let you answer both of those.

Gary Millerchip

Sure. Thanks, Rodney. Thanks for the question, Robby. So, as you think about the model for 2020, I'll maybe refer back a little bit to some of the things that we talked about at Investor Day. We very much look at the overall customer ecosystem across our food and grocery business, retail pharmacy business and also the fuel business and overall, how do we manage those multifaceted parts of the model. And I think as you look at our performance in 2019, some of the prepared comments, we feel like it's a really good demonstration of how we're managing that model where really the pharmacy headwinds that we saw in 2019 were fully offset by the fuel benefits that we saw and then the sort of foundational food and grocery business was pretty stable within that environment.

I would say as we look toward 2020, we'll be managing the business in a very similar way. When you think about our overall guidance for 2020, we're essentially expecting that ecosystem to be relatively stable overall and alternative profit will drive us toward the operating profit growth that we've shared for the full year. Within that guidance, we do expect that pharmacy will continue to have some headwinds, nothing to the extent that we saw in 2019. We think the gross margin structural challenges will continue in 2020, but the team has done a great job in continuing to look for opportunities to take out cost where they don't have value for the customer, our associates, and looking for ways to improve our cost of goods where we have control over those items. So we would expect just to see less of a headwind albeit still somewhat of a headwind from pharmacy in 2020.

We would also expect fuel obviously to start to normalize and so probably something of a headwind there within the overall model and really the way that we cycle those will be through the strength of continuing to improve our IT sales in the core and the $1 billion of cost savings that I talked about overall within the model. So, overall, we think about it very much is, all those moving parts creating a relatively stable core business from an operating profit point of view in 2020 and also the profits driving the growth in the year.

Rodney McMullen

Gary's last point on the incremental profit from alternative profit is an important part – thing to remember as well. And as we shared in our guidance, we expect it to range somewhere between $125 million and $150 million.

Robby Ohmes

That's very helpful. Thanks so much, guys.

Rodney McMullen

Thanks, Robby.

Operator

The next question is from Ken Goldman with JPMorgan. Please go ahead.

Ken Goldman

Hi. Good morning. Thank you.

Rodney McMullen

Good morning.

Ken Goldman

Two for me. First, I wanted to – I know it's way too early for you guys to sort of quantify the coronavirus impact, but that won't stop me from trying to ask. And I appreciate any help you can give. Can you at least directionally talk about whether it's been a benefit so far in the last couple of weeks? I mean, Campbell Soup yesterday talked about how they are experiencing better orders in the last week or so from some of their customers. We've certainly read about stockouts of water and so forth. At least directionally, do you think it's been somewhat of a help so far or is it really just way too early to say for sure?

Rodney McMullen

Personally, I'll let Gary if he disagrees; I just think it's way too early to say for sure and the key thing is, as I mentioned before, we want to make sure we're there for our communities, our customers and our associates. And the comments that Campbell's and others have said, certainly, we would see an increase in volume in certain categories. And if you think about a lot of the basics and things that people would need to be able to keep and maintain their health and those things, but it's so early in the process in the United States and the only pattern that we would have any idea on how to look at it would be China, because it's the most far developed in terms of going through the impacts. And all of our teams, our stores, our supply chain team, our procurement folks are incredibly focused on making sure that we stay in stock on those critical items and partnering with CPGs and our own supply chain to replenish that. I don't know if, Gary, anything you'd want to add to that?

Gary Millerchip

Yes. I would completely agree with your comment, Rodney. I think it's really too early for us to really, have a sense of how customers' overall behavior will change and what the impact will be. The situation obviously, evolves in the U.S. market. I guess, just to build on a couple of points, Ken, with the data points that we do see today. As I mentioned in the prepared comments, February was generally in line with what we would have expected for the period, the first month, if you like, of our new year. So, we didn't see anything dramatically different from what we would have expected during that time period. Certainly, the trend has improved over – slightly, over what we saw in Q3 and November and December. So, we will have to see that after January was a month that we knew would be a tough one to cycle.

And as Rodney mentioned in the last few days, I think you've seen more advancing response to the media activity and sort of the advice out there in the market of customers starting to spend more on things like water and hand sanitizer, hand soap, paper, and then some of the maybe, the box dinners and soups that you might expect just based on the guidance that's being given to consumers in the market. So, there's certainly been heightened activity in that regard. But how that plays out and how it impacts the overall shape of the way customers behave and shop, I think it's really – it's really literally nothing in the last few days that I would say there's anything different that we would have seen versus what we expected and how that plays out over a longer period of time is really, I think, impossible to tell.

Ken Goldman

Totally understand. I appreciate that. Can I ask a very quick follow-up? Depreciation and amortization seemed to be a little bit higher than most people we're looking for this quarter. Gary, can you help us understand or think about how to model that for 2020? What numbers do you have in your internal models?

Gary Millerchip

Yes, sure. Thank you for the question. Yes, it is an area, Ken, where we saw some lumpiness during the year. A part of that is to do with the fact that as we've been dynamically changing our capital allocation, the average life of some of the investments that we make in technology look different from some of the traditional investments that we would have made in a traditional store remodel or a new store opening. We're still investing in those areas, but the mix is certainly changing over time. As that normalizes out, we would be looking at a range of 3% to 5% as sort of an annualized increase in depreciation to kind of give you more of a big picture perspective on how to think about 2020, if that's helpful.

Ken Goldman

Thank you so much.

Rodney McMullen

Thanks, Ken.

Operator

The next question is from Rupesh Parikh with Oppenheimer. Please go ahead.

Rupesh Parikh

Good morning, and thanks for taking my questions.

Rodney McMullen

Good morning.

Gary Millerchip

Good morning.

Rupesh Parikh

I want to go back to the comments Rodney made about Ocado and the flexibility to just – to not just assume large facilities. If you can just talk more about the flexibility you guys have to – I guess that different facility size, and just how you guys are thinking about that flexibly going forward.

Rodney McMullen

Yes. As we've talked about before, we really do believe it will end up being a combination of our physical stores, sheds that are small, medium and large size. The ones that we've announced so far have been all large size, but over time, Ocado continues to spend significant money in R&D and continues to push. So, we would expect it will be a combination of a store-based model, smaller type facilities and bigger type regional facilities, and Ocado will be a critical partner in that overall ecosystem. And by having those combined, it will also allow us to have the best cost of goods coming into the various sheds and using the total assets that we have today.

So, we feel really good about the pieces of the puzzle that we're putting together, and we really think the – it will support the ability to do both same day and next day, and what we find is, in some cases, customers like same day, some things they like next day. But – and we're excited – we're really looking forward to the facility in Monroe opening and the second facility in Florida will open soon after that.

Rupesh Parikh

Great. And then just one follow-up question. So, I guess, you announced the closing of 35 stores. Is this the right way to think about the cadence going forward or just maybe, just walk us through I guess the rationale for these store closures.

Gary Millerchip

Sure. Thanks for the question. It's – I think I've talked a little bit about it at the Investor Day and then in the prepared comments. What we are really focused on is taking a step back and making sure as we think about how the overall portfolio of assets are performing, how do we make sure we're really setting ourselves up and making the right investments to accelerate and grow the business, but also looking, where we have opportunities to optimize the portfolio and to drive obviously, ROIC over a period of time.

I would say that this is very much sort of a stand-alone review that we've taken a step back and said, look at stores where – the average to give some context around it, the average store age is about 28 years old. So, these are in many cases older stores. They are geographically spread across the country. So, there aren't particular markets that is focused on. It's very much more about looking at our portfolio and really making sure that as we see where the customer is going, where we invest our dollars to really drive and support our customers, and how we continue to evolve the whole ecosystem that Rodney referred to in his opening comments, just making sure that we're really being disciplined in investing, where we see the future growth in the business. And so it's one of those things that just is part of as we manage the business and look for ways to continue to improve and optimize, we're looking to be very deliberate in making those decisions.

Rupesh Parikh

Great. Thank you for all the color.

Rodney McMullen

Thank you.

Operator

The next question is from Kelly Bania with BMO Capital Markets. Please go ahead.

Kelly Bania

Hi. Good morning. Thanks for taking my questions.

Rodney McMullen

Good morning.

Kelly Bania

I wanted to just talk about – hello – just alternative profits and really, where trade promotion dollars ended up for the year. In your conversations with CPG, just curious if you're finding that there is not any cannibalizations or plans for cannibalizations as this matures. And just updated thoughts there?

Rodney McMullen

I'll talk broadly, and then I'll let Gary get into the specifics. It's one of the reasons that we partner on the media side of the CPGs. And one of the things that we have a very open and transparent relationship going both ways. So, we don't want to spend money on media if the CPG isn't getting a return for it. And that was the reason why we thought it was so important to get the Platinum certification from the Trustworthy Accountability Group, is that we want to make sure that when we invest the CPG money that we're able to show that they get a return for it.

And by making sure that people are getting a return, that's the best protection to make sure that they're just not moving trade dollars over and we tell the CPGs, it doesn't do us any good if you just move the trade dollars over. What we're trying to do is provide something that you can't get in the marketplace from a media standpoint. We're getting great feedback from the CPGs. We have an incredibly high retention rate and many CPGs continue to expand the amount of money they spend with us. Gary, I'll let you get a little bit more into some of the details.

Gary Millerchip

Sure. Thanks, Rodney. And obviously, I would agree with everything you shared there. I think one of the key things that the team is focused on is really working collaboratively across Stuart Aitken's team that leads the media group and then Joe Grieshaber's team that leads our merchandising capabilities to make sure that we really are managing all the moving pieces together. And I would say we feel very good around how those relationships are working to make sure that we're capturing the dollars and really helping support our CPG partners to grow their business effectively through the work that we do in the merchandising group, and also through the alternative profit streams with the media business.

I wouldn't say that we see anything that's causing us to believe that as the way this is being managed that they are very much discrete buckets that are generally being allocated to particular activities. We feel very positive about the progress that we're making there on how we see – I would probably characterize it as how we see it choke in cost of goods and how it flows through to the gross margin. I would say it's one of the reasons that we called it out in the quarter earnings releases. We certainly continue to invest in price and personalization for our customers, but the combination of cost of goods, benefits and alternative profit streams fully offset that in terms of the impact on gross margin and a part of the reason why we were able to see a solid performance on gross margin during the quarter.

Kelly Bania

Okay. That's very helpful. And maybe, just – since we were on gross margin a little bit, maybe just another question on pharmacy. So, it sounds like the headwind there should moderate a little bit from last year as we look into 2020. But what is the – what is your long-term expectation there? Does this ever go away or is this kind of the new norm?

Gary Millerchip

I think certainly, our assumption in the model is that we expect to continue to see pressure in certain parts of the way the pharmacy business is structured. Our focus is on really making sure that we're continuing to improve our operation in a way that ensures that in addition to all the great things that our pharmacy business does for us today around driving overall customer loyalty and delivering a great experience in the store for customers that we continue to evolve the way we think about the business model. I mentioned some of the things in one of the earlier comments around how we're taking cost out of the model, where that makes sense and doesn't create value for our associates working in that part of the business or for our customers.

We've launched a number of new services like the Kroger pharmacy program that allows us to be able to deliver the more value for the customer. I'm sorry, but also if we had an influence more of the dynamics of how the profitability works in the marketplace and to really deliver more value for customers through that program.

And then I think the third piece that we talked a little bit about, I think, on our previous call is, we truly believe that the power of our data and the overall relationship that we have with the customer potentially opens up opportunities to develop new revenue streams in connecting food to how we deliver our health and wellness services in the store. So, thinking about the trend towards food as medicine, and how can we connect those relationships even more clearly to help our customers live and eat more healthily, where they want to do that, but also to connect into the healthcare system and helping to take out some of the cost and complexity in that model and generate new revenue streams.

Rodney McMullen

We are actively testing where food is actually written under a prescription in helping people live healthier and when you look at all of that together, we continue to have great script count growth as well. We really think it's our pharmacy teams and their connections with the patients that's creating that deeper relationship. And as Gary mentioned, when you look at the overall ecosystem, half of healthcare costs can be affected by the way people eat and we really believe with our data we have the right to help people eat better.

Kelly Bania

Thank you.

Rodney McMullen

Thanks.

Operator

The next question is from Edward Kelly with Wells Fargo. Please go ahead.

Edward Kelly

Yes, hi. Good afternoon, guys and a solid quarter. My question around – my real question for you is, Rodney, if we take a step back and just assess the last year and the evolution of the state of the business – your business, your stock has gone from $30 to $20 back to $30. This quarter was a good quarter, right? FIFO EBIT even if you back out the one-time – the benefits of one-time lapse, it was up, right, despite a tough fuel lap, but you had some tough quarters in core grocery. I guess have you finally turned the corner here? What level of confidence do you have? And just kind of curious as to your big picture, thoughts and sort of like the last year how things have evolved and your confidence level in the business and where it is right now?

Rodney McMullen

Thanks. If you look at overall, as we mentioned before, if you look at the momentum during the year, we felt really good about the progress and momentum during the year, and that's in terms of identical sales, and if you look at the operational execution. I think Mike and the whole team, really have done a great job on those areas, where we're really taking care of the customer. We continue to aggressively invest in the seamless experience and if you look at the alternative profit, it continues to come as we expected it would. So that's – when you look at all those things together, it's what gave us confidence to continue to support the guidance we gave in November on EPS of $2.30 to $2.40. We expect the business to continue to generate good cash, strong free cash flow while at the same time continuing to aggressively invest capital in a seamless experience.

So, when you look at all those things together, as you know, the last two or three years, we've been working hard on transforming our fundamental business model, and we feel like we've made significant progress on that and continue to invest in the future from a digital experience. So, we're excited about where we are. We're even more excited about where we're headed.

Edward Kelly

Okay. And I just wanted to ask you a question about new share repo and expectations for 2020. Especially Q1, I mean, Q1 is your big cash flow quarter, it seems like share repo is back on. Historically, you bought a lot of stock in Q1. Just thoughts on how we should be thinking about that in the coming years for modeling?

Gary Millerchip

Yes. Thanks for the question, Ed. So obviously, I mentioned a little bit around this in the prepared comments we committed that as we continue to see strong free cash flow generation, which is a core part of our total shareholder return model, we are committed to continuing to buy back stock as part of the model. As you know, we had $1 billion authorization from the Board. And as long as we continue to deliver on the performance of the business that we expect and generate the strong free cash flow that we guided to during the year, while also maintaining our debt-to-EDITDA ratio within that target range to support our commitment to our investment grade rating, we would expect to be continuing to buy back stock within the overall authorization that we have.

I would say that the way that we're approaching it is very much in a structured way. We're not specifically trying to time the market in some way, it's much more based on a great approach to how we determine and look at the intrinsic value of the stock and then we'll put a grid in place to make sure that over time if there are opportunities to buy back, we will certainly be executing on that plan throughout the year.

Edward Kelly

Great. Thanks, guys.

Rodney McMullen

Thanks, Ed.

Operator

The next question is from Christopher Mandeville with Jefferies. Please go ahead.

Christopher Mandeville

Hey, good morning.

Rodney McMullen

Good morning.

Christopher Mandeville

I guess, as it relates to some of the expense control measures found within Restock, can you flesh those on a little bit more specifically, how much of this is related to possibly some headcount reductions at the store level or even some reductions in store hours for that matter? The reason why I bring it up is because we have been hearing certain regions that some layoffs at the assistant store manager level and there has been some reductions in hours of operations. So maybe, you could just kind of talk about that a little bit and then to what extent, maybe some of those reductions are being offset by wage increases that you're putting forward to your associates?

Gary Millerchip

Sure. Thanks, Chris. So, as we mentioned in some of the prepared comments, the quarter four result obviously, did include some cycling of increased investment that we made in Q4 2018. And so some of that is certainly expected and I know we guided to that as part of we shared in the EPS expectations when we shared what we thought the cadence would look like throughout 2019. We're really seeing the improvements across a broad wave of activity across Restock Kroger. I listed out many of them in the prepared comments, whether it's some of the biggest areas would be in goods not for resales as example, where we're sourcing products better and we're managing to really make sure that we're finding opportunities to be more efficient in the way that we're buying and joining the dots across all the different pieces of procurement across the organization.

Certainly, we're leveraging technology and automation to make sure that we're taking work away, where it doesn't add value for the customer. A good example of that might be in cleaning, where it's something that can be done more efficiently and allow our associates to really focus on serving the customer and doing work that the customer really values. And then of course, we did announce last quarter that we did make some structural changes to really simplify the work in our divisional offices to make sure that we're again, putting our associates and talent closer to the customer in these key store management roles, and at the same time, reducing duplication in work, so that we can make decisions more quickly and respond and serve the customer more effectively.

So, I think we feel very good about it. It's a good balance across the way that we're managing the cost base. And certainly, as we look at the performance of our stores, one of the things that building on maybe, Rodney's comment to the last question that was asked around confidence in the model, we're very excited about as we see our stores continue to execute at a higher level and continuing to deliver improvements in the fresh experience, the friendly experience in our in-stock position and how we're delivering on Kroger Pickup. So, we're very focused on making sure our stores are in a good place to be able to deliver on the experience that we know our customers are looking for, and some of those are the reasons why we feel confident as we're guiding to the higher ID sales in 2020, because of the great work our store associates are doing in delivering for our customers.

Christopher Mandeville

Okay. And then just my follow-up, this may be a little bit too early, but in the areas, where we've seen some of the natural organic, not named Lucky's shutter and then with Ahold Delhaize pulling Peapod out of the Midwest, have you realized any benefits already or maybe, you guys talk about how you're planning to be positioned to capitalize on the share being up for grabs? Thanks.

Rodney McMullen

Yes. Thanks, Christopher. If you look at natural and organic, it continues to be one of the highest growing areas. And we really think it's something that over the years, our teams have done a great job on continuing to make sure that we have the most recent products things on trend, the example that I talked about in the prepared remarks in Simple Truth and plant-based. So, for us, we're incredibly excited about natural organic, it's grown above the company average for several years and we would expect it to continue to do that.

Any time market share becomes available, we're going to fight for making sure that we get our fair share plus some and we certainly feel good about what we're getting and we continue to focus on taking care of our customers, because when our associates are able to take care of the customers, it turns out really well.

Gary Millerchip

Thanks. The next question?

Operator

Next question is from Simeon Gutman with Morgan Stanley. Please go ahead.

Simeon Gutman

Thanks. Good morning, everyone. Hey, Rodney. You mentioned on the free pickup that you were pleased with some of the customer satisfaction, I think. Can you tell us, was it a reasonable assumption or did you assume that your business would accelerate offering that feature? And was that the case? Did your overall business grow because of it?

Rodney McMullen

It did pick up. And as I mentioned, we did get some new customers. Overall, it was kind of what we expected it to be and we did it, so we can continue to learn. And I think the thing that's important is that at any point in time, we'll probably have 20 or 30 different types of test going on. And the key will be identifying those tests when you put them together that creates something that's not easily – that a competitor can duplicate and really create something new for the customer. One of the things that's always our strength is our incredible strength on fresh product and our customers tell us that relative to our big traditional competitors, we score very well. We think things like that and the service that our associates provide is equally as important.

Simeon Gutman

Yes. And I guess, just checking on some websites, it looks like it's still being offered. I think you may have mentioned you're not going to divulge if that's your strategy. And just tied to it, Ocado broadly, and I guess it's early, but you still haven't opened the first facility yet, but do you think in this world of click and collect and delivery, that this Ocado model you could be able to offer services for free as table stakes and still have pretty good economics on doing those type of fulfillments?

Rodney McMullen

Yes. When you look at Ocado and the combination of our physical – existing physical stores, we think we'll be able to offer the customer an incredible customer experience and convenience based on what they want. The fee part won't be – isn't the major driver of making the economics of that work or not, and whether we charge a fee or not will really depend on what's the market opportunity, but Ocado is incredibly efficient.

Simeon Gutman

Got it. Okay. Thanks. Good luck this year.

Rodney McMullen

Thank you.

Gary Millerchip

Thank you.

Operator

And our final question today is from John Heinbockel with Guggenheim Securities. Please go ahead.

John Heinbockel

Hey, Rodney. If you think about the $1 billion of cost saves, right, the core business ex alternative profit being flat. So that – you think about that $1 billion going to cover normal inflation in OG&A and then investments in the business. Would you think that would be a 50-50 split in terms of how that $1 billion gets spent? And then do you think there’s another $1 billion more or less in 2021?

Rodney McMullen

Let’s see. I’m trying to do the math in my head as you are asking the question. If you look, we would certainly believe there’s opportunities in 2021. We really haven’t done the in-depth analysis for to be able to say what do I think the specific number is. One of the things that I think is interesting on cost saves and process changes; the more we learn how to do it, the more that we find. So, we would be very excited about continuing to identify opportunities to simplify our business and take complication out, which every time we do it saves money.

In terms of – we would – I don’t know that we would say 50-50. I guess what we’re looking to do is making sure that we deliver the TSR that we outlined in November at our Investor Meeting and the cost saves, along with our continued improvement from our seamless customer experience in terms of that becoming a bigger tailwind. All of that together is what allows us to be confident and make the commitments we did on TSR. I don’t know, Gary, any specifics that you would want to add?

Gary Millerchip

No, I would agree with your points, Rodney. I think in terms of the cost savings, as you mentioned it for me, many of the opportunities that we still see out there around how we can continue to use technology more effectively and really, simplify the design of the works to make it easier for our associates to be successful in the role. And it also means, as you know, John, we're often reinvesting in other areas of the store experience – a digital experience, so that net-net, it doesn't necessarily translate through to a total saving in cost, because what we're often doing is redeploying those savings into new ways to either improve the experience or to meet the customer where they're at. So, it is – back to Rodney's comment on what's inflation versus what's incremental, it gets a little bit more difficult as the worlds get blurrier around whether the minimum expectations of the customer and where things like average ways goes in the marketplace.

John Heinbockel

And then just lastly maybe, just talk to how the Walgreen partnership is ramping up on the procurement side, and is that become a much bigger driver – a part of that $1 billion later this year and even bigger next year?

Rodney McMullen

Yes. Thanks for the question, John. That's a good call. Actually that would be very true in the way you characterize it. So, we really just got off the ground with that part of the partnership. As you know, the retail test that we have in market has not been going sometime and we've been pleased with the progress there and we continue to develop our thinking around how to connect more deeply with the customer and fulfill on that convenient shopping experience. The group purchasing organization part of it is very much in its infancy stage. We just started to work on where the opportunities are there and that would certainly be part of the tailwinds into 2020 and beyond in driving more efficiency and cost savings.

John Heinbockel

Thank you.

Rodney McMullen

Thanks, John. As always, before we end today’s call, I’d like to share a few final comments directed to our associates, and how we live our purpose every day. To our associates, thank you for everything that you do for our customers, communities and each other every single day, every single hour of every day. You truly make a difference. This difference makes people’s lives better, and this was obviously incredibly evident earlier this week when the devastating tornado touched down in Nashville. I’m always amazed and proud to hear stories of our Associates pulling together in the aftermath of events like this. One story that was shared with me is some customers that didn’t have protection came to our store to seek shelter inside of our dairy case when the tornado hits. And that’s just one example. And the thing that’s even, to me, more impressive is what our associates do, what you do when your own families are personally impacted. And to all the work that you do to ensure our stores are open and serving our communities.

As I mentioned earlier on the call, in regard to the threat of the coronavirus, always being there for our community is part of our heritage. This is Kroger at our best. When we come together and uplift our customers, communities and each other, thank you for what you do for everyone every day, and thank you for joining our call today.

Operator

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