The Kroger (NYSE:KR) Q2 2013 Earnings Call September 12, 2013 10:00 AM ET

Executives

Cindy Holmes - Director of Investor Relations

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

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

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

Analysts

John Heinbockel - Guggenheim Securities, LLC, Research Division

Scott Andrew Mushkin - Wolfe Research, LLC

Deborah L. Weinswig - Citigroup Inc, Research Division

Priya Ohri-Gupta - Barclays Capital, Research Division

Karen F. Short - Deutsche Bank AG

Charles Edward Cerankosky - Northcoast Research

Stephen W. Grambling - Goldman Sachs Group Inc., Research Division

Jason DeRise - UBS Investment Bank, Research Division

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

Edward J. Kelly - Crédit Suisse AG, Research Division

Operator

Good day, ladies and gentlemen, and welcome to The Kroger Company Second Quarter 2013 Earnings Conference Call. My name is Derek, and I'll be your operator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to Ms. Cindy Holmes, Director of Investor Relations. Please proceed.

Cindy Holmes

Thank you, Derek. 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 call will be available on our website at ir.kroger.com. After our prepared remarks, we look forward to taking your questions. [Operator Instructions]

We are hopeful that you can join us for our 2013 Investor Conference in New York on October 30. We look forward to seeing many of you then.

I will now turn the call over to Dave Dillon, Chairman and Chief Executive Officer of Kroger.

David B. Dillon

Thank you, Cindy, and good morning, everyone. Thank you for joining us today.

With me to review Kroger's second quarter 2013 results are Rodney McMullen, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

I am very pleased with our strong second quarter results, which puts us on target to deliver the identical supermarket sales and earnings per share growth we promised for the year. Kroger's second quarter operating performance and financial results show that the common thread in our story is consistency.

We achieved our 39th consecutive quarter of positive identical supermarket sales, maintained return on invested capital and expanded FIFO operating margin without fuel on a rolling 4-quarter basis. Every supermarket division and every department had positive ID sales.

We controlled costs throughout the business. As you know, we announced a merger agreement with Harris Teeter, a company we have admired for a long time, which will expand Kroger's footprint into new exciting growth markets. And customers continue to tell us our associates are improving their shopping experience.

As we've shown quarter after quarter, our consistent execution of the Customer 1st Strategy deepens customer loyalty, increases sales and creates sustainable shareholder value. As you know, the list that I've just covered was prepared in advance so that we could formally review the quarter that we just finished. I'm not sure it does the quarter justice, so let me depart from our normal script and describe our results this way.

We've just completed what is nearly 10 years of positive identical sales growth. We have invested in price for each of those 10 years when compared to the year before. At the same time, we focused on lowering our costs. We've actually lowered our costs now for over 8 consecutive years.

Last year, in our investor meeting, we raised the guidance for our long-term earnings performance expectations. In fact, for the past 2 years, and our guidance suggests that this 2013 would be the third year, we've been performing within this new higher earnings per share growth range already. Plus, don't forget the dividends.

Also, last October, we offered a number of other keys to our successful growth plans for future years. Everything you're hearing today in our quarter suggests we're on the path to successfully achieve all of those goals that we set out for you last year in October.

Maybe even more important, the progress we've achieved these past 10 years sets a wonderful foundation on which to build for an even brighter future. And the most important part of all is that the team at Kroger is large, broad-based, with dedicated associates, team Kroger, who have collectively come together to achieve these results. And it is that combination that I think is unmatched in the industry today.

The results achieved by our team, team Kroger, make me most proud. I don't use words lightly, this quarter especially, when I say we are very proud of the quarter we have just delivered.

Now I'd like Rodney to cover some more details about the second quarter. Rodney?

W. Rodney McMullen

Thank you, Dave, and good morning, everyone. As you know, we regularly seek customer feedback on how well we are executing in each of the 4 key areas of our Customer 1st Strategy. We continue to improve our performance in each area and our efforts are being noticed. Customers are telling us that our associates continue to connect with them by showing them that our people are great, our product selection and quality is improving, we are making the shopping experience faster and easier and we continue to give our customers better value for their money.

Doing the 4 keys together is what separates us from our competitors, competitors of both the past and the future, because the hard part is doing all 4 and doing them reliably. We are also more agile in balancing our investments in the 4 keys with the savings we realize and we are consistently improving the efficiency of those investments on a rolling 4-quarter basis. Our lower gross profit rate today means customers are saving nearly $3 billion a year compared to when we started this journey.

I want to echo Dave's appreciation and also thank our associates for keeping their focus on our customers and delivering shareholder value. We are very proud of reaching a merger agreement with Harris Teeter and we are especially pleased it has not diverted our associates' efforts to achieve a good quarter and continuing -- continue to driving the business.

One of the most important measures of our business is loyal household growth. It lets us know how well we are connecting with our best customers. And our loyal customers, on average, spend about half of every $1 with Kroger, which means we have tremendous opportunity to increase their spending across our family of stores.

During the second quarter, we grew the number of loyal households. Our loyal household count grew at a much faster rate than total household growth, which was also up for the quarter.

Overall, customers continue to visit our stores more frequently, purchase fewer items per trip and buy more on a monthly basis. Total units sold were up compared to last year. We estimate the rate of product cost inflation at 1.6%, excluding fuel and pharmacy.

As we've discussed throughout the year, and in fact for the last several years, consumer confidence continues to improve but at a slow and steady pace. Factors that affect consumer confidence at any given time include fluctuating gas prices, payroll taxes and government policy uncertainty, along with the overall state of the economy. We continue to monitor these factors closely.

Overall, we would characterize the economy as continue to improve but fragile.

Kroger leveraged operating expenses in the second quarter as associates did a good job controlling costs and driving positive identical sales. Our OG&A costs plus rent and depreciation, without fuel, were down 17 basis points as a percent of sales. On this basis and excluding one-time items, as Dave mentioned before, we've improved this metric for 8 consecutive years and our year-to-date results have set us up to achieve our ninth consecutive year.

Now I'd like to update you on our corporate brands offering, which is one of our key differentiators for Kroger versus our competition. Our focus is on new products, which we are continually evolving as customer tastes change. We have modeled our team to facilitate a culture of innovation. This year alone, we will have introduced more than 650 new items by the end of the year.

In the second quarter, corporate brands represented approximately 24.5% of total units sold and sales dollars were 23.8%, excluding fuel and pharmacy.

Finally, an update on labor relations. Our store associates ratified new labor agreements, covering stores in Indianapolis, Roanoke and Little Rock. We have several contracts that have expired or will expire soon, including contracts in Seattle, Cincinnati and Dallas.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages; good quality, affordable health care; and retirement benefits for our associates.

Kroger's financial results continue to be pressured by rising health care and pension costs, which some of our competitors do not face. Kroger and the local unions, which represent many of our associates, have a shared objective: growing Kroger's business and profitability, which will in turn help us create more jobs and career opportunities and enhance job security for our associates. In fact, over the last 5 years, we've added 33,000 jobs.

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

J. Michael Schlotman

Thanks, Rodney, and good morning, everyone.

Total sales increased 4.6% to $22.7 billion in the second quarter compared with $21.7 billion for the same period last year. Total sales, excluding fuel, increased 3.9% in the second quarter over the same period last year.

Net earnings for the second quarter totaled $317 million, or $0.60 per diluted share. Net earnings for the second quarter of last year were $279 million, or $0.51 per diluted share. FIFO gross margin, including fuel, was 20.6 -- 20.46% of sales for the second quarter. Excluding retail fuel operations, FIFO gross margin decreased 11 basis points from the same period last year.

The company recorded a $13 million LIFO charge during the quarter compared to a $35 million LIFO charge in the same quarter last year. This is consistent with our original expectations. FIFO operating margin, excluding fuel and the extra week in fiscal 2012 on a rolling 4 quarters basis, increased 9 basis points.

Turning now to retail fuel operations. We disclosed many items with and without fuel due to its effect on operating cost and gross profit rates, but we view fuel as a core department that, over time, is expected to contribute to earnings per share growth. About half of our supermarkets have fuel centers today.

In the second quarter, our supermarket centers -- our supermarket fuel center's rolling 4-quarter margin per gallon was approximately $0.14 compared to $0.136 a year ago, excluding the 53rd week. Total gallons sold showed solid growth.

On a rolling 52-week basis, return on invested capital grew slightly to 13.49% compared to 13.44% during the same period last year. As we increase capital, it will be more difficult to grow ROIC in the near term. However, as these investments mature, we expect them to be accretive to return on invested capital.

Our planned uses of cash remain unchanged: maintain our current investment grade debt rating, repurchase shares, pay dividends to shareholders and fund capital investments.

You will see on our balance sheet that our current portion of long-term debt has decreased because of our recent financings and our net total debt to adjusted EBITDA ratio has declined to 1.77. We have not been repurchasing as many shares as we originally expected at the beginning of the year. This is purely because of our work to prepare for the Harris Teeter merger. This lower ratio gives us the flexibility to finance the Harris Teeter transaction and we are now well positioned to reestablish and maintain our targeted 2x to 2.2x net total debt-to-EBITDA ratio, in line with our long-term financial strategy, within 18 months after the Harris Teeter transaction closes.

In fact, this puts us in a better position than we originally expected from a debt standpoint. We are committed to executing our financial strategy, including maintaining our current investment grade rating and repurchasing shares.

During the quarter, Kroger repurchased 2.4 million common shares for a total investment of $90 million. Kroger's strong financial position has allowed the company to return more than $920 million to shareholders through share buybacks and dividends over the last 4 quarters.

Capital investment, excluding acquisitions and purchases of leased property, totaled $507 million for the quarter compared to $444 million for the same period last year. Year-to-date, we have spent $1.1 billion. We continue to expect full year capital investments to be in the $2.1 billion to $2.4 billion range.

Now I'll update our growth objectives for fiscal 2013. We are maintaining our net earnings guidance to a range of $2.73 to $2.80 per diluted share for the year. This is consistent with our long-term growth rate guidance of 8% to 11% based on fiscal 2012 adjusted earnings per share of $2.52. Shareholder return will be further enhanced by a dividend that we expect to grow over time.

Keep in mind, our long-term growth rate assumes no effect from year-over-year LIFO swings. A higher LIFO charge in any given quarter or year will lower the growth and a lower LIFO charge will increase the growth.

As you look at our guidance for the year, please note that we expect an EPS growth rate in the third quarter similar to what we reported today for the second quarter. We still expect this year's fourth quarter to be behind the third -- fourth quarter of last year on a 12-week basis. This is because we currently assume a $13 million LIFO charge in the fourth quarter compared to a $41 million credit in the fourth quarter of last year.

The bottom line of this is we think current estimates for the third quarter are a little low and for the fourth quarter, they're a little high but by offsetting amounts. This is why we continue to be comfortable with the $2.73 to $2.80 per share level for the year.

We are increasing our identical supermarket sales growth expectations, excluding fuel, to approximately 3% to 3.5% for fiscal 2013. The original guidance was 2.5% to 3.5%.

And now I'll turn it back to Dave.

David B. Dillon

Thanks, Mike. I'm really proud of what we are accomplishing. We're growing in such a consistent way that it may seem deceptively simple. But the truth is that our hard work over the past 10 years since we began our Customer 1st journey has created a platform for sustainable growth. We are improving our connection with customers and associates, creating new jobs and strengthening job security and rewarding shareholders with consistent earnings per share and dividend growth.

Now we are happy to take your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question is from the line of John Heinbockel, Guggenheim Securities.

John Heinbockel - Guggenheim Securities, LLC, Research Division

So guys, 2 things. One, when you look at the 50% share of loyal households, when you talk to those customers and get a sense why they're not spending the other -- a larger piece with you, what do you typically hear from them? And then secondly, I know you want to -- you don't want to give too much detail here, but where do you think there are particular opportunities where you're way under-indexing with those loyal customers in certain product categories?

W. Rodney McMullen

Well, thanks, John. If you look at why they're not shopping with us, it's kind of interesting. When we talk to them, they'll tell us they're actually giving us more business than they give us. And it's really a mixture of 2 things: one, things that they don't put on their Kroger list and they, just for the last several years, just put it on another retailer list; and the other part would be when they're out taking their kids to soccer practice or some other type of event, they'll just stop by and pick up a few items somewhere else. And most times, people will pick up a few extra things. The big opportunities, the easiest way to answer it, there are certain categories where we've significantly improved what we offer from a variety and a price standpoint that those customers don't realize that we've changed. And it really is trying to make sure the customers realize the improvements that we've made, would be the biggest opportunities that I could answer your question without giving a tremendous amount of detail. Obviously, there's a lot of detail behind that statement.

John Heinbockel - Guggenheim Securities, LLC, Research Division

But it's safe to say that the things that they might think of first in another retailer, whether it be paper, cleaning, HBA, I would think those are all areas where you probably under-indexed as opposed to food. Correct?

W. Rodney McMullen

That would be correct. Anything that's not food-related, we would probably under-index on.

John Heinbockel - Guggenheim Securities, LLC, Research Division

Okay. And then secondly, because I know you guys like to kind of peer around the corner a little bit, what's the current take? Because I know you've been a little bit skeptical about the whole food e-commerce channel. Do you think that will ultimately be, maybe not 2 years from now but 5 or 10 years, something people will -- it'll be more mainstream and something you want to start noodling around with? And if so, do you still think it would be more store-level pickup, a better option for the consumer, ultimately, than home delivery, as you think about it?

W. Rodney McMullen

Well, we continue to experiment with it, as you know, in Denver, Colorado, we have for the last several years. We have a few customers that are very loyal to it, but it's modestly growing and it has modestly grown for a long period of time. We think, over time, it'll just be one part of the way a customer shops, along with physical assets too. So we don't think it's "in place of," we think it's "part of." And we're really focused on trying to deliver something along those lines. One of the things -- we're looking forward to merging with Harris Teeter. Harris Teeter has a pickup model in a lot of their stores. We don't have too much -- we have a little bit of insight, but it's very little at this point until we merge, because obviously, in some markets, we're in the same markets together. So you don't have the complete understanding of how successful it is, but we want to make sure we understand that and what pieces of that make sense to use in other places.

David B. Dillon

And John, I would add that we're thrilled in the meantime at the development of the whole digital world and how our customers are engaging with us. Everything from the Kroger app to the online work we do, to the downloading of digital coupons, has all been very successful for us.

W. Rodney McMullen

Yes. It's kind of exciting, but if you look at our digital app now, it's one of the top 2% -- it's in the top 2% of downloads off of -- from Apple.

Operator

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

Scott Andrew Mushkin - Wolfe Research, LLC

I had a kind of housekeeping one to start off with. I know you gave us the 4-quarter rolling on fuel. Did you have it for just this quarter on fuel penny profit?

W. Rodney McMullen

It was higher than the rolling 4 quarters. Go ahead and ask your second question and I'll get -- I don't have that exact number in front of me, but we'll get it.

Scott Andrew Mushkin - Wolfe Research, LLC

Okay. And then kind of along what John was asking, but maybe asking it a little bit different way, it's a more strategic question. Kroger's probably been the biggest share gainer in the industry for a long time, I think partly because you've just driven the price gaps down with Walmart and then also widened them with some of your conventional guise. But you also did a huge amount on service and perishables and merchandising. But I guess the question is, going forward, how do you envision share gains? Can you -- do you think you can keep up the same pace? And what's going to be the biggest mechanism to drive it?

David B. Dillon

Well, it's -- as I mentioned in my own comments, we see this as a sustainable model that continues to build on itself. And I think the most important fact that demonstrates that we believe this can continue for a very long time is the fact that roughly half of the business our best customers can give us, they are giving someplace else. And Rodney addressed that in his comments earlier. I think that's the best evidence. Now there's plenty of other evidence, too. Just the fact that we have 39 quarters in a row of positive identical sales illustrates that there's -- continues to be room to grow. And so we think that the future is still bright and that we see very good opportunity to grow our market share ahead.

W. Rodney McMullen

Hey, Scott, [indiscernible] in the quarter was $0.17 versus $0.164 last year. So while higher, the spread was about the same. So the profit margin per gallon in the quarter was 6/10 higher and the rolling fourth quarter was 4/10 higher. So the incremental was not that significantly different, even though the absolute number was higher.

Scott Andrew Mushkin - Wolfe Research, LLC

I appreciate that. And then my last question goes to kind of the current environment. Are you seeing anything different out there as far as your current trends go? But also, I wanted to talk about, there has been a lot of talk of some changes to the food stamp program. Some of those are just going to happen and then maybe there's going to be some further adjustments as we go forward into the fall. So both current environment and then how you're thinking about the current environment, vis-à-vis some of these changes that may roll through the food stamp program.

David B. Dillon

I'm not sure I followed the first part of your question about current trends. You're just talking about generally in the economy?

Scott Andrew Mushkin - Wolfe Research, LLC

Yes, generally in the economy and your -- I guess your trends. I mean, are you seeing anything different out of the consumer that you've been -- that lifts your comps that you've produced this quarter? And then as we go forward, how are you thinking of your business, particularly on the sales line, with the pending cuts?

David B. Dillon

Well, first, as you saw, we moved the lower end of our sales guidance up, which should tell you that we are reasonably confident in what the second half of this year looks like. Sales so far, we have 3.5 weeks in this quarter. And while that's hard to predict, it's a whole quarter from that. But they are slightly ahead of where we were for the second quarter. So we're good -- we're comfortable with that picture. Rodney described the economy. The way we're thinking about it is it's still quite fragile but continues to improve and those signs of improvement are many. So there's lots of categories and items and areas that you would say are more kind of discretionary items that people are buying more of today than they were before. And the growth in areas like apparel and cosmetics and toys and greeting cards, Starbucks, sushi, all of those areas, natural food, Boar's Head, cheese, prepared meals, all of those are doing really well and growing at good pace. Food stamps are still at a reasonably high level. They did kind of plateau for a while. And you could argue right now, in the last few weeks, anyway, that there's been a slight softening, but it's still at a very high level. And so I wouldn't read too much into that. Your question about food stamps is what happens if those get cut substantially. And I know there's lots of conversations in the Congress on that topic. We, of course, don't know how Congress comes out on that. We don't know how the states will come out on that. We do know that there's a reasonably high demand for food stamps. But remember that food stamp customers also spend some of their own cash on food. That's not their only source to pay for food with us. And while we have a lot of households that use food stamps, just the fact that we've seen some little softening in these last few weeks and yet the sales through the 3.5 weeks I've just mentioned is a little stronger than last quarter, that's a good sign, too. That even in a case where food stamps might get a little softer, we still think we can do quite well in sales. Rodney, do you want to add anything to that?

W. Rodney McMullen

No, I mean, it's something that we certainly look at and we work every day trying to make sure that we give all customers a better value for their money. And if you look at our digital app and everything that we're doing, we're trying to make sure that we continue to take costs out of the business so we can give the customers a better value for their money. So hopefully, the customer that's on food stamps would be able to take advantage of many of those opportunities as well.

Operator

Your next question is from the line of Deborah Weinswig, Citigroup.

Deborah L. Weinswig - Citigroup Inc, Research Division

So if you look back to the beginning of the year when you had a 2.5% to 3.5% projection and now raising the bottom end of that to 3% to 3.5%, what have been the biggest differences in terms of -- whether it be consumer behavior but just in terms of increasing confidence, et cetera?

David B. Dillon

Actually, the -- I think the answer is a silly answer, but it's a 6 months passage of time, that before we were looking at a whole 4 quarters, trying to predict where it was going to be, and now we've seen 2 of the quarters and we just have 6 months left in front of us to try to predict. And I think we feel more confident of that. But the factors are the same that I listed with Scott that helped get us to a confident level.

Deborah L. Weinswig - Citigroup Inc, Research Division

Okay. And then in terms of -- if you look at the general merchandise sales that you've seen so far, could you just maybe give us some color in terms of what you've seen in the quarter? And will you also see pockets of opportunity as well?

David B. Dillon

Well, we certainly see pockets of opportunity. But in the GM -- I listed several GM categories that I've noted have improved, and GM on the whole has improved. One of the points I made earlier was that all of our departments had positive identical sales and GM did have reasonably good improvement. But it had been, for a long time, it had been more of a laggard. So we're glad to see some improvements there. You want to add anything, Rodney?

W. Rodney McMullen

Well, I was just going to say, it was a little embarrassing, but in terms of the opportunity, I think we're really -- the Fred Meyer team is really having a tremendous amount of success, working deeper with all their divisions across the company and picking up some good new items across the company. We're having very good success on identifying the right items to add in our stores. We're starting to reduce some of our marketplace stores with categories different than what we initially did and very pleased with the success there. You could -- if you looked at it half empty, you would have said, "Well, why didn't that happen 10 years ago?" The half full is, "At least it's happening now."

Deborah L. Weinswig - Citigroup Inc, Research Division

Great. And then last question, obviously, with all the work that you've done with dunnhumby, et cetera, and with the relationship that you have with the customer, can you talk about how aggressive you are in terms of pushing mobile coupons, what you've seen in terms of customer response and just what the opportunity lies ahead?

W. Rodney McMullen

Wait. What? You said coupons, but I couldn't quite, Deborah, hear what you said right before coupons. Did you say mobile coupons?

Deborah L. Weinswig - Citigroup Inc, Research Division

Just in terms of where are you right now in terms of pushing mobile coupons with your relationship that you've had with dunnhumby? And where are you in terms of working with the consumer? And what has been the customer response?

W. Rodney McMullen

Yes. If you look at -- the usage of digital coupons is significantly higher than the percentage improvement in the download of our apps. We're working with dunnhumby in terms of making sure those coupons are targeted for each customer. And it's -- it's some are at the segment level, some are at the individual customer level. And those would be some of the things that we continually work with and trying to improve. dunnhumby is putting a lot of resources on R&D today to get better and better at that in terms of targeting overall. And obviously, we're partnering with them to make sure that we continue to improve that. The percentage increases are so big that it really doesn't mean much because it's triple digits, but it's huge triple-digit increases.

David B. Dillon

And Deborah, just to illustrate a point, one of my favorite things on our Kroger app when I go to my own list, and I'm starting to make my shopping list and I want to download some coupons, it used to be I would just get a long, long laundry list of coupons that were available to download. And now, they're in the order of priority based on my actual shopping. And that would be true for any of our loyal customers that would have enough of a pattern to give us that. In that way, I don't have to go through 100 coupons to find the 4 or 5 or 6 that I want. And it's a terrific feature as an example. So we keep making improvements. About every 6 weeks or so, we make improvements in the app, which often is focused on the digital coupons and improving that experience.

W. Rodney McMullen

And overall, we communicate with about 9 million households on a regular basis, and all 9 million have unique offers based on their behavior.

Operator

Your next question is from the line of Priya Ohri-Gupta, Barclays.

Priya Ohri-Gupta - Barclays Capital, Research Division

Mike, I was hoping you could just provide a little bit of an update on your thoughts around through the timing of issuance related to Harris Teeter, whether that's changed at all given the current market trends? And then, as we think about what you could potentially issue across the curve, you've previously talked about wanting some varied exposure, and given that you just came with 10s and 30s, should we expect more front-end issuance around that?

J. Michael Schlotman

Yes, thanks. Relative to the timing, obviously, their shareholder meeting's October 3 and then we'll still be waiting on final FTC approval after that. So we'll gauge where we are in the FTC process post the shareholder meeting and try to time it relatively close to when the transaction would close so we don't have a lot of negative carry. As we said back when we did the 10s and

30s a couple of months ago, we had several calls during that time and we were very open about the fact that if you wanted 10s and 30s from Kroger, you needed to be in this deal because the next issuance was going to be at the front end of the yield curve. It does 2 things. One, it does what you said, gives us exposure across the yield curve, but it also gives us a better maturity smoothing so that we have some debt coming due every year, so as we need to have the opportunity to pay off some debt to get our ratios at that 2x to 2.2x, we can do that by actually having some debt maturing.

Priya Ohri-Gupta - Barclays Capital, Research Division

Great. And just around your desire to maintain some floating rate exposure, how should we think about that? Do you have a targeted percentage or amount that you look at?

J. Michael Schlotman

Don't necessarily have a set amount. We currently, today, are extremely fixed. We were floating for a lot of this year until we did the bond issuance. In fact, post that bond issuance, you can see in our balance sheet, we have cash invested, which is some of that will go towards financing the Harris Teeter transaction. But I would expect our exposure of floating rates would be either -- it will probably be some combination of commercial paper issuances plus potentially a floating rate note issuance as part of the financing for the Harris Teeter transaction.

Operator

Your next question is from the line of Karen Short, Deutsche Bank.

Karen F. Short - Deutsche Bank AG

I just -- I wanted to focus a little bit on inflation and deflation. Looking back the last time when you saw a deflation, it also happened to coincide with a pretty challenging economic and competitive environment. And if I remember, you were investing pretty heavily in price, so selling gross margin was down pretty materially in that particular time frame. I guess looking into 2014, commodity costs appear to be coming down quite a bit and it looks like there is a potential for deflation. So I guess my first question is, what's your outlook for inflation into next year? And then the second question would be, how do you think about pushing the vendors kind of in the face of the potential for deflation and input costs, because I'm assuming you don't really want to be in a deflationary environment in the center stores?

J. Michael Schlotman

I guess your question on don't want to be in an inflationary environment, I can't do anything to change that, so our job is to make sure we can operate in whatever the environment gives us. At this point, I think there'll still be some slight inflation next year from everything we can see. Don't forget, while there are some -- certainly some commodities that are down, things like meat and some of the other categories continue to have some pressures out there relative to herd size and things like that. Now the chicken complex may come in as the corn crop gets harvested. And if it's as strong as it sounds like, that could help. But when you look at the grocery category, which is, in my mind, the one that's most important, we've actually had more inflation in the first half of this year than we had in the back half of last year. On the back half of last year, grocery inflation was under 1%. It was still inflationary, but slightly. And so far this year, it's north of 1% in the grocery category in both the first and second quarter. So I don't think -- I'm not really overly concerned about actual deflation. There could be less inflation, but that's still prices going up.

Karen F. Short - Deutsche Bank AG

Okay. That's really helpful. And then, I guess the second question I had was just ROIC. Obviously, now that your compensation is tied to ROIC, you commented that ROIC might take a hit near term. And I guess the first question is why, because Harris Teeter's ROIC was fairly respectable. But maybe a little color there just on that comment.

J. Michael Schlotman

Yes, I don't know that the comment said that it was going to take a hit. I said that what we're trying to describe is the fact that -- of the metrics we gave last October, it's going to be the one that takes the longest to have upward momentum on because we are increasing CapEx as we do it. And keep in mind, all the numbers we gave today and our expectations and our predictions and thoughts about the rest of the year are exclusive of Harris Teeter. Once that transaction closes, we'll obviously update our expectations as a combined company. But today, we just can't do that.

Operator

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

Charles Edward Cerankosky - Northcoast Research

Taking a look at your increased comps guidance, which is great to see, in a generally tamer inflation outlook for the second half of the year than maybe we were talking about on the last call, are you suggesting better volume growth?

W. Rodney McMullen

Certainly -- Chuck, this is Rodney. Certainly, based on what we see today and Dave mentioned earlier, what we're seeing the last 3 weeks or so and a little bit of the last part of the second quarter, we would feel a little bit better volume growth in terms of what our expectations are.

Charles Edward Cerankosky - Northcoast Research

What implications does that have for mix?

W. Rodney McMullen

Well, as Dave mentioned, the -- we're having extremely good growth in the perishable departments, in those areas of the store and grocery is improving a little bit. So when you look at mix, we would expect it to probably be more driven by the center of the store than the perishables just because of the way we're starting out.

Charles Edward Cerankosky - Northcoast Research

So that would suggest customers doing more of their shopping at your stores?

W. Rodney McMullen

Well, as I mentioned in the prepared comments, we're seeing good growth in loyal households. And that growth as -- and we have total growth as well. So we would believe we're continuing to pick up a meaningful market share. And it's both in terms of new customers and loyal shoppers spending more with us.

Charles Edward Cerankosky - Northcoast Research

We've seen some of the marketplace stores in our travels, including some with the apparel in them. Can you comment on that group of stores?

W. Rodney McMullen

Well, the marketplace is one of our many formats in terms of driving our growth. What we're finding is the Fred Meyer folks are helping us identify the right apparel items to have in. And customers are -- it's one more reason to come to one of our stores. Obviously, it's not typically on your Kroger list. But once you're in the store, you can get a great value for some reasonably trendy apparel at a reasonable price. So, so far, we're pleased. And we continue to add it in our new marketplace stores and as we remodel our marketplace stores.

Charles Edward Cerankosky - Northcoast Research

Well, the one in -- maybe it's even open, will the new marketplace in Hilton Head have apparel?

W. Rodney McMullen

That one, I don't know. Mike actually probably knows that one better than me.

J. Michael Schlotman

You're right, it gives me grief that I'm the construction manager for that project. It's actually not a marketplace store. It's about a 90,000-square-foot supermarket. So it will be a big supermarket, kind of like when you think -- if you've been to our Anderson store here in Cincinnati or the Fort Mitchell store, it'll be more along those lines than a marketplace store. The site just wouldn't accommodate a 123,000-square foot footprint.

Operator

Your next question is from the line of Todd Duvick, Wells Fargo Securities.

Unknown Analyst

Just filling in for Todd here. Most of our questions were answered. But just kind of wanted to circle back financial policy and just more of a confirming question, I just want to make sure I heard you correctly. So ultimately, I guess, everything kind of flushes through over the next couple of years, you'd like to be at 2x to 2.2x on a net debt-to-EBITDA basis, is that correct?

J. Michael Schlotman

That's always been our long-term target. We typically, over the past several quarters, have been right around 2x. We were just under 2x at the second quarter. And just in anticipation of the Harris Teeter transaction, we were a little conservative from July 8 when we announced that until now on the use of cash to try to pre-lower that ratio a bit, if you will. We're actually a little bit ahead of where we are. And we feel comfortable we're going to be able to execute on all prongs of our financial strategy going forward, including the 2x to 2.2x. We think that's a good proxy for what it takes to maintain a BBB flat credit rating.

Unknown Analyst

Got you. And markets are hard to gauge a couple of months out and I know you have a meeting coming up. But can you talk to where that ratio would be maybe in '14 in terms of kind of a max or any type of range, how you think...

J. Michael Schlotman

Yes, I wouldn't -- I'm not going to speculate on where it will be immediately post the transaction. But if you assume a $2.4 billion, $2.5 billion acquisition price and all that debt goes on day 1, it's going to take a full year to add in any Harris Teeter EBITDA. Though the ratio is going to look pretty high on day 1, but by the end of year 1 and you have all of that EBITDA, if you just assume the EBITDA they've been generating, you'll probably get pretty close to a range of what we would expect by the end of the first full year post the transaction.

Operator

Your next question is from the line of Stephen Grambling, Goldman Sachs.

Stephen W. Grambling - Goldman Sachs Group Inc., Research Division

I know you don't like to give a quarter-by-quarter guidance, but since you did make some references there, is there anything in the fourth quarter that we should be thinking about? It looks like, even as you strip out some of the timing shifts, it looks like it embeds a little bit of a change in trend.

J. Michael Schlotman

I'm not sure what you mean by change in trend. I mean, if you look at purely the swing in LIFO, it's a $0.09 or $0.10 per share effect, just the swing of what last year's LIFO credit was and what this year's was or what this year's is projected to be. So it's a pretty dramatic shift between -- just on that line between the 2 years. If you were to neutralize that, I don't think you would -- I think you would find a quarter that's within our guidance range for the year. We've -- the first couple of quarters have benefited from the opposite of that and that we had a higher LIFO charge last year and a higher LIFO charge -- and a lower LIFO charge this year. If you were to neutralize the first and second quarter LIFO charges, our results actually were nicely at the high end of the range, not a 17% quarter like the headline reads, it's probably an 11% or 12% quarter growth, with LIFO neutralized. And that's why for the year, I mean, if you want to say it's a change in trend for the fourth quarter, mathematically, that's how it would work. But that's just because of the LIFO shift. One of the quarters has to be low when we're at 17%, the first 2 quarters in our guidance is 8% to 11% and it's purely that LIFO in the fourth quarter. It's not a change in the base business. Obviously, with raising the low end of our ID sales expectations, it's not any expectation that the business won't be strong in the fourth quarter.

Stephen W. Grambling - Goldman Sachs Group Inc., Research Division

Okay. That's helpful. And then one quick follow-up on, I believe it was Chuck's question. Just fresh produce has been highlighted as -- you highlighted it last year as a big opportunity at the conference. And we've also heard some re-emphasis from Walmart, the high-growth specialty players. Can you just highlight some of the things that you're doing that have been driving the growth there? And then, also, more a long term, as you think about the category, how it might be changing either in terms of pricing, the relevance, et cetera?

W. Rodney McMullen

Well, if you look -- as you know, we continue to add organic produce. We continue to work on shortening our supply chain. Our produce team has done a great job on connecting with local suppliers, which significantly increased the amount of local produce that we have, and we're doing a better job telling the customers about it. So it's really all those things together. From a trend, we would expect that to continue into the future. And on produce, we think we're going to be very strong and successful in produce, but we think probably some of the other companies you talked about, I think there's enough growth that all of us will be successful.

Operator

Your next question is from the line of Jason DeRise, UBS.

Jason DeRise - UBS Investment Bank, Research Division

It's Jason DeRise. A couple of questions. I wanted to potentially get a little bit more color on the FIFO gross margin x fuel, down 11 basis points, if you can share a bit of the drivers within that. And if that is indicative of the range that you think can be maintained as part of the 8% to 11% growth model long term as opposed to what has been happening in the past now that we've got a couple of quarters in there. And then I just wanted to follow up on the guidance change for sales without EPS. Is it just that the share count and interest view for the year has changed since the beginning of the year when -- or since last quarter when that guidance was updated?

J. Michael Schlotman

On the gross margin, as Rodney alluded to in his prepared comments, one of the things we've been focusing on, on a rolling 4-quarters basis, is the balance between the leverage of our ID sales, actual cost savings that we achieved and when and how we invest those savings that typically results in lower gross profit. But some of those investments actually wind up increasing OG&A efforts on people via training or something like that, so not everything affects the gross profit. So that gross margin is really dictated on our opportunity to save dollars elsewhere in the organization. The other thing that has helped that and until we cycle some of the bigger ones, clearly, pharmacy gross profit rates are up because generic gross profit rates are higher than non-generic gross profit rates. And that's one of the tailwinds that's in that number which, ultimately, will dissipate. I don't know if that gets to your FIFO gross margin question.

Jason DeRise - UBS Investment Bank, Research Division

That helps. By any chance, would you want to quantify this quarter what the pharmacy benefit was?

J. Michael Schlotman

No.

Jason DeRise - UBS Investment Bank, Research Division

I don't think so. I figured that out.

J. Michael Schlotman

That was a good -- it was a good driver. And what was your second question?

Jason DeRise - UBS Investment Bank, Research Division

Just about the reconciling that the sales guidance has come up, but EPS is still the same.

J. Michael Schlotman

We raised our guidance, EPS guidance in the first quarter, to reflect the results we had in the first quarter. And we continue to post sales essentially just above the midpoint of our current estimate. And anytime you give a range, a company is continually striving to, at their worst, be in the middle of the range and hopefully towards the high end of the range. So it's probably safe to assume that we weren't expecting -- we really didn't want

2.5% sales for the rest of the year to drive the EPS we were giving and really needed sales closer to where we are. And as Dave said, with 7 periods now and the books at 3.3%, for the year to have wound up at 2.5% IDs, that would've inferred a 1.6% ID number in the back half of the year. We just don't see that in the books. We see a number much closer to where we -- we don't see that in the future. Rodney is touching wood by the way. We -- that's our expectation. And I would say it's in the -- both of those are within the range of what we expected when we began the year.

Jason DeRise - UBS Investment Bank, Research Division

Okay. And I guess the part of the question that maybe I didn't hear on the first part, is it that the share count and the interest outlook is different than when that guidance was issued at the end of Q1? And I guess the Harris Teeter deal, is that sort of the reconciliation there?

J. Michael Schlotman

The share count and the interest have -- the share count a little bit of effect, but not a dramatic amount of effect on the full year. Interest really not, because for the period of time we were drawn on commercial paper until we termed that out a couple of months ago, we actually were lower on interest during that period of time than we expected. So for the year, we'll probably be a little better on interest than the original expectation. And that will actually help offset some of the lower share repurchases that we're expecting for the year. And I'll reiterate one more time, none of our guidance has any assumptions relative to the effect of Harris Teeter. When that transaction happens, we'll have to reset the bar on what our expectations are. But there's nothing in there relative to Harris Teeter. And one other thing I'll remind you about on those is our guidance for the year would also exclude any transition or transaction expenses related to that. So we'll call those out separately as they occur. We had a little bit in the third -- in the second quarter, but nothing that changed the ultimate answer. And again, we still have the expectation that Harris Teeter will be accretive in the first full year.

Jason DeRise - UBS Investment Bank, Research Division

Okay. If I can squeeze one more in. With the new stores that you're opening up and I guess some of the remodels that you're doing, how is that progressing at the early stage? Are the stores generating the revenues that you expect?

J. Michael Schlotman

We're very happy with the early results in the stores we're opening. It's one of the reasons we're keeping our CapEx expectations and spend where we plan to be. And as we said last October, we expect to increase that a couple of hundred million a year. And I would expect, at this point in time, that 2014 would be a couple of hundred million higher than what we have out there as expectations for this year, again, excluding anything relative to Harris Teeter.

Operator

Your next question will be from the line of Andrew Wolf, BB&T Capital Markets.

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

I also want to follow up on the gross margin. This year's rate has improved sequentially quite a lot. And you guys signaled at your last investor conference that, I think, the rate of price investments Kroger needed was going to abate, so you'd need less going forward. So I just wanted to ask you straightforwardly, is that the major driver of the improvement in the gross margin rate, less contraction, to be precise, this year so far? I know you've called out other things like generic drugs, but is that one factor, if not the major one, one of the major ones? And what does that imply about the price environment in general?

W. Rodney McMullen

Well, if you look, I mean, we obviously have an overall price strategy in terms of our relative price value versus our competition. And we've had that for several years. And we continue to be very aggressively promotionally in terms of giving customers a good value on promotion. I wouldn't overread what this year's number is versus the long-term trend. We're really focused on making sure that we maintain our relative price position. We continue to improve our reputation with our customers. And we balance that with as we take costs out of the business, that we have a slightly improving operating margin. So it's really all 3 of those together. One of the things that's been helpful this year is the pharmacy that Mike mentioned. We're also having good success on reducing some cost of goods on some things that we're doing as well. So that's helping it. The other thing, we probably are investing a little bit more in service this year than a normal typical year. And that's something that, each year, you would balance based on what we see the opportunities in the marketplace.

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

Okay. And I just wanted to switch gears to labor negotiations. There's been some press reports and I think some Kroger officials have commented as well, that with the coming changes in health care in the system, the Affordable Health Care Act, there have been some changes to contract terms. Does Kroger view that these changes to be Affordable Health Care, coming from the Affordable Health Care Act, as something Kroger can use either to -- well, to reach its goal, which you've stated to have the competitive cost structures, particularly, when you think about the industry having one of the most generous health care benefits in corporate America?

W. Rodney McMullen

Thanks, Andy, for the question. The law really isn't driving -- the changes that you would have read about, the law isn't what's causing those changes. And as you've known Kroger for a long time, we want to make sure our associates and our family have access to affordable health care coverage. And we still are spending about $1.5 billion a year on health care. We would expect that cost to continue to increase even with the changes that you've heard us talk about. Every contract is separate. Every situation is separate. What we find in some cases, our health care plan is so much better -- a lot of spouses will be working. Our health care plan is so much better than a lot of the spouses would have. Spouses are coming to our plan on an increasing rate. And what we're trying to do is to set up where spouses that have coverage, they go to where they have coverage to, in some cases, to take it for that coverage. So overall, we're looking at each contract individually and it's the solution that works fast for that market for that situation.

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

Just to follow up, I think in Dave's preamble, he talked about how growth has -- it sounded like it made a more amicable relationship with the unions. So am I understanding that correctly, that maybe the unions are more willing -- and I know each one is a separate entity, but in general, more willing to make certain helpful changes? Because I know Kroger is expanding and adding opportunity for more membership, for example.

W. Rodney McMullen

I guess I would never say that the union has been more helpful. I certainly believe the unions -- we continue to have a partnership to try to work together to figure out what's best for our associates. So I wouldn't say that -- they're not becoming suddenly easy to negotiate with. They're still looking out for their members. But when you look at it overall, one of the things that we're able to bring to the table is a growing company that improves job security. We're creating jobs that have -- and obviously, when you're a department head, you get paid more money than when you're not a department head. And it's those types of opportunities that we're able to provide for our associates. So it's really all those things together that will create a growing company, improves job security and improves what somebody makes on an individual basis because they're getting promoted.

Operator

Final question will be from the line of Edward Kelly, Credit Suisse.

Edward J. Kelly - Crédit Suisse AG, Research Division

I just had really just a couple of follow-ups, I guess. Mike, a question on generics. The pharmacy margin in general and the contribution from generics, I know you don't want to give the amount. But sequentially versus last quarter, how did the contribution compare? Was it similar, less?

J. Michael Schlotman

A little less.

Edward J. Kelly - Crédit Suisse AG, Research Division

A little less. Okay. And could you also give us an update on shrink? I know shrink was something last year that was a little bit of a headwind. I know you guys have been making some progress. Where do you stand on shrink today in terms of your progress and how you feel about that?

David B. Dillon

Rodney, you want to comment on that?

W. Rodney McMullen

Yes. Shrink is one of those where -- I don't know that I would ever say I'm ever pleased. We're certainly not satisfied, but we always work -- we're very careful when we are trying to improve our shrink result because it's one of the easiest ways to affect the customer's experience. So we don't want to have low shrink just for the sake of low shrink. We're not as far along as we'd like to be. We're making some progress in some of the areas of the business, but it's one of those things where it's a constant balancing between the pieces. So overall, the answer to your question is we're making progress in some areas. We're still not where we want to be, but we're making sure we do it on a balanced basis.

Edward J. Kelly - Crédit Suisse AG, Research Division

Okay. And then just a final question for you. I know you guys recently announced the Harris Teeter deal. What's the M&A environment generally look like today? Are you seeing more opportunity, less opportunity? Just curious as to your general view on what's available.

David B. Dillon

Ed, I'll give you a general comment and Mike may want to add more specifics if he wants. But I think we see the environment pretty much like we've been seeing it, that there's lots of things we look at regularly, but very few of them actually fit things that we think are worth doing and worth spending the money on and investing our time. And obviously, we've described Harris Teeter as one of those companies to merge with them. We've admired them for a long time and it's a kind of asset that really helps us grow into a new market. Do you want to add anything else to the environment?

J. Michael Schlotman

No.

David B. Dillon

Okay. So we're going to wrap up and I had just a couple of comments...

J. Michael Schlotman

I just wanted -- Paul Heldman was nice enough to point to me in my prepared remarks on, I said corporate brand units were up, market share was 24.5%. It's actually 25.4%. I transposed. I just wanted to correct that before we got off the call. Sorry, Dave.

David B. Dillon

Well, that's good for the record to get that in there. Thank you.

So before we end the call, though, as we often do, I'd like to share some additional thoughts with our associates who we encourage to listen in on this call. October is Breast Cancer Awareness month across our company. Associates in the offices and the supermarkets and convenience stores and our plants, distribution centers, participate in many activities to honor and pay tribute to those who are fighting this disease. Including many local Susan G. Komen Race for the Cure and Making Strides Against Breast Cancer events. I'm always moved by the outpouring of support and generosity that I see from our associates at events like these.

In the next few weeks, we'll also begin our annual Giving Hope A Hand campaign to support the fight against breast cancer in our stores. This year, we'll be featuring associates like Lori [ph], an apparel manager at one of our Fred Meyer stores in Oregon, who says, "Losing this battle is never an option."

Lori and 20 other courageous women will share their stories of hope and courage on specially marked packages of our corporate brands and national brand products. These items will be sold exclusively in our stores from September 22 through October 5. And I encourage you to read our coworkers' inspiring stories at sharingcourage.com.

Well, that completes our call today. We want to thank everyone for joining us. Thank you.

Operator

Ladies and gentlemen, that concludes today's conference. We thank you for your participation. You may now disconnect. Have a great day.