Kroger Co (NYSE:KR) Q3 2019 Earnings Conference Call December 5, 2019 10:00 AM ET

Company Participants

Rebekah Manis - Director, IR

William McMullen - Chairman & CEO

Gary Millerchip - SVP & CFO

Conference Call Participants

Edward Kelly - Wells Fargo Securities

Judah Frommer - Crédit Suisse

Charles Cerankosky - Northcoast Research Partners

Antonio Tabet - Evercore ISI

Kenneth Goldman - JPMorgan Chase & Co.

Erica Eiler - Oppenheimer

Michael Lasser - UBS Investment Bank

Joshua Kamboj - Morgan Stanley

Robert Ohmes - Bank of America Merrill Lynch

Operator

Good morning and welcome to The Kroger Company Third Quarter 2019 Earnings Conference Call. [Operator Instructions]. Please note, this event is being recorded.

I would now like to turn the conference over to Rebekah Manis, Director of 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 the business on an ongoing basis is contained in our SEC filings. The Kroger assumes no obligation to update that information.

Both our third quarter press release and our prepared remarks for this conference will be available on our website at ir.kroger.com. After our prepared remarks, we look forward to taking your questions. [Operator Instructions].

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

William McMullen

Thank you, Rebekah. Good morning, everyone, and thank you for joining us today. With me to review Kroger's third quarter 2019 results is Chief Financial Officer Gary Millerchip. I would like to thank those of you who were able to attend our investor conference last month where we shared our progress on Restock Kroger. We believe that Restock Kroger is the right framework to reposition our business to create value for all of our stakeholders. It provides us with a clear purpose and our vision to serve America through food inspiration and uplift. It focuses us on redefining the customer experience, identifying the partners who will help us deliver customer value today and in the future and putting the right talent and teams in place to focus on growth in our supermarket business and our alternative profit businesses.

We are proud of the progress we have made, and we've learned from the challenges we've experienced. We are on track with a stable and growing supermarket business as a result of our customer obsession, renewed intensity around operational excellence and continued investment in seamless. We are growing our supermarket business by focusing on three levers to drive identical sales: fresh, power brands and data and personalization. And we continue to build a seamless ecosystem that is available, relevant and accessible for our customers. All of this combined to generate positive results in the third quarter.

We continued to grow identical sales, reduce costs and deliver strong free cash flow. We had a broad-based identical sales improvement. 15 of our divisions had increasing supermarket identical sales without fuel compared to the second quarter. We delivered a slightly improved FIFO gross margin, excluding fuel and pharmacy. Headwinds in pharmacy were offset by strong fuel performance during the quarter. We are on track to deliver $100 million in incremental operating profit through alternative profit stream growth.

Kroger continues to invest in digital as we build a seamless ecosystem for our customers. We know our customers value greater convenience this provides, and our data shows it's an essential component of growing overall loyalty. Digitally engaged customers not only drive growth through our digital modalities, they also help drive brick-and-mortar sales growth as well and share of wallet. So seamless is a both, not an either/or.

Our data clearly shows that over time and after initial investments, the profitability of a digital customer is the same as an in-store customer. We continue to see an improving operating profit trend in digital, and therefore, our investments are maturing as expected and consistent with the graph we shared at Investor Day.

Our digital sales grew 21% in the third quarter. As we shared previously, we expect our digital sales growth to moderate year-over-year primarily due to the cycling of Home Chef and as a result of our disciplined focus on growing the Ship customer. We have expanded our digital coverage to reach 96% of our customers. This means that 96% of our customers who shop Kroger in a brick-and-mortar store can also shop with us for pickup or delivery.

We continue to invest in digital platforms as this is where the customers are increasingly going to meet many of their needs. Providing our customers with the ability to have anything, anytime, anywhere 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.

We continue the rollout of Ocado facilities. In November, Kroger announced plans for a new high-tech customer fulfillment center in Wisconsin. The automated warehouse will serve customers in Wisconsin, Northern Illinois and Northwest Indiana. What's so exciting about Ocado is their model to deliver to the customer is significantly less costly than our existing model and any of the other models we've examined as well. Not only will these facilities accelerate our ability to provide customers with a seamless experience, they will also help us to do it in a much more cost-effective way. We know Ocado's value is not just its current capabilities but also how quickly the company is able to innovate to serve a rapidly developing online consumer market. One of the comments we made at IR Day is that Ocado keeps learning and improving their model. Ocado's recent announcement of a micro fulfillment center in Bristol is a good example of this.

We believe that the food industry is special. It is huge, a $1.5 trillion market. And not only do people need to eat, they love to eat. Food isn't a commodity, but it's the center of our lives. Customers deserve a partner like Kroger who can provide inspiration and fulfill their passion for food. And unlike our national competitors, Kroger is food first. We believe that no matter who you are, where you're from, how you shop or what you like to eat, everyone deserves to have affordable, easy-to-enjoy fresh food that tastes amazing.

As we shared in November, fresh is an important driver of sales for Kroger. Our fresh departments drive trips, loyalty and gross margin. Our product standards, selection criteria and supply chain are core strengths and are built to deliver first-to-market and best-of-season fresh products across the United States.

Our produce department led the way in sales for the quarter, demonstrating how our store teams are focused on improving everyday execution in ways that are highly relevant to our customers. In addition, we launched our Fresh for Everyone brand transformation campaign, and the initial feedback from both our customers and our associates is very positive.

One of the many ways we demonstrate our passion for food is through Kroger's best-in-class Our Brands portfolio. While many grocers offer private label products, Our Brands is a real differentiator for Kroger because our customers tell us through blind taste tests that Our Brands' quality is better than not only the competitors' private label products but also many leading national brands as well. Kroger's Our Brands grew 3.4% this quarter. We also introduced 231 new Our Brand items during the third quarter.

Kroger's third differentiating lever to drive identical sales growth is personalization. Data is a differentiator for Kroger. Many retailers have transactional data, but none have the customer data and the insights to make meaningful suggestions to their customers like Kroger. We continue to see incredible effectiveness and efficiency from a focus on loyal customers and investing in their satisfaction.

One specific area I'd like to highlight is our strong fuel points program. As we shared at the Investor Day conference last month, an amazing 83% of our loyal customers engage with our fuel rewards program each year. We are increasingly targeting promotion and personalization of fuel rewards, and fuel drove trips and sales in the third quarter.

We are using the power of Kroger's stable and growing supermarket business to create meaningful incremental operating profit through the alternative profit stream businesses, which adds up to a business built for long-term growth that generates consistently attractive total shareholder returns.

Kroger continues to generate strong and durable free cash flow as reflected by the fact that the company has reduced debt by $1.5 billion over the prior four quarters and continues to increase its dividend to create value for shareholders. We are confident that we can deliver even stronger TSR in the future because of our strong free cash flow and sustainable net earnings growth.

Restock Kroger is the right framework to reposition our business to create value for all of our stakeholders both today and the future.

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

Gary Millerchip

Thanks, Rodney, and good morning, everyone. I want to echo Rodney and thank those of you who were able to attend or view the Investor Day webcast last month. As we shared in New York, our model for a strong and durable retail supermarket business begins with the customer and our obsession with increasing customer loyalty. We believe that our intensified focus on execution and continued improvements in the value and experience we deliver for our customers is driving increased identical sales across our store and digital ecosystem.

To drive sustainable sales growth for the long term, we will continue to invest in areas of the business that are important to the customer. This includes ongoing investments in talent, price, digital and store experience, with an even greater emphasis on fresh, Our Brands and personalization. We are demonstrating through the first three quarters of the year we are being very deliberate in balancing these investments with disciplined execution of cost savings that simplify our business.

Our supermarket business and the traffic and data this generates serves as the foundation from which we are able to drive higher growth in our asset-light, margin-rich alternative profit businesses that we continue to expect to accelerate our results. We expect our model to deliver improved operating results over time and continued strong free cash flow, and we expect this to translate into a consistently strong and attractive total shareholder return through EPS growth driven by sustained net earnings growth and the return of cash to shareholders via share repurchase, plus a growing dividend over time.

Now I'd like to share third quarter results. For the quarter, we delivered an adjusted EPS of $0.47 per diluted share. As noted in this morning's press release, that includes a $0.03 out-of-period charge that I will share more detail on in a moment. But first, I'll highlight a few areas of our business that were particularly robust.

Our Brands contributed as both a sales driver and a profit leader. The entire Kroger team brought discipline to controlling costs during the third quarter, and our fuel performance mitigated retail pharmacy gross margin headwinds in the quarter.

LIFO charge for the quarter was $23 million compared to $12 million for the same period last year driven by inflation in dry grocery, pharmacy and dairy. We now estimate LIFO for the year to be approximately $90 million versus our original expectation of $50 million.

Our adjusted corporate tax rate for the quarter was 70 basis points higher than the same period last year due to a decrease in the benefits of federal tax credits and an increase in reserves.

I'll now provide additional detail about two specific items that affected our results in the third quarter. First, the out-of-period charge of $29 million that I referenced earlier. This charge is related to a provision in a single pharmacy contract that should have been recognized over the previous six quarters. Given the complexity of the contract and the introduction of new clawback provisions, a part of the contract was misinterpreted. The required correction was identified in our standard management review process. This charge is not material to total company results, and the financial effect in each of the prior individual quarters was immaterial to net earnings per diluted share. However, the cumulative effect on our performance in the third quarter reduced adjusted net earnings per diluted share by $0.03 and gross margin by 9 basis points. We, therefore, felt it was important to provide a greater level of insight into this item. There is no effect on earnings guidance for 2019 or 2020 as a result of this contract going forward.

I'd now like to talk about Lucky's Market. During our investor conference last month, we committed to continue to be disciplined in prioritizing capital allocation to improve return on invested capital and create sustainable shareholder return. As part of a portfolio review, we made the decision to evaluate strategic alternatives in relation to our investment in Lucky's Market. As a result of this review, the company has decided to divest its interest in Lucky's Market and recognized an impairment charge of $238 million in the third quarter. Accounting rules require Kroger to record the gross amount in operating profit. However, the real economic interest to Kroger is a pretax charge of $131 million. Additional details are provided in the financial tables of our press release.

The impairment charge is a noncash charge and reflects the write-down of our initial investment in Lucky's Market as well as additional funding provided to operate and grow the business. There is no effect on earnings guidance for 2020 as a result of this decision.

Turning now to some of the highlights in the third quarter as underlying trends were very robust. Kroger reported identical sales without fuel of 2.5% during the third quarter, marking our strongest quarter since we launched Restock program. Several supermarket departments outperformed the company, including produce, key beverage categories, pharmacy and natural foods. Digital contributed approximately 70 basis points to identical sales, with Kroger pickup and delivery continuing to show strong momentum.

Adjusted FIFO operating profit for the third quarter was $653 million compared to $664 million in the third quarter of 2018. Gross margin was 22.1% of sales for the third quarter.

FIFO gross margin, excluding fuel, decreased 24 basis points from the same period last year primarily driven by industry-wide lower gross margin rates in pharmacy and continued growth in our specialty pharmacy business.

Gross margin rate, excluding fuel and pharmacy, improved slightly in the quarter as cost of goods savings and growth in alternative businesses offset continued retail price investments.

While profitability in retail pharmacy is lower than we had budgeted this year, it remains an important part of our strategy and continues to generate good returns. We were pleased to see the decline in gross margin rate compared to last year was lower in the third quarter than the first two quarters of 2019, and this trend is expected to continue in quarter four.

As a result of continued growth in pharmacy sales, improved product sourcing and initiatives that lower the cost of fill trips, our expectation is that pharmacy profitability will be less of a headwind in 2020.

Our associates continue to do an impressive job managing shrink, which improved in the third quarter compared to last year. This represents the ninth consecutive quarter of year-over-year shrink rate improvement.

OG&A cost as a rate of sales, excluding fuel and adjustment items, decreased 15 basis points. This was achieved through broad-based improvement of Restock Kroger cost-saving initiatives.

We remain on track to achieve over $1 billion of cost savings in 2019 on top of the $1 billion savings achieved last year. We also have clear line of sight to the $1 billion of incremental savings in 2020 that we shared at our investor conference. These savings are being achieved through improved productivity and automation, elimination of waste, improved sourcing of goods not for resale and administrative efficiencies.

Like many industries, grocery retail is navigating through disruptive change. As part of the company's ongoing evolution, store operating divisions recently evaluated and reduced middle management roles to ensure they have the right talent in the right roles closest to our customers in store leadership positions. As a result, Kroger incurred severance charges in the third quarter totaling $80 million.

Fuel is an important part of our strategy to drive customer engagement, and our loyal customers continue to receive hundreds of millions of dollars in fuel rewards each year in the form of price discount at the pump. As Rodney mentioned, fuel is driving lower customer trips and sales, and the amount of fuel rewards paid to loyal customers increased by 8% in the third quarter.

The average retail price of fuel was $2.62 this quarter versus $2.81 in the same quarter last year. Our cents per gallon fuel margin in the third quarter was $0.30 compared to $0.26 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 improvement in fuel cost of goods in the third quarter.

Alternative profit streams are on track to contribute an incremental $100 million in operating profit in 2019. Media and Kroger Personal Finance continue to be the primary drivers of growth this year.

Kroger Precision Marketing continues to build momentum, increasing engagement to over 1,000 brands with a 90% retention rate and significantly higher spend. We have relationships with all major agency holding companies supporting their media activations as they deploy brand building programs. Our Media business continues to release new inventory and create new publisher relationships to support the demand of advertisers.

And now to update on labor relations. As we have previously shared, we are proud that our average hourly rate is over $20 with comprehensive benefits factored in, benefits that many of our competitors don't offer. As a result of Kroger's investments in our associates, we are improving employee retention in one of the tightest labor markets in years. We continue to invest in our associates as 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 Southern California, Portland, Seattle and Michigan during the quarter. We are currently negotiating with the UFCW for contracts covering store associates in Las Vegas and Memphis. 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. We strive to make our overall benefit package relevant today to associates.

Our financial results continue to be pressured by inefficient health care 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.

A key element of our capital allocation strategy is to use our free cash flow to invest in the business and drive profitable growth while also maintaining our current investment-grade debt rating and returning capital to shareholders. We actively balance the use of cash flow to achieve these goals.

We committed to prioritize free cash flow in 2019 to reduce the company's net total debt to adjusted EBITDA ratio to within our target range of 2.3 to 2.5. Over the last 12 months, net total debt has reduced by $1.5 billion, and Kroger's net debt to adjusted EBITDA ratio is 2.5 for the third quarter of 2019 compared to 2.72 a year ago. We remain committed to our target net total debt to adjusted EBITDA range.

Now that we are operating within our target range, and as we expect to generate strong free cash flow, we anticipate starting to buy back shares in the fourth quarter under our $1 billion Board authorization. This is not expected to have a material impact on fourth quarter EPS.

Turning now to guidance for 2019. We continue to expect identical sales growth, excluding fuel, to range from 2% to 2.25% in 2019. We continue to expect adjusted net earnings to range from $2.15 to $2.25 per diluted share and adjusted FIFO operating profit to range from $2.9 billion to $3 billion for 2019.

We expect underlying identical sales growth in the fourth quarter will be similar to third quarter. However, incremental SNAP dollars that were in the market in January 2019 represent about a 50% -- 50 basis point -- excuse me, 50 basis point headwind in the quarter. We, therefore, anticipated reported ID sales will be towards the lower end of our 2019 guidance range for quarter four as we cycle the effect of SNAP.

We continue to expect the fourth quarter to deliver double-digit EPS growth on an adjusted basis. Where we land with our adjusted EPS annual guidance range will be heavily influenced by fuel margins in the fourth quarter, which were at record highs in quarter four last year. Our customers' shopping behaviors affected by the lower SNAP dollars in market in January will also influence the outcome.

As you know, we typically share annual guidance when we report our fourth quarter results in March. But this year, we provided guidance for 2020 several months early. We remain confident in the 2020 guidance that we shared last month at our Investor Day in New York.

And now I'll turn it back to Rodney.

William McMullen

Thanks, Gary. As I shared when we first began the call, we believe that Restock Kroger is the right framework to reposition our business and create value for all of our stakeholders. We are on track with a stable and growing grocery business as a result of our customer obsession, renewed intensity around operational excellence and continued development of our seamless ecosystem. Our focus on the fundamentals generated positive results in our supermarket business in the third quarter, which gives us strong momentum heading into the holiday season.

Now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions]. The first question is from Edward Kelly with Wells Fargo.

Edward Kelly

I just wanted to start with a question on the Q4 outlook. So you have a fairly wide range. That, I guess, implies earnings growth anywhere from sort of like mid-singles all the way up over 20%. One question, I think, that I have related to this is what are the puts and takes around that range? And I know you mentioned fuel, but a second question related to that is that to get to these numbers sort of either way, you need core grocery earnings to improve, and that's despite what is a harder comparison on SNAP and quite frankly recent pressure in grocery. So can you just kind of walk us through those puts and takes and then what you think will drive core grocery earnings to inflect positively in Q4?

Gary Millerchip

Yes. Thanks for the question. I'll cover that. So you're correct, we expect -- as I mentioned in the prepared comments, we are expecting adjusted EPS growth to be in the double digits in the fourth quarter. Obviously, as I mentioned a moment ago, we're assuming and expecting identical sales growth to be in the range in the quarter, continuing the sort of trend that we saw in Q3, but there will be some SNAP headwinds that will bring it down towards the lower end of the range. So that's the kind of core assumption around ID sales for the quarter.

We do cycle some investments. In Q4 last year, if you recall that we set up costs around some facilities in D.C. So from a gross margin perspective, we do have some tailwinds that will help the quarter. We also expect to continue to see the cost saving improvements that we've been accelerating throughout the year as we continue to execute on the $1 billion cost saving plan. And of course, I think we shared on previous quarters that alternative profit streams tends to be skewed more towards the fourth quarter, predominantly because both KPS has a heavy fourth quarter influence on the results and then Media continues to accelerate, and Q4 is always a higher Media quarter as well. So you combine an accelerating rate and the fact that Media is higher in the fourth quarter helps the alternative profit part of the business to continue to grow.

In terms of the sort of puts and takes in the quarter that could influence where we finish in the range, on the headwind side, obviously, we have been investing in a new brand launch, and we're obviously spending dollars there in continuing to improve the messaging and translating that into a connection with our customers. We also launched the promotion on free pickup for the quarter as well and seeing how that plays out in terms of customer behavior. And then, of course, we also have the fuel headwind in the fourth quarter where our rate was $0.34, which was a record high last year. So those would be the headwinds that we're pushing against versus the assumptions I mentioned earlier.

The unknowns around the range, really, with fuel being a record high in the fourth quarter last year, if fuel performs in line with where it's been on average for the year-to-date position, it would obviously be at a certain level. If it was -- which is a $0.29 to $0.30 range, if it was at the similar level as last year at $0.34, that makes a meaningful difference to how the quarter ends. And then, of course, seeing how customers behave as a result of the SNAP dollars not being in market in January is a further factor in really causing us to leave the range as wide as it is. But we do feel confident in the way we see the model in the fourth quarter, which is why we still believe double-digit growth in the earnings per share is what we'd expect to achieve.

Edward Kelly

And just a follow-up. It seems like what's new in terms of what we're learning in the guidance this quarter is it -- I guess it seems like there's a $0.03 pharmacy charge that's in the guidance given that it's in your $0.47. Your LIFO charge is going up by $0.04. So that seems to be something that's a bit more unexpected. What's offsetting that to allow you to maintain guidance?

William McMullen

Ed, this is Rodney. Just a couple of comments, and I'll let Gary fill in. Obviously, our identicals continue to improve and strong there. If you look at gross margin without fuel and pharmacy, a slight improvement there. We had great balance between cost improvements and gross investment and it's the continuation of those pieces coming together. So it's really -- the core business continuing to improve and move in the right direction, that's providing the tailwind to offset the $0.03 on the pharmacy that was out-of-a-quarter adjustment and the LIFO as well. I don't know, Gary, anything?

Gary Millerchip

I would completely agree with you, Rodney. I think the key thing for us is that, to your point, that those headwinds, even with those headwinds, if you strip those back in the quarter and look at Q3, underlying EPS and operating profit would have been positive excluding the out-of-period adjustment, as Rodney mentioned. Obviously, ID sales was very positive during the quarter. But we mentioned on the call, we didn't include it in the press release, but the impact of the out-of-period on gross margin rate was 9 basis points. So actually, in the quarter, gross margin rate, even with the pharmacy headwinds that we called out, would have been balanced with OG&A improvements over 15. So we were 24 basis points reported gross margin decline, excluding fuel. Taking out those 9 basis points, you get to the 15 basis points of underlying, if you like, gross margin investment after the -- excluding the onetime -- sorry, the out-of-period adjustment.

So when we look at 15 basis points of investment, including pharmacy headwinds that we faced and we achieved 15 basis points of OG&A improvement, we actually feel like the progress that we're seeing in the model has been masked quite a bit in the quarter and we feel very positive about the underlying trends that we're seeing in the business.

Operator

The next question is from Judah Frommer with Crédit Suisse.

Judah Frommer

Maybe first, just following up on fuel. Can you help us with the benefit you're getting from improved sourcing and the sustainability of that relative to just kind of a general step higher in industry profitability and how that's playing out?

William McMullen

It's a combination of really some technology investments that we've made in terms of how to buy fuel and making sure, from a market standpoint, how we're pricing on a daily basis and reacting to what our competitors are doing. So it's the benefit of the way fuel is being bought plus being much more disciplined relative to the market. So it's really the combination of those.

In terms of expectations going forward, from a procurement standpoint, we don't believe that's something that will continue to incrementally get better. We do believe it's something that we'll be able to maintain, and it's something that we've reflected in our guidance going forward.

Judah Frommer

Okay. That's helpful. And then maybe just following up on the Lucky's write-down. I don't think it was that long ago that you guys were citing double-digit IDs at Lucky's and great trends in produce. Maybe just a little bit more on the decision to exit the investment, the write-down of the investment. And is there any commentary on that kind of subchannel of food retail, kind of the specialized fresh-led food retailers and smaller boxes that's causing you to say maybe the traditional larger store fresh-led format is the way to go?

William McMullen

Yes, it really gets back to Gary's comments in the prepared remarks is -- and we talked about at Investor Day, it's really reviewing our whole portfolio of things that we are involved with and working on. And it really -- the amount of investment that it would take for Lucky's to be a meaningful contributor to Kroger overall and the efforts that it would take, we just didn't think it created a good return for the investments that were needed to be made relative to that. So it was really driven by narrowing our focus and the additional requirements to make it something that would be meaningful to Kroger. I don't know, Gary, you've been more on a day-to-day basis involved, anything you want to add?

Gary Millerchip

I think you characterized it well, Rodney. I think the only thing maybe to build in the second part of the question, I -- we do believe that as we get better connecting on fresh and continue to evolve the strategy around natural and organic, obviously, we're providing a far more comprehensive level of experience for that customer than ever before and continue to do more of that as we continue to build out the strategy around freshness and connecting with our loyal customers.

We do believe that there's still a role for the small format store. I think it's certainly proven. And I think it's still probably to be proven in the industry about what is the right model for a smaller format store and how do you make that economic model work and how do you connect with the customer in a way that drives the right value on those smaller shopping trips as well. So we still believe and continue to look for opportunities. And obviously, our Walgreens pilot continues to provide an opportunity to learn how to continue to build a strategy that has a small format presence in there. But I do think it also demonstrates your comment that it's hard to figure out that small format model and to make it work effectively.

Operator

The next question is from Chuck Cerankosky with Northcoast Research.

Charles Cerankosky

Been looking at the Thanksgiving sales and how customers were spending, trading up. Can you talk about what that might mean for the Christmas selling season later this month?

William McMullen

Yes. Thanks, Chuck. If you look at quarter-to-date, our identicals would be pretty similar to where we were in the third quarter. The balancing of it is significantly different than the last few years because, obviously, there's one less week between Thanksgiving and Christmas. If you look at the way how customers spend their money, we continue to see obviously strong on people trading up, strong performance in wine, cheese, all those types of categories, and we would certainly expect that to continue to stay consistent through Christmas as well. So we really expect the business to continue where it is through Christmas. Obviously, if you look at January of next year, it's really the SNAP cycling, the SNAP impact would affect the kind of the numbers that we've provided for guidance.

Charles Cerankosky

Related to customers trading up, is that what you're trying to do when you invest in the customer experience? Prepared food strikes me you're making investments there. But are there other things we should think about?

William McMullen

Yes. It's fascinating because the customer is trading up both in terms of buying bigger package size. So what we find is when people are tied on budgets, they go to smaller package size. So we see people trading up there. We see people trading up to products that's better for you, natural and organic category. Prepared foods would be an area that we see people continuing to trade up for, and it's an area where we've focused a lot of attention on how do we get better. We view it as a huge opportunity to improve from where we are. And it's one of those things where we're just at the beginning part of that journey but certainly see customers very willing to pick up dinner at Kroger but do it with a Home Chef meal or something already prepared.

Operator

The next question is from Michael Montani with Evercore ISI.

Antonio Tabet

This is Antonio Tabet taking over for Mike Montani. I just wanted to ask something on the 4Q comp outlook. You guys are obviously cycling SNAP in January. But I'm curious as to what you're seeing so far now with the whole rebrand going on.

And another follow-up to that is with the option of free pickup promotion going on right now until January 1, is there a possibility that, that stays? Or what are you seeing from that so far from the reception of customers?

William McMullen

Yes. If you look at the outlook for the fourth quarter, so far in the quarter, we're tracking pretty similar to where we were in the third quarter. So it's really up until the SNAP period, we really don't see changes there. In terms of the pickup, free pickup option, we really aren't to a point yet of deciding whether to continue it or not. As you know, we've done it in several markets, and we're still early in the analysis. We -- the customer adoption has been stronger -- a little bit stronger than what we were expecting. But it's -- we're still at a point where we don't need to decide that yet in terms of whether we extend it or not.

Gary Millerchip

Just to add, Rodney, so it is literally a few weeks obviously into -- since we announced the promotion. It's interesting. We're seeing a combination of new customers starting to use the service as well as existing loyal Kroger shoppers using the service more frequently as well. So we'll be using all of that data, as you might expect, to really analyze and evaluate. And that's certainly a factor that could also influence how the quarter plays out in terms of sales, which is another reason why we're trying to be clear about sharing the different moving parts that could still affect the quarter.

Antonio Tabet

Okay. That's helpful. And just a quick follow-up on the digital side. You guys grew digital sales 21% this quarter. And just the way we're thinking about it, for the full year, we're thinking somewhere in the range of $5 billion to $5.5 billion digital sales versus 2018 value somewhere around the baseline of $4 billion. So that implies around 31%, 30% year-over-year growth. Is that somewhat reasonable to think of? Or is that an attainable target? Just want to get your color on that.

William McMullen

Yes. If you look at it on a run rate basis, the numbers that you shared would be very consistent with what we see. The other thing I always think is important to remember that I mentioned on our digital business and Yael shared it on a graph is the profitability of that business is maturing as we expect. And if you look at the early adopters on digital, the profitability of that customer was the same as going in store because we get such a higher share of their total spend. And we continue to see that maturity happen as well, which, for us, is something that makes it a sustainable model longer term as well.

Gary Millerchip

Just one thing to add, Rodney, you said in your prepared comments and I mentioned it briefly as well, but I think we shared before that it really is the cycling of the Home Chef merger that caused the absolute percentage growth rate to show a declining trend. The underlying progress that we're seeing in customer engagement through Kroger pickup and delivery continues to be very strong and very consistent in the underlying results that we're seeing beyond the headline number.

Antonio Tabet

Okay. And does that headwind continue to 4Q?

Gary Millerchip

We've cycled that now. So it kind of -- it was partly through Q3, so you have kind of roughly half of it in the -- sorry, partly through Q2, so roughly half of it in the second quarter, and now it's fully cycled through in Q3. I think Yael may have shared, too, at the investor conference that we expect the growth year-over-year going into 2020 to be in that 20% range, consistent with what we shared this quarter.

Operator

The next question is from Ken Goldman with JPMorgan.

Kenneth Goldman

Rodney, thank you for the update on the quarter-to-date comp. Can you -- I know you probably will say no, you've never done this before. But just given some of the puts and takes for the fourth quarter, could you give us an update on sort of where you stand on your core gross margin quarter-to-date and your fuel margin as well? The reason I'm asking is there does seem to be a little bit of hesitation from some investors on your ability to sort of hit the high end of your guidance range for the fourth quarter. I just wanted to get your thoughts on that.

William McMullen

Yes. I really would just go back to the comments that Gary made before. If you look at the underlying supermarket business, it continues to be strong. Identicals continue to be strong. A very good balance between cost reductions and investments in service and growth. The biggest swing would be the fuel margin. And even internally, the swings can be so much from day-to-day that it's really -- the value of where we are quarter-to-date, I don't think it can change overnight. And I remember the other day being in a market where in the morning, the margins were $0.40. In the afternoon, the margins were $0.15. It's that type of swing. But when you look at overall, it's a great return and it creates a lot of customer loyalty. And then the other piece is SNAP. So I don't know, Gary, if there's any additional insight. But to me, quarter-to-date, fuel margins are just kind of hard because it swings so much.

Gary Millerchip

Yes, I think that's right. And just to put the number into context, I mentioned it briefly earlier, but the rate that we've been trending at year-to-date in that $0.29-ish range, $0.34 was the Q4 rate last year. That $0.05 range can make a $50 million difference in terms of profitability. So -- and obviously, we have a very clear strategy of how we connect with customers on fuel and making sure that we're in line with the market. And so it is one of those areas where it can have a significant impact, and hence why I appreciate it does leave a much wider range than we normally want to, I think, have in place for the fourth quarter, and it's certainly not a lack of confidence in what we're seeing in the underlying core business, but it's just -- with that level of uncertainty out there on something like rates, it's -- we felt it was prudent to leave the range where it is.

Kenneth Goldman

I get that. And then my follow-up is, obviously, the government made some changes that are going to take some people in the America off food stamps, and it sounds like there's more of that coming. I'm curious, to what degree does your 2020 guidance factor that as a risk? Because, clearly, I think that if 700,000 or eventually some of the people think it will be closer to 3 million Americans get off food stamps, I can't say that as a positive for you, but I'm curious if there's any way to think about numerically how that might affect you?

Gary Millerchip

Yes. Thanks for the question. Ken, obviously, it's something that we continue to watch very closely. And obviously, it's one of those things that we knew was a potential risk that's out there in the business, and we'll continue to watch it and evaluate. From our perspective, we really try and build the business model around being able to adapt to the circumstances, and we do believe that the model that we're creating and our ability to connect with customers and deliver an overall experience, the personalized pricing offers that we can generate that obviously are -- what we tend to see when customers have less dollars, they'll tend to gravitate more to own brand products, and you'll start to see some behavior shift. But because food is a nondiscretionary spend, usually, the customer is going to make adaptations that they have to, to be able to still buy the groceries that feed the family.

So from our perspective, it's certainly something that we contemplate as a risk as we think through how we'll continue to build our model and drive connection with customers. And it's something that we'll continue to adapt as we hear more and learn when and if the changes occur. But obviously, it's one of those things out of our control. And our focus is much more on how do we make sure we win the customer and continue to adapt strategy if some of those things were to hit us as a headwind in 2020.

William McMullen

Yes. Just a couple of additions. Obviously, the overall economy continues to be strong as well, which provides support. And when you look at SNAP, we would be less dependent on SNAP than many of our competitors would be as well.

Operator

The next question is from Rupesh Parikh with Oppenheimer.

Erica Eiler

This is actually Erica Eiler on for Rupesh. Firstly, just wanted to touch on price investments. I think last quarter, you called out, I think it was about 12 basis points of price investment. Just curious if there was a similar level of price investments this quarter.

Gary Millerchip

Yes. I don't think we've typically called out specifically price investments. What I would say in terms of maybe a couple of thoughts, when you think about gross margin and what happened in gross margin during the quarter, the way that -- to sort of break it down, if you like, and I covered a couple of these points earlier, but if you exclude fuel from the results, we had a 24 basis point investment in gross margin, 9 basis points of that related to the out-of-period charge that we shared in the press release this morning, which essentially brings it down to 15 basis points. All of that gross margin headwind was essentially in the health and wellness space between Kroger specialty pharmacy and retail pharmacy. And as Rodney mentioned, our gross margin rate overall improved slightly when you exclude pharmacy from the core business.

So another way to say that is through the cost of goods savings that we were able to execute on during the quarter and the alternative profit growth that we were able to achieve during the quarter, which both support improvements in gross margin, we fully offset the continued price investments that we made in the business to drive the continued improvement in ID sales growth.

We are continuing to invest in price. As we've shared, I think, at the Investor Day, a lot of our focus this year is on really making sure that we're using our data to drive the price investments in areas that matter most to our customers. And some of those are going to be personalized offers and promotions, but some of it will also be in fuel rewards. And we mentioned in the prepared comments that while the profitability of fuel improved during the quarter, that was offsetting the supermarket business by an 8% growth in the amount of fuel rewards that we paid to customers to incentivize them to continue buying Kroger.

So it's a complex model in that sense, but we are continuing to invest in price. We're pleased with the way that customers are reacting to the investments that we're making because it's certainly allowing us as that one component of driving the identical sales growth that we shared in the quarter. But we're being very deliberate in balancing those investments with cost of goods savings and alternative profit growth.

William McMullen

Yes. The other thing that helped gross -- our shrink improved for the ninth consecutive quarter and warehousing and transportation costs improved as well.

Erica Eiler

Okay. That's helpful. And then you briefly mentioned the prepared food opportunity. Could you maybe talk a little bit more about your vision behind the recently announced ClusterTruck partnership? And does this at all impact how you're thinking about Home Chef?

William McMullen

I'll start with the end of your question first. It doesn't affect us how we look at Home Chef at all. And if you think about our overall strategy on trying to serve the customer anything they want, anytime they want, anywhere they want, as you know, about half of food is food already prepared where people spend their money. And our market share there is significantly less than on the traditional supermarket business. And we really view that it will be a combination of Home Chef, something physical in stores in terms of meals ready to heat, ready to eat. And ClusterTruck is one of those where we think it's an addition to that overall ecosystem. Obviously, they have incredibly good technology. It's made to order quickly. And they will be able to leverage -- and we're doing -- it's obviously on a test basis, they'll be able to leverage some of our physical assets to be able to scale as well.

So it's really an additional piece in terms of how do we get the customers what they want, when they want it, the way they want it. And it's just an overall part of the overall ecosystem. And we just see the opportunity on food that's already prepared is a massive opportunity.

Operator

The next question is from Michael Lasser with UBS.

Michael Lasser

So you said you've been encouraged by some of the early learnings from your expansion of the free digital pickup initiative. Can you give us a sense for how that initiative has impacted the P&L? So is the financial performance in line with what you expected?

Gary Millerchip

Thanks for the question. Just recall, again, it is really early days in the journey with the promotion because we literally launched it a few weeks ago. And obviously, part of the modeling that you would expect us to do as we understand customer behavior is to look at -- as Kroger does on everything that we do, look at the longitudinal behavior with the customer and not just the individual transaction but how does that change the level of engagement with the customer, and that's going to need to happen over a longer period of time, as Rodney mentioned earlier.

Certainly, the early encouraging signs are, as I mentioned, we're starting to see new customers experience the service and start to engage in Kroger pickup that haven't before. We're also seeing existing Kroger pickup customers start to increase the frequency with which they use pickup service. And so a lot of the financial modeling that we will do will really be looking at those metrics over a longer period of time and saying, how does that play out in terms of the value it creates and how does it drive loyalty. And then, of course, as we talked a little bit about at the investor conference, we'll look at that in the context of the investments that we're making in the business and how does customer value this part of the experience versus other ways in which we're creating value across price investments, across fuel discounts and obviously through the experience that we're offering in the store.

So it's a pretty complex area. And certainly, we'll look at it over a longer period of time. We're seeing kind of the type of behavior we have expected to see, and it's certainly been positive. But it's really going to be a longer period of time before we could really evaluate the way in which it impacts the model with the customer.

Michael Lasser

And just to clarify, Gary, you have assumed that in your 2020 guidance that you've provided, the test will be limited to 2019 so it will not continue into 2020 at this point. And then I have a quick follow-up.

Gary Millerchip

We haven't really gotten into specifics around what our pricing strategy will be in 2020. As we talked about, obviously, I would think about it more much as you think back to the chart that I shared at the investor meeting in New York and how we're balancing the investments that we're making in the cost savings in the business. So we certainly have a clear view of how much we believe we want to invest in the business next year and how that will be supported by the $1 billion of cost savings that we're expecting. So if we were going to see the value in pickup driving more value in our model, it would be because either we expect it to drive higher sales and support the investment or we believe it would be a better way to invest the dollars that we think are important to driving value for the customer in 2020.

Michael Lasser

That's helpful. My follow-up question is, Rodney, you've seen some pretty good momentum in your ID sales. There's probably a variety of factors that are contributing to that, including a healthier overall environment, being further away from some of the disruptive changes that you've made and better execution in the business. If you had to rank those factors and maybe any others in order of importance and magnitude that they've contributed to driving this improvement, how would you do that?

William McMullen

Yes. Great question, Michael. We would really view those as pretty equal. The other thing that we would add on top of that is really using personalization and data to be more specific for each customer individually. So like on -- the example I gave on fuel rewards, but it would be true for offers more than just fuel rewards, but really personalizing it to each household individually. And it's really all of those -- we would call it, the sum of all parts. It's all of that together that's creating and improving the momentum. It's not just one single thing.

Operator

The next question is from Simeon Gutman with Morgan Stanley.

Joshua Kamboj

This is Josh Kamboj on for Simeon. So sales trends are improving and the grocery gross margin increased slightly in the quarter. How sustainable do you think that combination is in the near term? And then more broadly, what changes in the competitive landscape would you need to see to undergo a deeper round of price investments over the next three years than what's currently embedded in your plan?

Gary Millerchip

Yes. Thanks for the question. I think on the first part of the question, I would kind of draw back again to what we talked about at the investor conference. The way we think about the model going forward is, certainly, we're going to continue to invest in price. We're going to continue to invest in the customer experience because the long-term sustainable growth in loyalty, we think that's critical to our plan. What we're doing very deliberately is being very disciplined in how we're managing costs within the business, both cost of goods savings but also OG&A cost efficiency, which obviously was strong during the quarter. And then alternative profit streams continues to accelerate and obviously offset the gross margin investments that we're making as well.

So I think we look at it much more of an overall ecosystem, if you like, is how do we use food as the foundation for customer loyalty, which drives the traffic. And then fuel obviously builds on that in terms of causing customers to shop more frequently. And then you think about the health and wellness business and alternative profit streams layering on together to create this overall ecosystem that drives customer loyalty and drives total profitability of the customer. And the way we think about it is how do we pull those levers together in a way that allows us to continue to invest and build loyalty. And we're using the different dynamics there around alternative profit and cost savings to be able to continue to invest.

I think when we look at the market, certainly, obviously, there's always high competition. We expect that to continue. We always assume that within our model. And we feel very good about the plans that we're implementing around driving costs out and continue to grow alternative profit that we can make the investments that we need to, to be able to continue to grow customer loyalty.

William McMullen

Yes. I'd only add a couple of things. One, and Gary briefly mentioned it, if you look at continuing to learn to improve the customer experience, that provides support and ongoing support because we still -- we've made good progress, but we still see opportunities to get better.

The one area that I've been pleasantly surprised, as you know, we've been able to -- in 2018, we were able to take over $1 billion of costs out. We're on track to exceed that again incrementally in 2019, and we have plans to do that in 2020 as well. We continue to see good opportunity to take costs out. And when you look at all those -- both those pieces together and the free cash flow of the business is what gives us confidence and comfort in the comment that Gary shared at the investor meeting of TSR of 8% to 11% per year.

Joshua Kamboj

That's helpful. And then in general, maybe you could just quickly touch on your price gaps versus some of your key competitors. Have they been widening or narrowing? And are you pretty happy with where they sit at the moment?

William McMullen

Yes. One of the things that we always think it's important, we're comfortable where we are, but it's always important to remember that customers decide where to shop based on freshness of departments, and we shared with you that our customer feedback on fresh is better than our big box competitors. We also have tons of personalized offers where a customer gets value, both in terms of individual mailings, individual e-mails and fuel. So it's all of those pieces together, and we feel good about where we -- our gap is.

Operator

And the last question will be from Robbie Ohmes with Bank of America.

Robert Ohmes

Just two follow-ups. Just the first on the LIFO increase, can you maybe just -- you mentioned procuring better, but LIFO is coming in higher than expected. I think in the press release, you guys called out grocery and dairy inflation. Is this all commodity driven? Or are CPG companies pushing through price increases? And then also, could you tell us what the inflation component of IDs was to the third quarter? So maybe just paint us a picture of what exactly is going on between all those things.

Gary Millerchip

Sure. Thanks for the question, Robbie. Yes, it's an interesting question around LIFO and inflation because -- I'll maybe answer the two questions slightly differently. From an inflation point of view, as you know, we've shared before, we were assuming inflation in the range of 0% to 1% in the year. I would say it's trending slightly above that range. Actually, for Q3, I wouldn't say it's materially different than it was in Q2. There are a couple of categories like produce went slightly down and meat went slightly up, but nothing that would have been dramatic in terms of the overall change in inflation. So just slightly ahead of that 1% assumption that we had during the year. And actually, even though our LIFO charge forecasted increasing, we haven't really seen a dramatic change in the overall inflation rate across the categories. Everything I just said now I should probably caveat excludes fuel and pharmacy because those two obviously tend to have a different trajectory versus most of the food categories.

Interesting -- with LIFO, it is a one data point in time at the end of the year that we follow to support the accounting rules that are in place around making that LIFO adjustment. With the data point that we used in the third quarter caused us to, in following that process, believe that we should increase the rate and based on what it's telling us, that's why we called out the forecast is expected to be a headwind for the year. Of course, it's a noncash item, and it doesn't really impact the underlying performance of the business. But it will impact the earnings for the year based on the trend that we're seeing right now. But I wouldn't say it's a reflection of a major change in what we're seeing in inflation.

And obviously, we've shared before, when we see price increases, generally speaking, we'll be pushing back on them based on our knowledge of our own brand products and managing those. But where we are seeing them, we're generally looking to pass them on to the customer where it makes sense in those markets.

Robert Ohmes

And just my other follow-up question. Just on fuel rewards, so you're expecting the CPG profitability of fuel kind of -- it sounds like flatten out next year. But it sounds like you're also going to be pushing harder, if I understood it, to kind of drive IDs more using the fuel rewards program. Just how should we think about that? And has there been a change in the responsiveness to fuel rewards that's got you interested in pulling that lever a little harder to drive IDs and penetrate loyalty more?

William McMullen

Yes. It really is an important part of our overall connection rewards on -- back to our customers for them shopping with us. I would say part of it is just continuing to learn new approaches that connect with the customer. So over the last, really, 6 to 12 months, we've been doing a lot of different types of tests and learns, trying to identify additional approaches that connect well with the customer. And it's really some of those are working, so we continue to scale that. How much we scale will really be driven by the degree of customer connection and how much does it drive the business. But customers still love an incredible great value for fuel. And we have so many convenient fuel locations. It really works out well for our customers and for our business as well.

Robert Ohmes

And just, Rodney, how should we think about -- if you do keep growing it at 8% year-over-year, how will you fund that in 2020 if you're not going to be growing the profitability of your fuel business at the same rate?

William McMullen

Yes. Well, when we talk about fuel cents per gallon, we do not reduce that for any rewards at all. That doesn't show up there in terms of our internal financials. If you look at the overall guidance that we gave for 2020, we would be reflecting what we expect and plan to do on fuel rewards. But it really gets back to Gary's comment in terms of by -- improving identicals by this much, these type of process changes and getting costs out, what type of capacity does that give us to invest in service and price. And we would look at fuel rewards as part of that price investment because that's how our customers look at it.

Thanks, Robbie. We really appreciate everybody joining us today. And as always, thank you for your questions. Hopefully, you can get the sense from Gary and my comments that our underlying business results continue to be strong. Identicals continue to move in the right direction. We had good balance on investing in growth and cost improvements, and the free cash flow of the business continued to be strong, which positions us to get into a position of being able to buy stock back as well. So when you look at it overall in the quarter, feel very good about the underlying results and where we're headed.

As you know, before I end today's call, I always like to share a few final comments that's directed at our associates and how we live our purpose every day. Last week, I was visiting with store associates in our Collierville Kroger in Memphis. And a customer approached me when I was walking into the store, and he just wanted to share why he shops at Kroger. And he said -- first of all, I gave an example where one of our associates just gave incredible customer service. And then he said, "Krogers, you always are great at donating food and funds to serve hungry families in our communities." And he specifically talked about his community. And to me, that reminded me of the privilege that we all have, to serve our customers and communities and each other, whether it's generously giving back to our neighbors in need or by being there for our more than 11 million customers that come into our stores and online every day, especially during this busy holiday season.

We open our doors and welcome everyone in as guests, whether they shop with us all the time or it's their first time shopping with us. Each celebration or tradition is unique, and we can be there for our customers when they need us most. Because we believe no matter who you are, how you like to shop or what you like to eat, everyone deserves to have affordable, easy-to-enjoy, fresh food. Each of us, all 460,000 associates, play an incredibly important role in bringing fresh for everyone to life. From stores to plants and distribution centers and our corporate and division teams, thank you for all you do every day and especially during this busy holiday season. I wish all of you and your friends and family happy holidays, merry Christmas and a happy new year.

Operator

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