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Executives

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

Analysts

Mark Wiltamuth - Morgan Stanley, Research Division

John S. Glass - Morgan Stanley, Research Division

Mark Wiltamuth - Morgan Stanley, Research Division

All right. Okay, are we ready? Okay, welcome back. Again, I'm Mark Wiltamuth, the grocery, drug store and discount analyst. We're here to welcome Kroger, Kroger CFO, Mike Schlotman, to the stage. So thank you so much for coming, Mike.

J. Michael Schlotman

Absolutely.

Mark Wiltamuth - Morgan Stanley, Research Division

We're covering you for 10 years now. I think you've come down to this event several of those years. So wherever should the event be then, in Arizona, in Texas and now Florida. This -- we were in Florida last year, too.

J. Michael Schlotman

Very good.

Question-and-Answer Session

Mark Wiltamuth - Morgan Stanley, Research Division

Mike, if you look back, at the October Analyst Meeting, you really started to shift your tone for the investment community. You started talking about --

more about return on invested capital for investors, more margin and more offensive expansion story. You've taken your growth rate from 6% to 8% EPS growth to up to 8% to 11%. Let's talk about the returns part of it. Where do you think you're going to get the better returns? Is it going to be more of a margin story? Or is it going to be asset turns where you kind of push sales and control your capital spend?

J. Michael Schlotman

I actually think the return part will be a little bit of both. As we talked about in October, the ROIC growth won't be a rocket ship, it will be a slow ROIC growth because we are expanding and increasing the amount of capital we deploy. But as you saw at our year end, we spent a lot of capital, we spent $2 billion of capital last year and maintained the 13.4% ROIC on the metric that we use. So we were pretty pleased with that given the amount of capital we spent. And that was fueled by the asset turns, as well as the slightly expanding operating profit margin we had.

Mark Wiltamuth - Morgan Stanley, Research Division

Have you gone back and kind of adjusted the management compensation plans and built that return metric in there?

J. Michael Schlotman

We have -- actually, there's -- for the top 150 people in the company, there's actually 2 incentive plans out there. One is an annual plan that the basic tenets of that everybody that's on an incentive plan in the company has the same basic principles. And that's ID sales growth, EBITDA and how we do on different attributes of our Customer 1st strategy that we want to deploy that year. So it's more tactical things to support the long-term strategy. That remains unchanged. We also have a 3-year long-term incentive plan, and there's a new one out there every year. So there's a payoff every March based on the previous 3 years. The new one that was instituted this year, so it will pay out in March of 2016, does have an element in it now that's dependent on growth and ROIC.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. If you look at how you kind of bucket your stores, you kind of talk about your top third, your middle third and your bottom third. Is there one of those you're focusing on in bringing performance up?

J. Michael Schlotman

All 3 thirds. Say -- there's -- there are different focuses depending on what spot you're in, in that group. We actually don't break it down exactly like that. But if you break it down like that, there are certainly things that every one of the stores, no matter where you are in that metric, there's something you can improve. And there's some department inside your store you can improve. One of the other things we do is when -- no matter when you make a list, there's always something at the bottom of the list. So if I look at my 100 worst-performing stores, frankly, most of those -- they would have negative EBITDA generation on a fully allocated basis. When you take overhead allocation out, it wouldn't be nearly that way. But one of the things we do with them is we don't go into those stores and those divisions that have those stores and say, "You have to turn these from red to black." In some of those cases, it would be a fairly daunting task on a one-off basis. But a lot of times, what we'll do is we'll go to those store managers in those divisions and say, "What's your strategy to make the store 10% better this year than last year?" And make it a goal that they can easily execute on an annual basis. And typically, if you give them a reasonable goal and they beat it, you'll wind up getting a 15% or 20% improvement. And before you know it, they're back to the point of being red without just acting like they have to do that all in 1 year.

Mark Wiltamuth - Morgan Stanley, Research Division

And if you look over the long term for you, you've now done 37 quarters of positive ID same-store sales growth. Did everybody catch that, 37 quarters? So a lot of this has been self-driven. You've been cutting gross margins purposely to drive the sales. A lot of times, we get questions from people, "How long does Kroger have to keep this up?" And when is enough, enough? And is that gap close enough to Walmart that you don't have to keep cutting gross margins at some point?

J. Michael Schlotman

Well the -- a few things there. One is we have committed to and we've done it -- have grown our operating margin. So internally, at Kroger, we focus solely on operating margin growing. Our view on gross margin is, is we're going to have permanently lower gross margin rate, offset by permanently higher gross margin dollars. So inside the company, we focus -- when we look at gross margin, we look at gross margin dollar generation. I look at the same thing on operating profit. But you all want to convert it to rates, so I commit to rate. It works either way, particularly with growing IDs. The answer isn't just Walmart, and that's -- I think that's one of the tougher parts of our story to get across is there's a dwindling number of comparative companies to look at in our industry, so are by things our industry is dying. What might be dying in some of the public people in our company, even SUPERVALU now is not going to be somebody who, regardless of where the results are, is going to be uttered in the same breadth because they're back to the kind of company they were 7 or 8 years ago. And then they're a primary wholesaler and have Save-A-Lot. They still have Farm Fresh in the Hampton Roads area. But they've shed a lot of their full-service grocery stores now. So even they won't be quite an apples-to-apples comparison anymore. The fact of the matter is, is the full-service grocery industry in the United States is very healthy. It's just that a lot of those folks that are running those stores, they aren't publicly held companies and nobody -- and I'm not faulting you all for not understanding who they are or analyzing or understanding them because you can't own their stock. So we'll be spending a lot of time -- when you don't have much time on something, the Publix, H.E.B, Hy-Vee, Wegmans, WinCo, all of these companies are great full-service grocery operators doing just fine like we are. It's just a lot of people that invest for a living don't recognize that they exist because they can't own a piece of that action. And I'm not saying that I think you ought to understand those people and spend time on them because you're all starved for a time because there's few and you have more and more -- a bigger universe to cover every day. So you can't spend time on something you can't invest in. But the fact of the matter is, is the high end is doing just fine, the low end is doing just fine and where we operate is doing just fine. And there have been winners and losers in every segment. People in what we do have lost, either the Marshes of the world, the Bashas's of the world. The Albertsons acquisition by SUPERVALU didn't turn out like they hoped. But there's plenty of us doing just fine in the middle. Wild Oats had to sell off to Whole Foods. So just being high end isn't an automatic ticket for a success. And Save-A-Lots, numbers on the low end, once they started reporting their IDs, obviously, just the value proposition isn't automatic formula for success. The formula for success, no matter how you go to market, whether it's one of you all managing money, one that obviously for you all is returns. But are you giving your customer what she want? Understanding the customer, so if you don't understand the goals of the customer whose money you all take in to invest, you're likely not to satisfy that customer over time. If I don't understand what it is my customer wants when they come in a grocery store and make sure I satisfy that need every trip, I'm not going to win over time. And I think where people have fallen by the wayside is they focus on numeric results rather than satisfying the customer. If you have a whole bunch of satisfied customers, the numeric results will follow. I mean, we have 7 million customers a day coming into our stores. We have the opportunity to make them feel better when they leave than when they came in. And if we're highly successful in doing that, the odds of them coming back in 2 or 3 days, like people do right now, is very, very high. And that's why we focus so much on the customer.

Mark Wiltamuth - Morgan Stanley, Research Division

Let's talk about that point there at the end, people coming back every 2 or 3 days. The old model of grocery, it was let's go after mom because she is stocking the pantry for the week and she's going to cook 7 dinners for the week. And so if you win the mom, you win the grocery store battle. Now most people don't know what they're having for dinner tomorrow or tonight, for that matter, and you're getting different people shopping, the dads are in the mix, the kids even get a vote. What are you doing to kind of shift your merchandising to pick up on some of those more immediate buying trends and people who want meals assembled rather than making something from scratch?

J. Michael Schlotman

Well, we have a lot of stores that have ready-to-eat meals, where there's a bistro inside the store where you can come in and get a hot meal and take it home, which would compete against takeout food from a quick-serve restaurant. We have a lot of ready-to-heat meals inside the store. There's also a growing trend of people cooking at home because the belief that when you prepare it yourself, you know what you've put into it and you're going to wind up eating healthier over time. And I think that's as big a piece of the trend change of how often people shop is not necessarily knowing what they want to buy. It's if you're going to cook more at home, people want to buy the fresh part of that shop closer to when they buy it because it just tastes better. And I think -- I actually think one of the issues that earlier description of the mom stocking up, they didn't always prepare the 7 days meal. That they might have bought stuff for 7 days and thrown some of it in the freezer. Well if you get home at 6:00 and you've got to have to have the kids somewhere by 7, you probably don't have time to thaw something versus if you shop for 2 or 3 days, you can put it in the refrigerator and you don't have to worry about thawing it out. It's fresh and ready to cook and you can use that product right away.

Mark Wiltamuth - Morgan Stanley, Research Division

Let's talk about that fresh angle. Now you've got the Fresh Market, Whole Foods, others that are 2/3 perishables. Have you ever thought about going with a more smaller store format with -- that kind of caters to that fresh and organic crowd?

J. Michael Schlotman

I wouldn't say purely an organic offering because Fresh Market isn't as wholly organic as Whole Foods.

Mark Wiltamuth - Morgan Stanley, Research Division

Neither is Whole Foods for that matter.

J. Michael Schlotman

Right. I mean, everybody thinks they only have organic produce, but I think they have some other stuff. We have a version of our stores called Fresh Fare, where it would tilt more to that shoppers' likings where the square footage -- in a 60,000 square foot store dedicated to the fresh product would be higher. Ralphs probably has more of those than anybody because that's an important aspect in the Southern California market. And not every market calls them Fresh Fare. We have a lot of stores in Kroger markets where we don't necessarily brand them Fresh Fare. But based on the demographics of the area, they're merchandised just like a Fresh Fare store. So I don't think you'll ever see us open up just that kind of a store but it's an iteration of the store we have. We think that's been one of the strengths we've had over time, as we haven't gone with the one trick pony of what our stores look like. And while it may sound it's difficult to manage a varied offering like that, it's really things on the margin. 80% of the store is probably the same and it's 20% that changes based on the demographics of the store. And it's fairly easy to execute the supply chain. All of our stores have some organics. It's just that some have more than others.

Mark Wiltamuth - Morgan Stanley, Research Division

So I'm sure you've added more organics as the popularity of that whole category has grown. Where are you today in maybe the mix of organic sales versus where you were maybe 5, 10 years ago?

J. Michael Schlotman

I don't have that exact number in organics, and it's actually a number I'm tracking down internally because I want to understand -- one of the things I'm trying to understand is what's our -- what's the sale of our products that are in the same categories of Whole Foods sales. And I think we're going to be surprised. And if we get comfortable with the number, talking about it outside, how many dollars we actually sell every year of items just like what Whole Foods sells. Will it be as big as a Whole Foods inside Kroger? I don't know if it's that big but I think it's going to be a pretty dog-gone, big number. Our natural foods, which we separate out from the organic piece of produce and meat, that category continues to grow at double-digit pace. Last fall -- or actually early this year -- late last year, early this year, we launched our Simple Truth line, which is a corporate brand line. But it's not really gone to market as a corporate brand. It's gone to market as a natural and organic food product, and the sales of that have been far above our expectations. And the reentry into the product by the customer, meaning they liked it the first time so they came back and bought it the second time, has exceeded our expectations. And one of the taglines of that product is it's -- the packaging all says it's free from 101 artificial ingredients, which is very important to that customer.

Mark Wiltamuth - Morgan Stanley, Research Division

And does that kind of type of product and the organic offering in general resonate in all the demographics? Or is it more middle and upper?

J. Michael Schlotman

There are people with plenty of money to spend who don't enter the organic market at all. And there are people whose budgets are more stretched that buy only organic. And so it really is a lifestyle choice in many cases, not necessarily a budgetary choice. Sometimes, budgets keeps people from it but there are plenty of people who would, in all other respects, look like a value customer but want a lot of organic and healthier food in their basket.

Mark Wiltamuth - Morgan Stanley, Research Division

Why don't we switch over to loyalty programs and your use -- your work with dunnhumby. You probably got a 6-year lead or more on analyzing royalty card data and applying it to a customer -- customized offering to the consumer when you send a flier to their houses. I noticed you brought this last week. Here's a coupon. How hard is it going to be to translate that over to a digital strategy?

J. Michael Schlotman

It actually is quite easy to move that over digitally if we wanted to flip that switch. The fact of the matter is, is we send over 9 million mailings on a quarterly basis, and over 8.5 million of those mailings to our customers are unique. So there's very little repetition in the uniqueness of what the customer gets. The redemption rate on those offerings is very, very high. So our customers come to accept that. As we go down a path of allowing that customer to get it digitally, do they want it just automatically loaded onto their loyalty card so they don't have to carry the coupon. we're going to let -- over time, we're going to let the customer decide because there are plenty of customers out there who you just can't engage with digitally. My mother-in-law, for example, doesn't have a smartphone. She doesn't have an iPad and barely turns on the computer that she has. So we have little hope of engaging someone like that digitally, but we don't want to ignore them as a customer in the offerings. So over time, we're just going to let the customer decide how they want to interact and engage with us. That said, if you go to the Kroger app, and I can't facilitate it here, but we've been doing it on our one on ones, it's kind of interesting -- right now when I call up the Kroger app, there's 189 digital coupons that I can click on and add directly to my loyalty card. And it's broken down. So if I'm in the beverage section, I can click on beverages and see what sorts of coupon for in the beverage section, add to my card when I go check out, scan my loyalty card and I automatically get a discount. Cindy, on the other hand is a little upset because she only has 187 digital coupons available to her, so there's a certain amount of variability of the coupons that get offered to a customer, and those can be used more than once. Those aren't a onetime use, the quarterly mailings are onetime use. And then there's oftentimes, you'll get an e-mail saying, "Hey, click here." There's a group of special coupons for you based on some of the shopping habits you want to -- that we've noticed you've done.

Mark Wiltamuth - Morgan Stanley, Research Division

I guess what I'm getting at in an indirect way, Safeway has got there Just 4 U campaign, where you can download coupons and they give you directed offers electronically. I mean, how different is your offering from that? You can get there pretty quickly, it sounds like.

J. Michael Schlotman

Yes. I mean, there are -- frankly, there's elements of their program that we don't do that are interesting. I think if they were sitting here and being very frank about it, there's -- I would believe they would think there's elements of what dunnhumby does for us that are interesting that their process doesn't do. That said, we do everything we can to understand exactly how they go to market with that program. My guess is they do everything they can do to figure how we go to market with our program. So I mean, it's like anything, there's certain elements of everybody's go-to-market strategy that are different than we do, and some we like and some we don't like. And we're all out in the public domain. And it's generally pretty easy to figure out what one person is doing versus another. And things you like, it's -- over time, it's -- they can be replicated.

Mark Wiltamuth - Morgan Stanley, Research Division

Let's talk a little bit about the current operating environment, some of the things you've done, how many data is telling you. Talk about the current pressures on the consumer. Did you feel anything from the 2% payroll tax? Have the delays in the tax refunds mattered? Any of those issues that are kind of going on today.

J. Michael Schlotman

Yes. I don't think tax refund has ever been a big driver in our business because we're more of a basic necessity. Probably, a little bit at the Fred Meyer general merchandise sales, there's probably a little bit. If it's going to affect anywhere, it's going to be there. It's really tough to see anything. It's relatively, it's big for them, but overall, small piece of our overall business. Relative to the 2% tax increase, we haven't seen blips in the radar screen as a result of that. And frankly, at the end of the day, if people have just a little bit less in their pocket, it's a little easier to stretch your money by cooking at home than going out to eat. And it, I don't want taxes to go up, but if anything, on the margin, it's probably a bit of a slight positive for what we sell versus a slight negative.

Mark Wiltamuth - Morgan Stanley, Research Division

We just did a survey that just went out this week that showed that 54% of the consumers didn't even notice that the 2% payroll tax went through. And for lower income shoppers, it was like only 25% were aware of this payroll tax. So interesting that people didn't notice.

J. Michael Schlotman

I saw that piece, and I was -- I guess people don't look at their payroll stub, they just look at their take-home pay. Maybe they thought they worked an hour less or something, I don't know.

Mark Wiltamuth - Morgan Stanley, Research Division

Well, that could be part of the issue. The lower income customers, maybe more hourly workers, and if they work an hour different, that will change.

J. Michael Schlotman

Their paycheck probably varies week to week, anyway.

Mark Wiltamuth - Morgan Stanley, Research Division

Let's talk about the dynamic of eating at home versus going out to eat. The casual dining restaurants have -- we've got these indicators that come in weekly, and we've been seeing some better indicators at the casual dining restaurants lately. Have you seen any shift in eating at home versus dining out lately?

J. Michael Schlotman

And I'm assuming when you say better trends, it's compared to last year?

Mark Wiltamuth - Morgan Stanley, Research Division

Right. And sequentially, they've gotten better...

J. Michael Schlotman

Sequentially, they've gotten better. But typically, when you talk about ID sales as compared to what you did last year. So sequentially doesn't surprise me. In the first quarter, there are a lot of snow disruptions. That always hurts their sales and helps our sales. And compared to prior year, it doesn't help because you always -- when you think about what your sales are doing this year, you always have to be aware of what affected sales last year. So this time last year, everybody thought the recession was well behind us. The healthy -- the consumer was great because their sales were great. There was very little snow disruption last year. So that's a slight negative in our business and a slight positive to their base business. And that's compared to a 2011, where in the first quarter of the year, there was a lot of snow disruption. So we were comparing to a period of time where we had a lot of benefit from snow and it would have hurt them. So I don't know that if you look at the trend lines over a 2- or 3-year period that there's anything economy related that you can discern from our trends and their trends versus just what was going on in those periods of time in the prior year versus this year. It didn't surprise me that last year in the first quarter, their sales were strong because our sales -- that's one of the things that caused a little weaker tonnage. If weaker year-to-year, in the first quarter last year than the prior year, because you get such huge tonnage lift when you have snow in a lot of parts of the country. You're never going to be able to make that up the next year on just a normal week.

Mark Wiltamuth - Morgan Stanley, Research Division

Yes. That's one of the things we like to do at this conference because we have the restaurant guys just presented before you, so we get a little tone out of everyone.

J. Michael Schlotman

Did they share my beliefs? I got to believe that there's some of that.

Mark Wiltamuth - Morgan Stanley, Research Division

Maybe, John will maybe chime in.

John S. Glass - Morgan Stanley, Research Division

I think I mean, no one wants to be that clear about it. So first quarter was definite close. But to Mike's point, that the last 4 to 6 weeks were very strong. Plus, your [indiscernible] is against tough comparison, weather has not been helping year-over-year. So something [indiscernible]

J. Michael Schlotman

In the last 4 weeks, I would agree with you. Correct.

John S. Glass - Morgan Stanley, Research Division

[indiscernible] whether it's [indiscernible]

Mark Wiltamuth - Morgan Stanley, Research Division

For those on the webcast, John Glass, our restaurant analyst saying things have gotten much better in the last 4 to 6 week in casual dining.

J. Michael Schlotman

It doesn't surprise me.

Mark Wiltamuth - Morgan Stanley, Research Division

Let's shift over and look at the industry growth volumes because we have had a turn there. And I want to know what your thoughts are on what drove that. I mean, there's been some chatter that it was the cooling of inflation and we've seen a turn to better volume numbers. And have you seen it broad based? Is it across the whole industry? I know your volumes are better, Safeway is a little better. Have you -- can you tell that -- if everyone is participating in this?

J. Michael Schlotman

Again, I go back to my earlier comment. Last year's first quarter was challenged tonnage-wise because we were up against the 2011 quarter. Now we didn't talk a lot about this back then. It's kind of in hindsight as people analyze things because our sales didn't go -- our ID sales didn't go negative. So a lot of people were using weather, in a lot of people's views, as an excuse for where their sales trends were. But I got to tell you, when you have a year like 2011 where there was a lot of snow, it's not a surprise to me that first quarter 2012 tonnage was challenged a little bit because you had no snow events to make up that tonnage. So I don't think the underlying health of the consumer really changed. It's just that their shopping habits changed because of the environment around them. This year's first quarter tonnage -- I'm a little easier to talk about first quarter because we're a January 31 year end, and we talked about results through

March. So I had January, February and 5 days of March when I announced first quarter results. It was helped by snow. And I'm up against a year where last year didn't have snow. So my tonnage is going to be better. I mean, you can see in individual store when a snow scare is coming. On that day before the snow, their sales are 50% higher than the prior year.

Mark Wiltamuth - Morgan Stanley, Research Division

And the amusing thing is even if it doesn't snow, it was just predicted, they'll eat it anyway.

J. Michael Schlotman

Well, because it's all perishable product. It's amazing that they go out and buy things that's only going to last 2 or 3 days versus canned product that will last longer. But that's okay by me. I don't want them to change.

Mark Wiltamuth - Morgan Stanley, Research Division

So you think it's more weather vagaries, it's not really a structural...

J. Michael Schlotman

I really don't, particularly in the time frames. Let's talk again in the summer and see where second quarter tonnage is year-on-year because you usually have less weather effect year-on-year over that kind of a time frame. The Thanksgiving to kind of March 1 time frame is always a difficult time to measure tonnage or sales for anybody in different segments of retail because there are a lot of weather events that can change habits. If you look at tonnage outside those trend lines, I feel more comfortable with it.

Mark Wiltamuth - Morgan Stanley, Research Division

How about an inflation update? I think on the quarter, you said you thought that the year would end more inflationary in 2013 than it is today. But I guess, the corn crops, already there's some chatter that maybe we've got good supplies and maybe inflation is even more positive.

J. Michael Schlotman

Hope it rains in July this year. If it doesn't rain in July, all my bets -- all my views of inflation are off the table because that's what happened this time last year, we were going to have a bumper crop as well, then it didn't rain for 6 weeks. The snowstorm has actually helped a little bit in the Midwest, maybe not as much as they wanted because the ground in the Midwest was actually very dry coming out of the drought last summer. And the snow helped to get some liquid back in the ground. So the dirt wasn't -- because it was pretty arid to begin the planting season, and that certainly is a better start to it than people would have thought 2 or 3 months ago before we got the late winter snow.

Mark Wiltamuth - Morgan Stanley, Research Division

So category-wise, we're still inflationary in meats, maybe go through some of the big categories?

J. Michael Schlotman

Yes. Meat continues to be inflationary, although it's not as inflationary over the prior year, as a lot of people think it is. But that's -- it got pretty high last year. So last year -- again, it's back to -- it's a 3% inflation right now in meat, for instance, but that's off of probably 12% last year. So you're still up in meat, and that's just a weekly kind of comparison. Seafood was deflationary in the fourth quarter. There are some elements of the seafood category that has some inflation in them. You're going to ask me why I don't know the exact why answer, I just -- because I haven't asked that yet. But salmon, for instance, has a lot inflation in it right now, and that's an important item in the seafood shops. In the center of the store, its relatively -- it's in the 1% to 2% range. We actually ended last year -- inflation trended down throughout the year and towards the back -- towards the very end of fiscal 2012 for us. So December and January, there was really no inflation at all that we could discern in the grocery category, but we do expect a little bit this year.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. Any questions from the crowd? Landon?

Unknown Analyst

So one of your competitors has mentioned that with the new economy, the inflation rate sweet spot for that is now lower than previously. Do you agree with that view?

J. Michael Schlotman

I think somewhere around 2% is a decent place for inflation to be. And our view right now is inflation is probably in the 1.5% to 2% range.

Mark Wiltamuth - Morgan Stanley, Research Division

How about the acquisition environment right now. I mean, Harris Teeter is probably on the block. There may be parts of their former SUPERVALU that could become available. Are you interested in doing anything like that? Or is it really stick with the current strategy of fill-in acquisitions and some incremental new store growth along the way?

J. Michael Schlotman

Anything that is out there over time, it's probably safe to assume that as things go for sale, we take a look at just about everything that goes for sale in the industry. I'm not going to comment on individual things that may or may not be for sale. But not all of what Cerberus has bought from SUPERVALU would necessarily be a new market entry for us. A lot of those stores, depending what they want to do with them over time could be fill-in opportunities for us as well because some of those stores are in markets where we operate. It just depends as Cerberus gets their arms around what they bought, how they want to manage because they don't buy them to run them long term. That's just not what they do for a living. So at some point, they will want to start selling stores would be a matter of how they spin it. But again, we don't buy fixer-uppers, and it's -- it has to meet our internal hurdle rates to do it. Why -- if I can build new stores and hit my hurdle rate, why would I buy somebody else's store and not hit my hurdle rate?

Mark Wiltamuth - Morgan Stanley, Research Division

I mean, if you look at that Cerberus transaction where they bought 80% of the SUPERVALU stores, I mean, that is now a sizable grocery base that they've got. What are your thoughts on how they're going to run things? Do think they will divest a lot? Do you think there will be price reductions? What do you think is going to be the industry's takeaway from that?

J. Michael Schlotman

Yes. It will be -- I think it will be interesting to see what they wind up doing. Obviously, when they bought the pieces of old Albertsons that SUPERVALU didn't buy, they sold a lot of those assets relatively quickly. Some of them, they still operate. It won't surprise me, if you fast forward 5 or 6 years, you see a similar pattern out of Cerberus based on what they did when Albertsons sold itself. I don't work there, so it's pure speculation.

Mark Wiltamuth - Morgan Stanley, Research Division

And for you, what are the big overlaps with that -- that chain? Is it more Southern California...

J. Michael Schlotman

Southern California and some in the Pacific Northwest. But it's -- that would be the biggest. I mean, we're not in Chicago -- well, we're in Chicago with a different format and we're not in Philadelphia, we're not in Boston. So whatever they do there won't really affect us.

Mark Wiltamuth - Morgan Stanley, Research Division

I guess, on a related topic on other competitors. Tesco, Fresh & Easy has -- had a little bit of a flame out here. You've had many of those open against you in Phoenix and some of the markets out west...

J. Michael Schlotman

Southern Cal, Vegas.

Mark Wiltamuth - Morgan Stanley, Research Division

What are your thoughts there on that whole idea of the smaller grocery store? And where do you think there was a failure there? And is there opportunity for you to kind of look at that kind of format also?

J. Michael Schlotman

Well, I mean, we have roughly 700 convenience stores, some of those aren't your typical 2,000 square foot convenience stores. Some of those are 6,000 and 7,000 square foot convenient stores, if you will, that are in the right markets that can support a full-size grocery store, but need a better shop. So we -- when you look at the different formats we have, we have stores that are -- there's really not a format out there that we don't have, which is -- some people may think that's a bad thing. But we have Fred Meyer stores that are 220,000 square feet. They're as big as a Walmart Supercenter and we have stores all the way down the hard discount stores that are 12,000 square feet and are 85% corporate brand product. So we have everything, and we work very hard to understand what market and what part of a market needs, what kind of a store offering and try to get the customer what it is they need in that particular part of the market or market entirely.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. Any other questions for Mike? I think we'll -- go ahead.

J. Michael Schlotman

At the buzzer.

Unknown Analyst

You mentioned 5 years out how things look. 5 years out, how does the industry look? It seems like Walmart's making an extremely aggressive push with the smaller format stores. What does Kroger look like 5 years from now?

J. Michael Schlotman

I mean, I think 5 years from now, our footprint will be bigger. We've talked about going into the new geographies organically. It will probably a lot -- we'll decide internally long before you know externally where we're going to go just from a competitive standpoint and cost of procuring real estate standpoint. We're focused on -- there are some markets where we have decent market share. We could have a better market share. And our store density isn't where we want it to be, and the customers tell us that they like what we're doing based on how they shop with us and what they tell us from customer surveys. So we'll add in some -- there's 2 major markets that we've picked internally that we won't talk about, where we're going to focus on spending our incremental capital to dense up those markets. The opportunity in those markets is, in our judgment, is very, very strong. We already have 1,500 stores the size that Walmart is building. So actually, we're opening more 120,000 square foot kind of marketplace stores, which has been a great growth vehicle for us. It has about 30,000, or 35,000 square feet of general merchandise space on the side of a really good grocery store that have been a great vehicle for us. So you'll probably -- we only have 70 or so of those right now. You'll see us put more of those in. As we go into new markets, there will be some of those and there will be some regular grocery stores as well. So I think we'll continue down the path of our multi-format strategy. One of the nice things about going into a new market is we'll have a clean palette to go into a market and say, "All right, here's the 3 places we want a marketplace store. Here's the 3 places we want a 60,000 square foot grocery store. Here's the place we may want a convenience store that has expanded offering in it." So we'll be able to start from the ground up in a new market and give the customers in those markets exactly what we believe they want and they tell us they want.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. Any other last-minute ones before we break? Okay, very good.

J. Michael Schlotman

Thank you, Mark.