The Kroger Co. (NYSE:KR) Q2 2017 Results Earnings Conference Call
September 8, 2017 10:00 AM ET

Executives

Kate Ward - Director, IR

Rodney McMullen - Chairman and CEO

Mike Schlotman - EVP and CFO

Analysts

Karen Short - Barclays

Zack Fadem - Wells Fargo

John Heinbockel - Guggenheim Securities

Ken Goldman - JP Morgan

Ben Bienvenu - Stephens

Robby Ohmes - Bank of America Merrill Lynch

Mark Carden - UBS

Rupesh Parikh - Oppenheimer

Vincent Sinisi - Morgan Stanley

Stephen Tanal - Goldman Sachs

Shane Higgins - Deutsche Bank

Alvin Concepcion - Citi

Operator

Good morning, and welcome to The Kroger Company's Second Quarter Earnings Conference Call. All participants will be in listen-only mode.

[Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Kate Ward, Director of Investor Relations. Please go ahead.

Kate Ward

Thank you, Laura. Good morning and thank you for joining us.

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

Both our second quarter press release and our prepared remarks from this conference call will be available on our website at ir.kroger.com.

After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question, and one follow-up question, if necessary. Thank you.

Please save the date for our 2017 Investor Conference, which we will hold in New York on October 11th. Details will be coming soon and we hope you can join us.

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

Rodney McMullen

Thank you, Kate, and good morning, everyone, and thank you for joining us.

With me to review Kroger's second quarter 2017 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

As you know, Kroger has competed in an ever-changing retail landscape for 134 years. Our success over time boils down to one thing, our relentless focus on the customer. That focus allows us to deepen our connection with customers and create shareholder value. The customer remains the center of everything we do.

The four core elements of our Customer 1st Strategy are as relevant today as they were when we first introduced them. How we invest each year to drive customer engagement changes regularly based on customers' changing needs and wants.

This showed in our second quarter results, as we returned to positive identical supermarket sales growth, and both loyal and total households increased. Traffic was up, unit movement was up and market share was up. Our customers' perception of our prices is excellent and we continue to get even better.

Based on our second quarter results and expectations for the balance of the year, we have confirmed our annual net earnings guidance. The operating environment will continue to be incredibly dynamic. But more importantly, customer behavior is changing faster than ever before.

For the last few quarters we've talked with you about our expanded view of all the food our customers eat, and how we've been working to redefine the market as share of stomach rather than share among traditional grocery stores. We know that the massive, $1.5 trillion U.S. food market creates a unique and sustainable growth opportunity for Kroger. You'll see changes in the way we go to market as a leading indicator of the lens through which we view our market. We see anyone who sells food as competitors in the future.

Kroger has a history of successfully evolving to meet our customers' changing needs, because we put the customer at the center of everything we do. We are transforming today, too. We are reprioritizing and accelerating investments in our Customer 1st Strategy in order to anticipate and meet rapidly-evolving consumer demands to shop with us for anything, anytime, anywhere. Our transformation is all about redefining the customer experience.

As our business continues to improve, we remain committed to delivering on our guidance for 2017 and believe we have the ability to grow identical supermarket sales and market share in 2018 as well. In this dynamic operating environment, we will continue to provide annual guidance as we have done for many years but will no longer provide longer-term guidance. This will provide needed flexibility in how we invest to position us for the future success.

We look forward to getting into the details of our goals and priorities at our upcoming investor conference in October. But in the meantime, I’d like to begin to create a vision by sharing several ways we are redefining the customer experience to be America’s inspiration and destination for everything food. We’re doing this by combining our knowledge of food and our ability to personalize through the use of data analytics; we’re doubling down on digital; and we’re leveraging new and ongoing partnerships to deepen our connection with customers and drive revenue.

I’ll take a few moments to share more about each of these areas where we have deep credibility from our past and are aggressively developing for our future.

Food retailing is more exciting than ever before, especially as more of us become foodies. Customers have nearly an unlimited number of options when you combine tastes, flavors and types of meals with the growing number of food outcomes that consumers are focused on. Those outcomes might include eating for health or for enjoyment, for example, or for lifestyle or performance reasons.

Kroger is uniquely positioned to be the partner our customers turn to for their meal needs because we know food and we know our customers better than anyone. Meals have always been our expertise. Kroger is often the one driving change and innovation behind the scenes.

We are very proud of the role we've played for over a decade in making natural and organic products more affordable and accessible to America, especially for shoppers on a budget. We've always believed that our customers shouldn't have to pay higher prices just because a product is natural or organic. We developed our Simple Truth brand to be honest, easy and affordable because our data told us this was a great customer need in the marketplace. Today, Simple Truth is the biggest natural and organic brand in the country by volume. This market continues to provide a robust opportunity for Kroger.

Similarly, our culinary innovation team is bringing truly affordable and incredibly tasty meal kits to American households through our Prep+Pared offering. Just last week, we announced that we are expanding our offering of Prep+Pared to more than 50 stores in three of our divisions, Cincinnati, Louisville, and Ralphs.

Across Kroger, we know our customers better than anyone. We have a 13-year advantage of using data insights to connect with customers. Data analytics are fully integrated in our business, as 84.51° helps us make merchandising, operations and marketing decisions. In the last year alone, Kroger has made more than 3 billion personalized recommendations to customers through product offers, promotions, recipes and more.

Data analytics is helping us win with Our Brands by identifying the best products to bring to market based on consumer behavior and taste trends. Research by an independent third party shows us that our customers favor Our Brands over national brands and competitor offerings. The strength of Our Brands is what our customers realize Kroger quality is superior, and at a very affordable price. It truly is quality without compromise. Customers get the best and most innovative quality at the best prices. We will build this momentum to be the premier private label destination in America.

Combining our love of food with our data expertise allows us to offer content that inspires. We recently launched a new My Recipes feature on Kroger.com that serves up a personalized selection of suggested recipes. The recipes offer greater diversity of meal ideas, all based on your individual purchase behavior. Our growing collection of recipes is also searchable by a variety of filters including seasonality, world cuisine, meal or dish type, and cooking style. While online recipes are not new, serving them up on a personalized recipe for your family is and customer and your family will love the new offerings. And this is distinctly Kroger.

Personalized recipes are just one example on how we are bringing the combination of food and data together to create new and highly-relevant customer experiences, especially through digital and ecommerce. Customers expect a great shopping experience and the ability to interact with us digitally or online in a seamless way. Our digital efforts are all about making things easier for our customers and providing personal, affordable and exclusive options that fit their needs. This includes our mobile app, for example, in addition to Vitacost.com, ClickList, Express Lane and home delivery. Today, we have more than 25 million digital customer accounts. As we said in our press release, our total digital sales are up 126%, driven by ClickList.

We operate more than 813 ClickList and Express Lane locations offering the convenience of online ordering and curbside pickup. By the end of the year, we will offer the service at more than 1,000 locations. Customers continue to respond exceptionally well to ClickList.

We know that in the future more customers will want the option of home delivery, so we are also testing various home delivery models with companies like Uber and Shipt and on our own in more than 150 stores. We will keep making the strategic investments to serve customers anything, anytime and anywhere in the near future.

With new entrants in a fragmented market, we're also transforming our business and building partnerships to deepen our relationship with, and create value for, our customers. We've been preparing for new market entrants for years, and the fact that Kroger is trusted by more than 60 million households annually is a great strength when customers have more food choices than ever before. We continue to gain share in key categories like natural foods, produce and fresh prepared foods. We will continue to focus on growing our core business to generate free cash flow and deepen our personal connection with customers. These changes also create opportunities to work with our existing partners to deliver more value for customers and to identify new partnerships to create alternative revenue streams.

Now, here is Mike to share more details on our second quarter results and to walk you through changes to our capital allocation process and long-term guidance. Mike?

Mike Schlotman

Thanks, Rodney. Good morning, everyone.

We're pleased with our second quarter results, especially return to positive identical supermarket sales. That combined with strong market share, tonnage growth, and both loyal and total household growth demonstrates our ability to evolve with the changing preferences of customers. Kroger has the team, the skills, the knowledge, the scale and the data analytics to be a winner in food retailing.

Another positive sign is that we had overall product cost inflation for the first time since 2015. As you know, the change from inflation to deflation and back again is one of the toughest environments to operate in for our stores, and we're proud of our team's ability to manage through it.

Our Customer 1st Strategy has always guided our strategic investments to be there for our customers today and more importantly to where they are going in the future.

To undergo the transformation Rodney discussed, we recognize that we need to make these Customer 1st investments more aggressively, and faster than ever before. Like Rodney said earlier, we are eager to share the specific elements of our plan with you at our investor conference in October. But, today I will highlight two examples.

First, 84.51° has helped us redefine space optimization for the entire store. As this comes to life, it will drive sales and operating profit growth. In the short run, there is a cost to doing this but we feel the return is significant. This is another example of using 84.51° in new and innovative ways. Second, we're making sure we have the right products at the right cost and at the right retail prices for our customers. We are approaching these efforts, along with the areas Rodney outlined earlier, with even more focus and urgency than we have in the past.

For example, we've already reprioritized the way we invest capital by both reducing the amount we spend and by turning our capital allocation process upside down. We now look first for sales-driving and cost-savings opportunities through both brick-and-mortar and digital platforms. Second, we will continue to make sure our logistics and technology platforms keep pace with and scale to these demands through continued investment. Then, finally, we will allocate capital to storing activity. This process has allowed us to use less free cash flow for capital investments.

One thing I want to be very clear on is that we are not talking about a new strategy to replace Customer 1st. We are talking about better executing the elements of our plan to deliver on all four keys for our customers. As Rodney said earlier, our customer remains our focus.

We continue to see strong growth and amazing potential on Our Brands. During the second quarter, Our Brands sales grew more than national brands in our grocery, drug GM and meat departments. Identical sales for Our Brands also outpaced identical supermarket sales. The second quarter brought strong sales and unit growth, with Our Brands representing 27.7% of total units sold, and 25.4% of sales dollars, excluding fuel and pharmacy.

All of this is consistent with the research we commissioned last year to give us an objective view on Our Brands. This included blind taste tests with national brands and other private label foods. The research showed that the most-loved brands sold in our stores are Our Brands, above even the national brands. And in the blind taste tests, Our Brands outperformed competitive national brand and other private label products.

Now for an update on retail fuel. In the second quarter, our cents per gallon fuel margin was approximately $0.217 compared to $0.198 in the same quarter last year. The average retail price of fuel was $2.28 versus $2.20 in the same quarter last year.

Our net total debt to adjusted EBITDA ratio increased to 2.37, compared to 2.11 during the same period last year. This result is due to the merger with ModernHEALTH and the incremental repurchase of shares.

Over the last four quarters, Kroger has used free cash flow to repurchase $1.7 billion in common shares, pay $448 million in dividends, invest $3.1 billion in capital, and merge with ModernHEALTH for approximately $390 million.

The flexibility to return value to shareholders is a key strength of our financial strategy. We are committed to balancing the use of cash to maintain our current investment grade rating. We have reduced our 2017 and 2018 planned capital investments by a total of $600 million to maintain this balance and flexibility. Return on invested capital for the second quarter, on a rolling four quarters basis, was 12.37%.

On the labor relations front, we recently ratified an agreement with the UFCW for store associates in Atlanta and Dallas. We are currently negotiating an agreement with the UFCW for store associates in our Food 4 Less Warehouse Stores and with Teamsters for the Master Agreement. This fall, we will begin negotiations with the UFCW for store associates in Charleston, West Virginia.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality, affordable health care, and retirement benefits for our associates. Kroger's financial results continue to be pressured by inefficient health care and pension costs, which some of our competitors do not face. Kroger continues to communicate with our local unions and the international unions, which represent many of our associates, the importance of growing Kroger's business and profitability, which will help us create more jobs and create more career opportunities, and enhance job security, for our associates.

Turning now to guidance for fiscal 2017. We had previously indicated that the environment during the first half of the year would be similar to the back half of 2016, and that is what we saw. Cost inflation trends for the second quarter were consistent by department, with grocery, liquor, produce and meat all positive for the quarter. Deli was deflationary and pharmacy continues to be inflationary.

We are confirming our 2017 net earnings guidance for 53 weeks of $1.74 to $1.79 per diluted share. We are also confirming our adjusted net earnings guidance range of $2 to $2.05 per diluted share. Our LIFO expectation remains unchanged at $80 million.

We expect identical supermarket sales growth, excluding fuel, of 0.5% to 1% growth for the remainder of the fiscal year. Our guidance does not include any effect from hurricanes Harvey or Irma. Our insurance provides coverage and caps losses at $26 million for each event. Until the claim is finalized, it is difficult to provide an exact amount. And we expect capital investments excluding mergers, acquisitions and purchases of leased facilities, to be in the $3 billion to $3.3 billion range for 2017.

Now, I will turn it back to Rodney.

Rodney McMullen

Thanks, Mike.

I'm often reminded of the saying, "may you live in interesting times". These are interesting times in our industry, and I know some of you wonder how Kroger can continue to thrive in such a dynamic operating environment. We have a history of evolving to meet our customers' ever-changing needs. The key is to proactively see where the customer is going and to proactively address the changes. That is what we are doing today. Through innovation, Kroger is redefining the food and grocery customer experience based on our core strengths.

Kroger has more data than any of our competitors, which leads to deep customer knowledge and unparalleled personalization. We have incredibly convenient locations and platforms for pickup and delivery within one-to-two miles of our customers. We have a leadership team that combines deep experience with creative new talent. We have the scale to win with more than 60 million households shopping with us annually. In fact, we've been named America's most beloved grocery store several times. We have a proven track record of consistently returning capital to shareholders through an increasing dividend and share buyback program. And, we have a track record of connecting with our associates, customers and communities to uplift and improve lives, as evidenced by our team's response to Hurricane Harvey.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Karen Short of Barclays.

Karen Short

Hi, thanks. Just starting I guess with your guidance. I guess, what I'm trying to understand is, obviously you maintained your earnings guidance but you now have operating margins down 30 to 40 basis points versus prior 20 to 30. So, by my math, that's about $0.09 to earnings. And so, I guess, I'm wondering, just to clarify, the offset has to be below the line unless I am missing something. And I just had a follow-up on the operating margin guidance change.

Mike Schlotman

The benefit comes from multiple places throughout the income statement, Karen. There are efforts underway that will make the operating margin decline that you saw in the second quarter, not as much in the third quarter. We feel very good about the health of the business today, the trend of ID sales, our efforts on cost of goods reductions and our efforts on productivity and operating cost reductions. When we combine all of those, we feel comfortable with the $2 to $2.05.

Karen Short

Okay. But within the change in the operating margin, right, so it's now down 30 to 40 basis points versus the prior 20 to 30. Can you may be just talk then a little bit about where -- that was a first half event then, and so, we've already kind of seen that or is there more to come in terms of gross margin or operating expenses in the second half that we're not kind of -- or we haven't been previously contemplating?

Mike Schlotman

Yes. I am not going to go into every specific line of the income statement. But, we are seeing good flow of cost of goods coming in and good cost savings opportunities in the back half of the year.

Karen Short

Okay. And then, just one quick question, I guess on Bloomberg, you indicated sales in the third quarter to-date were off to a nice start. I think that's what you said. Maybe can you get a little more granular, meaning are they at the high end of your second half guidance or a little more color there?

Rodney McMullen

Yes. Currently quarter-to-date, and this is without the hurricane effects, we would be above where we finished the second quarter and we would be closer to the high side of the guidance range. The reason we exclude the hurricane is because one day it's a positive, one day it's not because of obviously one day you will have business that's up 100% or 200% and the next day it's basically zero. So, we just -- until we get completely through the two hurricanes and when we release third quarter, we will obviously give a lot more insight. But so far, we would be trending ahead of second quarter and closer to the top end of the range.

Mike Schlotman

And Houston is doing just fine. They have all the two stores back and operational and our warehouse is fully operational.

Operator

And the next question will come from John Heinbockel of Guggenheim Securities. I apologize that actually will be Zack Fadem from Wells Fargo.

Zack Fadem

Hey. Good morning, guys. I want to follow up on the ID sales. You mentioned the recent traction but your second half guidance would imply that you actually narrowed the annual range by 30 to 40 basis points. So, could you just talk about parts here, estimates, traffic trends and may be walk through the decision to narrow that range rather than just holding it steady or taking up the low end?

Mike Schlotman

Yes. And frankly, we talked about it a lot. And what our intention to do was really to take flat for the year off the table because we don't see that in the cards. We still clearly see 1% for the year in the cards. And our intent was really to get the notion of flat off of the table, maybe confusing to people so far today but that's what our intention was. We may not have done it as perfectly as we could have. But, we still think the high end of the original annual range is in the cards but we don't believe flat is in the cards, which is why we wanted to take that off the table.

Rodney McMullen

And on changing the range, as Mike mentioned, if we left the range the same as it was before, it could have meant, we would have had positive -- negative identical, excuse me, for the second half of the year. And obviously, we wanted to make sure that everybody understood that we do expect identicals to be positive and the trends that we're seeing so far, the identicals continue to improve.

Zack Fadem

And Mike, I also wanted to follow up on the quarterly EPS cadence that you provided last quarter. Should we still anticipate EPS up slightly in Q3 and then flat in Q4, excluding the extra week?

Mike Schlotman

We actually, purposely hold the quarterly guidance cadence out of the earnings release in light of focusing more on an annual earnings per share target. I don't see any big alterations to that guidance that we had last quarter. Halfway through the year, you kind of have to wind up with those kinds of numbers to be in the $2 to $2.05 range any way.

Operator

And now, our next question will come from John Heinbockel of Guggenheim Securities.

John Heinbockel

So, Rodney, two strategic questions. Let me start with the space optimization project you're talking about. Sort of big picture and to a little picture, is that less center store, more fresh; is it less brands more private label? What are you doing there? And then, what are the costs, simply labor costs to rearrange, shelving and the like?

Rodney McMullen

In terms of how much it encompasses, it would be everything that you mentioned plus some. And as Mike mentioned in his comments on the space optimization 84.51° is helping us look across the whole store and how do we use space. So, obviously, in some cases, it's continuation of adding more fresh space. It's also in terms of the products that we offer to the customer, every single item has to earn its right to be on the shelf and categories have to earn the right to have certain amount of allocation. So, it's all of those things. The expense would really be driven by two things. One, when you make some changes, there are some equipments that you would write off. As you make the changes, there is certainly the labor and the cost in doing the changes, plus some of the equipment gets written off almost immediately. So, it's both of those factors that is behind what Mike was mentioning.

Mike Schlotman

And if you move things around too much inside of a store, there is obviously disruption for short period of time that customers being able to usually navigate as we move a lot shelving and things around.

John Heinbockel

And then, secondly, when you talk about capital allocation, it sounds like you want to invest in existing stores more than new stores, at this point. So, what does that mean for your M&A philosophy? Does that suggest less of an appetite for M&A, does it suggest more of an appetite for digital M&A and less brick and mortar?

Rodney McMullen

I would say, the broad comment would be, from an M&A standpoint, we would be equally as excited today as two years ago, when we find the right person to partner with. And as you know, when we look for someone to partner, we're looking at somebody that brings things to us as much as we bring to them. We would continue to be aggressively looking at anything digital that adds capabilities. You may recall, in the past year and a half or so, we merged with a company called Market6 and another company called You Tech. And we were able to use in both of those situations, the 84.51° and accelerate the work that they did and accelerate some of the work that we're doing plus brought a great amount of talent to our Company. So, we would increasingly look at curtain capabilities that somebody would bring to us and how do you partner with them in a way that would bring that capability. But for the right merger opportunity, whether it's digital or physical, we would be as excited today as two years ago, but it would obviously have to be somebody that fit in well with where we operate and has a business that's strong.

Operator

And our next question will come from Ken Goldman of JP Morgan.

Ken Goldman

Two for me, if I can. Have you -- in your opinion your competitors, and I know it’s very soon, so maybe the answer is no, but have you seen new one or view yourself low at any prices yet as a direct result of price changes at Whole Foods? And I guess, can you talk a little bit about how your stores are doing the last couple of weeks? It’s not that Whole Foods necessarily has lowered prices that much, although arguably they have, it’s just that there has been so much news about it, just kind of trying to get a sense of really what you’re seeing so far in the marketplace.

Rodney McMullen

Well, as you mentioned, Ken, it’s only been a week and a half, so it’s very early in the process. And as I mentioned in our prepared remarks, we’re really proud of the work that we started over a decade ago, and making sure natural and organic product is affordable to all customers, and we never felt like just because something is natural or organic, you should charge a premium for it. In terms of the impact, obviously, it’s way early, but there isn’t anything that would cause you to develop any point of view at all, in terms of changing trends, but it’s only been a week and a half. So, I would caveat it a million different ways.

Ken Goldman

Feels like it’s been longer in my world. But, thank you for that…

Rodney McMullen

Obviously, the discussion around it has been longer than that.

Ken Goldman

Yes. It wasn’t a very quiet August for many of us in this industry, I’m sure not for you either. Can I just follow up on one thing? In terms of your guidance for the comps in the back half of the year, I just wanted to dig in a little bit more on that, because the business is doing clearly in some ways better. Right? You’re talking about comps being positive, positive tonnage, but the guidance does imply a fairly meaningful step down in the two-year stack in comp in the back half. And I know, there is many ways of looking at that. But that's one of the questions I've gotten from investors this morning. I just wanted to see if you had a comment on that, if you could sort of help us out understand why you're sort of thinking that comps will be a little bit maybe a weaker on a two-year level, maybe that means fundamentally weaker or is that not how you look at it?

Rodney McMullen

I don't think -- I actually don't look at two-year stacks very much, because I sold whatever I sold last year and I'm selling that plus more this year. And we feel very good about the underlying health of our business. As we said in the prepared remarks and in response to questions so far, ID sales so far in the quarter are pushing the high end of the guidance range. We grew loyal households, we grew total households, we have strong market share growth and strong tonnage growth. And I would also remind you that as our brands continue to gain strength and gain a bigger share of both units and sales that comes at the expense of a lower retail ring, which winds up being a bit of a headwind to reported ID sales. And we have been very aggressive with how we position those products inside of our stores.

Operator

And the next question will come from Ben Bienvenu of Stephens.

Ben Bienvenu

Hi, thanks. Good morning. Thanks for my question. On the digital revenue growth, pretty significant and obviously making progress there on the ClickList side. I'm curious, does that have any meaningful contribution to the comp that you referred to in the quarter.

Rodney McMullen

It’s a great question and it’s hard to answer because the thing that we’re trying to do for our customers is to do it in a way that’s totally seamless. So, the customer continues to come into the store and shop, so we actually get more of their total basket. So, it’s helping comps but it’s helping comps from that total customer household and how much they’re spending with us. So, it’s helping identicals but it’s really hard to say ClickList is X percent of it or Y percent of it. I don’t know, Mike, anything want to add?

Mike Schlotman

It’s clear that the customers love the service and it gives them an incremental connection with Kroger. And as Rodney said, it gives us a bigger share of their wallet, the longer they’re engaged in ClickList.

Ben Bienvenu

Understood, thanks for that. And then, second question on the private label business, that’s been a big success factor for you. Rodney, you highlighted in some of your initial comments, the customer perception of the brands that you offer under your corporate brand. I’m curious, as you think about the future opportunity, A, what is the magnitude of the opportunity as a percentage of sales; and then, B, how much capacities do you have for self manufacturing to deliver on that higher penetration opportunity?

Rodney McMullen

I’ll give a little bit broader answer than just your question. First of all, we would talk about it in terms of our brands versus private label, because from -- and it’s something that took us longer than it should have. But, if those brands, they are our brands and the customers tell us they love it and one of the things that we probably should have done years ago but we hadn’t but we actually, was much more aggressive on hiring a third-party company to do a broad test taste and quality preferences for our brands across multiple national brands and other companies’ private label programs. And we always thought we were good but we came out even significantly better than what we would have even thought. So, it really highlighted the progress that our team has been making on improving the innovation in our brands, the variety of offerings. If you look at Simple Truth, obviously five years ago it didn't exist; today, it continues to grow double digits.

So, when you look at overall, our customers tell us they love our brands. And we continue to even get more aggressive in terms of creating additional innovation, brands, offerings within, new flavors.

In terms of the potential, at this point, the only thing that I would say is it's -- would be massive. And one of the things that we did several years ago, we went to the outside and hired a new leader for that team and about half of our team is from the outside. And when you go and look at Europe, obviously, on the Our Brand product in Europe, the market shares there are significantly higher than the U.S. And we would be much more focused on how do we make sure the innovation, the quality and the offerings that we have, we earn the right for the customers to take it to that kind of level.

In terms of our plant capacity, if you asked our manufacturing team, they would probably tell you they're at almost capacity. I've always found and we've always found that we always figure out ways to produce incremental product and do it very efficiently. So, in terms of capacity, it is one of the great things about knowing how to operate plants, we could easily expand capacity, either through process change or additional expanding plants, things like that, whether is needed.

Operator

Next we have a question from Robby Ohmes of Bank of America Merrill Lynch.

Robby Ohmes

Rodney, Walmart -- you guys called out your great digital sales growth. And one thing is, can we get digital as a percent of sales from you guys?

Rodney McMullen

Not at this point. I don't know, Mike, if you -- not at this point. As you know, we are continuing to provide a little bit more insight than before. But…

Robby Ohmes

Okay. So, I will keep pushing on that but -- maybe in the future some time. But, so, I was going to ask, Walmart obviously is being really aggressive with the rollout of their version of ClickList. I was hoping you could maybe speak to us about where you are having crossover with them, sort of what the dynamic looks like? Because I think you two are being the most aggressive at going after this new way of grocery shopping. And then, the other question I had on competition. Aldi's been out there -- sorry, Lidl's been out there now a little bit longer than Amazon's owned Whole Foods. So, maybe you could kind of update us on what you are seeing there? Thanks.

Rodney McMullen

Yes, On the crossover with Walmart on digital, I actually don't know the answer to that. Mike, do you?

Mike Schlotman

I don't know how many we overlap with. I do know that the thing that customers really appreciate about our offering is the fact that most of our customers live within a mile or two of the store. They shop and they can go pick the ClickList offering. And so, it's extremely convenient for them to engage in that kind of an activity and often easy-in easy-out and not all of our competitors have that advantage.

Rodney McMullen

And it's incredibly easy to develop a shopping list with us, the work that our teams have done working with 84.51°. We do a lot of work on predicting what your shopping list will be, to make it really easy to do. The one insight that I can give you and we'll have to go back and look to see the overlap on Walmart is -- our success on ClickList is very consistent across the country. You don't see one place where it's 1% and somewhere else it's a 100% variance of success. It's pretty consistent.

On the Lidl, obviously, they continue to open stores. So far, what they've done has been pretty consistent with what we expected. And obviously, you've heard us talk about from a pricing standpoint, we won't lose on price; we're not trying to lead the market down on price, but we are not going to lose on price. The success so far in terms of being able to maintain our business and grow our business, we feel very good about the ability to compete against all the Lidl and anybody else. So, I wouldn't say there has been any surprises so far. Obviously, they are our great competitor but there is a lot of great competitors out there.

Robby Ohmes

And just last question, the lack of -- the move away from giving us long-term guidance, is the ramp up of ClickList a big piece of that, meaning does it really pressure store profitability in the short-term? Because you're having -- is that how we should think about it is ClickList is great, but in the short-term, it's a real pressure on margins?

Rodney McMullen

Well, as everybody on the call knows, we make our investment decisions in terms of what do we think is best for our business three to five years out and which intern means what's best for our shareholders three to five years out. There is no doubt that ClickList is a headwind on earnings currently and we've even continued to accelerate the speed in which we put ClickList in. And so, it's incremental headwind. We feel very comfortable, when you look at it over a three to five-year period of time. Our customers will appreciate that we offer ClickList; our associates obviously in terms of being able to provide the service will be glad; and our shareholders will be glad. So, we can clearly see where we're -- there is a path where we're indifferent on whether somebody comes into the store or shops with us on ClickList. It's you have initial paying and that would be a -- of what caused to affect the long-term guidance perspective.

Operator

And our next question comes from Michael Lasser of UBS.

Mark Carden

Hi. This is Mark Carden on from Michael Lasser today. Thanks a lot for taking my question. So, you commented earlier that periods transitioning from deflation to inflation can lead to a challenging operating environment. So, given we saw food at home CPI turn inflationary again this quarter, can you comment on how the competitive environment has held up relative to your expectations? And by that, has it been different from past cycles or pretty much in line with what you've seen recently?

Rodney McMullen

I would say it's fairly common or fairly traditional time of a transition. It's just at anytime you go from higher prices to lower prices, the thing that gets disruptive is how quickly will people lower prices and then the flip is the case as inflation creeps back in, how quickly will people adjust prices the other direction, to continue to protect the gross margin dollars that they would have in those products. And that's what causes the disruption in the short run as you're cycling through the two of those. I would say broad based, there isn't anything that's really out of the realm of what you normally see. The one exception to that would be what we talked about earlier in the year relative to some low milk prices earlier in the year and eggs continue to be pretty inexpensive as well. But, those would probably be the only two categories that I would hold out as maybe exceptions to the norm right now.

Mark Carden

And then, I guess a little bit more near-term. You mentioned that with hurricanes is obviously some variability. One day you could see a benefit from stock up trips, when the next day see a decline from closed stores. I guess historically, have you seen this trend towards either a net benefit or a net loss or is it really just varies based on the storm?

Mike Schlotman

It really varies based on the storm. I would say, at the end of the day, there is probably -- it depends -- one, it depends how the insurance claim winds up getting reconcile. But from your business insight, the store, there is usually a slight benefit. One of the things we've always done a great job at is being one of the first people fully back in business and being able to service our customers and the communities where we have our stores. And it's very important for those folks when -- as they've been evacuated and the local authorities lift the evacuation order, we have to be back in business for them or they're going to have a really big problem when they let folks come back into their homes. Many of these folks have lost product in their homes and they have start back up once they can get back in their homes. So, there are just so many factors in it. But, first and foremost, we try to be in it for our associates, our customers and our communities because they do need food to eat, and we've always been there to provide it for them.

Rodney McMullen

The other thing that we have such great relationships with local agencies, almost always we would be considered part of the first responder group, because people understand that it's important for the glossary stores to get stocks. So, our associates would be given clearance as a first responder in most cases.

Mike Schlotman

Once you to get to the store, often part of the first grids to come back on in power, there is a whole litany of things that before you come back from an evacuation, you have to get basic services up, you have to have food, and we typically always fall inside that and they are ready to help.

Operator

The next question comes from Rupesh Parikh of Oppenheimer.

Rupesh Parikh

So, I also just wanted to touch on may be some of the larger CPG players out there. We continue to see weakening trends from a number of larger players. And I was just curious, as you look at your partners just with them, are you all starting to see more efforts by them in terms of maybe supporting their products in store or maybe improving competitiveness?

Rodney McMullen

One CPGs, as you know, we always work with CPG partners, trying to understand how we grow our business on a combined basis. So, both of us are very focused on growing the business. I think CPGs continue to aggressively, incrementally try to work with us on helping grow their business. It's one of the things that's nice about having the great insight we have with 84.51°. We partner with most CPGs in a different and more deep way that also involves product innovation. So, there is no doubt, there is tremendous amount of change going on, the CPGs feel that change, and we're working with the CPGs for both of us to grow our business. But, obviously, we're also working and focusing on growing our business as well.

Rupesh Parikh

Okay, great. And then, going back to maybe a question that was asked earlier on the promotional environment. So, it sounds like some of the items that were more promotional, eggs and milk, you continue to see pockets of increased promotions out there. But outside of that, how would you characterize the promotional environment versus what you're seeing earlier this year?

Rodney McMullen

Outside of that, I really wouldn't say that it's -- there has been a massive trend change, what do they always say in economics, all short statements are wrong. So, you give the scenario and I can find it somewhere. The biggest change would be -- continue to be milk and eggs across the country; everywhere else would be puts and takes.

Operator

And our next question will come from Vincent Sinisi of Morgan Stanley.

Vincent Sinisi

Just kind of go back a little bit more to the overall pricing strategy. Obviously kind of since last quarter, it's been a big topic for you guys. What is the 84.51° data telling you? Like, when you're making decisions in different geographies to either be the leader or matcher or close follower on pricing on some of these high velocity items, is it kind of always the case that you kind of have to match it to keep that well customer or if they go somewhere else, how long does it take to get them back and maybe just a little bit around the consumer behavior that data is telling you?

Rodney McMullen

The biggest thing that the 84.51° insight shows us is the customer decides where to shop based on their total experience. And obviously that total experience is what's the shopping environment like, so what's how the associates treat the customer. What kind of rewards do you have, what type of personalized offers are you making, which is very hard for anybody to see that other than each one of us as a customer individually. And then, obviously from fresh product standpoint having great produce, meat, deli, dinner tonight, these kind of things. So, the thing that's really important is the all of that together, the price, the specific price items, really each one of us would have different items that are in our biggest hot button. So, it would be factoring in all of those things in terms of how we decide where to price and how to price. And the insights, the biggest part of the insights is, it really is important to customers for their over total experience not just one dimension of the experience.

Vincent Sinisi

Okay. And then, maybe just a quick follow-up, just going back to the maintained EPS guidance for the year. It would seem that at least with 10 basis points lower margin, at least one of the large offsetting factors would be from fuels. Maybe just any thoughts on the profitability on fuel side for the back half of the year? And also just -- I don't know, I might have missed it, but can you give us some inflation number as well for this quarter? Thanks a lot.

Mike Schlotman

What was the last part? You kind of…

Vincent Sinisi

Yes, the inflation for the quarter.

Mike Schlotman

Yes. So for fuel, it continues to be a strong year in fuel. And I don't want to play the hurricane card again. But, obviously, refineries have been shut down. The Colonial Pipeline was shut down for a while. Supply has been tight in some places. So, there will probably be some disruptions overall in the third quarter. We haul fuel from a lot of distant places to get -- to keep a lot of our stores in fuel. So, I still think fuel has a relatively good back half of the year. Relative to inflation, I ticked off the categories that saw some inflation and deflation. We did have inflation for the first time ever in the grocery category. It was -- probably it was 48 or 49 basis points of inflation, which is the biggest driver of where the overall business winds up going. And that's the first time in -- my sheet goes all the way back to third quarter of

2014 in the grocery category on a quarterly basis, that's the first time since the fourth quarter of 2014 that we had any inflation in the grocery category.

Operator

The next question comes from Stephen Tanal of Goldman Sachs.

Stephen Tanal

Just to better understand the reduction in the non-fuel operating margin guidance. Is that more about gross margin or operating expenses versus sort of the initial thought process?

Mike Schlotman

What was your comment on the guidance of reducing the non-fuel operating margin?

Stephen Tanal

Yes. Is the reduction more about gross margin being a little worse than initially thought or operating expenses being a bit higher?

Mike Schlotman

I don't know that we gave -- I am unfamiliar with us having given guidance on operating margin for the back half of the year.

Oh, it's in the 8-K. Okay, I got you. I was going to say, we didn't talk about it in -- on the call. It's the continuation of what we've seen. We do think from a dollar standpoint that we are going to continue -- that we'll start to see some strengthening of gross profit dollars and operating profit margin dollars as we go throughout the year, as ID sales continue to get stronger that will grow the dollars which is obviously the most important thing to grow earnings per share by. And at the end of the day, we focus on the dollars, not the rate.

Stephen Tanal

Okay. Fair enough. And just to follow up on the milk and eggs comment. I think you might have mentioned, just now sort of across the country, and I don't know that that was consistent with sort the last time I heard about that. Has it broadened out, did I catch that right? And pursuant to that, the price investments that you guys announced last quarter, do you feel like still they're really sufficient?

Rodney McMullen

Yes. On the milk and eggs, I just -- I didn't -- the comment I made, I didn't intend to infer that it changed anything from the first quarter in terms of broadening out or narrowing or anything on milk and eggs. What was the second part of your question?

Stephen Tanal

Second part is just around the price investments in this category. Do you still feel pretty good about that or what you've done already, is that sufficient at this stage based on the geographies where you're seeing that pressure?

Rodney McMullen

Well, I guess, I would broaden it. We feel good about the pricing investments that we make and based on what the customers' telling us, it continues to connect as we expected. And it's -- we feel good about it when you look at everything in total.

Stephen Tanal

Got it. And just a last one, just on the inflation comment. Was that specific to groceries or the center store or was that kind of all-in applicable to IDs? And if not, could you give us sort of an all-in number?

Mike Schlotman

The all-in number was ID sales without inflation -- without the pharmacy business was about 60 basis points with inflation, so not a whole lot different than the grocery category.

Operator

And the next question comes from Shane Higgins with Deutsche Bank.

Shane Higgins

Hey. Good morning. So, non-fuel FIFO gross margin excluding ModernHEALTH were down about 30 basis points. That was pretty good improvement versus the first quarter. Could you guys just walk us through some of the puts and takes of that decline? And is that more reflective of some moderation to price investments, is it private label mix? Just any color there would be great.

Mike Schlotman

I would say there would be two things that helped that, and one is the continued strength in growth of our brands, which while it dampens the top-line a little bit, comes at a better gross margin rate. And the second is as we continue to do great job on cost of goods and the input cost of that. And one of the things the CPGs partners like about the cost of goods investments is we do pass those on to the customers but it does help strengthen the gross profit rate in dollars over time when you have the better cost of goods that are out there.

Rodney McMullen

Also in some of the costs -- operating costs categories, the second quarter trends improved versus the first quarter as well.

Shane Higgins

And should we expect that to continue into the third quarter, that trend?

Mike Schlotman

I would think so.

Shane Higgins

And just a quick follow-up, just, I had a bigger picture question on just -- obviously the retail environment has been pretty challenging over the past year or two. Do you guys anticipate any kind of acceleration in store closures from weaker competitors over the next year or two years? Not sure how much visibility you guys have into that. But, if so, would you guys be prepared to maybe purchase any of these assets or locations similar to what you did with Marsh? And how does your decision to pare back CapEx kind of play into that dynamic if at all? Thanks.

Rodney McMullen

We feel very strongly that we would expect additional consolidation going forward and the consolidation will happen the way you describe, plus other ways in terms of companies merging and other thing. So, we don't think there is any doubt that you'll continue to see a lot of consolidation. You've always heard us talk about -- anything that happens, you should assume that we've looked at it. And if you look at what we did with Marsh, obviously those work out really well for us, because of specific trade areas that we haven't been able to get into. And by buying some stores from somebody in that situation, you're able to get into trade areas and leverage all your existing infrastructure. Those we always like, but they're lumpy. So, you won't have any for a couple of years and then you'll have a whole bunch of them happen. But, those are once that we will always be interested in and always take a look at. But, you should assume that our overall view on the merging with somebody is the same and we continue to look at stuff.

Operator

Okay. The final question will come from Alvin Concepcion of Citi.

Alvin Concepcion

Just curious about your natural and organic portfolio. The growth rate you're seeing there, what portion of your business it now represents? And related to that, what is your private label penetration in natural and organic?

Rodney McMullen

If you look at natural and organic overall, it's over $16 billion business for us on an annual basis. So, obviously, it's an important part of our business. It continues to grow strongly and we would continue to see a great opportunity in that space. We find more and more customers. For some items, they will purchase natural organic items and other places, they will buy traditional items. And for us, what we try to do is, we don't judge a customer on how they eat, and we try to make sure we have what the customer wants at a great value. In terms of the share of market, it depends on how you define share of market. If you look at Simple Truth, last year it was about a 1.7 billion category for us. And if you look at the $16 billion in total that would obviously include some non-branded meat items and other items. So, that would give you some insight in terms of share of market. If you look at grocery overall, grocery typically on units is close to 30%. So, obviously, there is still a lot of room to grow.

Alvin Concepcion

And my follow-up is just on click and collect. Just curious, what kind of penetration you've seen in stores that have had it longer, where you think that can go and also how do visits and basket compared to an in-store customer?

Rodney McMullen

When you look at total, we get more of the customers business and that's what we find the reason why we are so supportive and keep working on it. In terms of the share of business, at this point, we wouldn't give the specifics on stores and what percentage of their business is in ClickList. It's a reasonably wide range. And the range isn't driven by anything that -- it's more specific stores. So, I know one store that has a pretty high percentage, it's right off the interstate, so that store has gained a lot of new customers because it's easy on and easy off, the interstate and their trade area for ClickList is completely different than their trade area for the store.

For us, what we've tried to design is a business model that we know at certain percentage of business it's more efficient to do it in store because of not having incremental asset investment. At the point in time that it grows, it's easily converted to dark stores or a freestanding warehouse facility where you put in more automation. So, what we've tried to do is design where we can support and partner and make money and the customers will take it to whatever percentage of our business they take it and we'll be there for them as they go. So, we've really worked hard on having a model that's easily scalable and scalable in terms of what percent of penetration it becomes. So, thanks Alvin. Anything else?

Alvin Concepcion

That's all. Thank you.

Rodney McMullen

Okay. Thanks, Alvin. Thanks to everyone on the call. Obviously -- hopefully you hear some of the comments that Mike and I are making, Kroger is playing to win. And the things that we do are what we believe will be best when you look out three to five years for our customers and associates. And what we've always found, when we do both of those, then, our shareholders are well rewarded as well. And the business continues to generate great free cash flow and we have great opportunities in front of us. So, and then one other comment, as you know, I always like to share some additional thoughts with our associates that are listening in.

First of all, I would like to send our well wishes to the people of Huston and especially members of our Kroger family whose lives have been turned upside down by the recent hurricane and its aftermath. Our thoughts and prayers are with those who are now bracing for Hurricane Irma as well.

Since the rains stopped in Houston, you have shown nothing can stop the strength, resilience and power of our amazing associates. Many of you stayed in or couldn't easily leave stores, distribution centers, plants and offices and stayed overnight and worked tirelessly to not only serve our customers, but to provide food and supplies to first responders and local shelters. As a company we've sent nearly 2,800 semis packed with food, water and other critical supplies to the region. More than 350 individual associates from all corners of the country traveled to Houston to lend their hands to help uplift the community.

Having a physical presence and truly being part of a community is always important. This is perhaps never more apparent than when natural disasters strike. You and our stores are a vital part of the communities we serve.

What I'm most proud of is how you've taken care of each other. Whether that's giving a hug to someone who needs it or traveling across the country to work side by side in reopening our stores and warehouse, we take care of each other, it's who we are. Each day we open our doors and welcome our neighbors with true hospitality and generosity, and together, we make the world a better place. Thank you for all you do in big ways and small ways to feed the human spirit. We are truly Kroger Strong.

That completes our call today. Thanks for joining.

Operator

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