The Kroger Co. (NYSE:KR) Q1 2010 Earnings Call Transcript June 17, 2010 10:00 AM ET

**Executives**

Carin Fike – IR

David Dillon – Chairman and CEO

Rodney McMullen – President and COO

Mike Schlotman – SVP and CFO

**Analysts**

Andrew Wolf – BB&T Capital Markets

Chuck Cerankosky – Northcoast Research

Deborah Weinswig – Citigroup

Charles Grom – JPMorgan

Ed Kelly – Credit Suisse

Scott Mushkin – Jefferies

Robby Ohmes – Bank of America-Merrill Lynch

Karen Short – BMO Capital

**Operator**

Good day, ladies and gentlemen, and welcome to the Q1 2010 The Kroger Company earnings conference call. At this time, all participants are in listen-only mode. (Operator instructions) I would now like to turn the call over to Carin Fike, Director of Investor Relations. Please proceed.

**Carin Fike**

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 first quarter press release and our prepared remarks from this conference call will be available on our website at www.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 topic with one question and one follow-up question if necessary. Thank you.

Before I turn the call over to David Dillon, Kroger's Chairman and Chief Executive Officer, we want to take a moment to invite you to join us here in Cincinnati for our 2010 Investor Conference on September 28 and 29. We will be sharing more details with you soon and look forward to seeing you then.

I'll now turn the call over to Dave.

**David Dillon**

Thank you, Carin. Good morning, everyone, and thank you for joining us today. With me to review Kroger's first quarter 2010 results are Rodney McMullen, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

I am pleased with the strong positive identical sales growth we achieved in the first quarter on striking a better balance of margin investments. Our Customer 1st strategy continues to deliver results through improvements in all four key areas we target; our people, our products, the overall shopping experience in our stores, and prices. As a result, the total number of families we serve continues to grow and our most loyal customers are buying more with us.

We are also reducing debt and returning value to shareholders through dividends and share repurchases. Identical supermarket sales increased 2.4% without fuel during the quarter. This continues Kroger's trend of positive identical sales growth that is among the strongest in the industry. Each one of our 18 supermarket divisions had positive identical sales results. Let me repeat that. Every supermarket division we operate posted positive identical sales results for the quarter.

I want to thank all our associates for these great results. Growth in loyal households and strong sales of our own brands and national brands continued throughout the first quarter, demonstrating the strength of Kroger's overall competitive position and the value proposition we provide to customers.

As you know, several years ago, we developed a strategy to strengthen our connection with customers. Our Customer 1st strategy focuses on four key areas, our customers have told us are important to them; our people, our products, the overall shopping experience in our stores, and our prices. All of these – all of these are important to our customers when they decide where to shop.

Based on feedback from our customers, we continue to make good progress in these four key areas, as we focused our offering on offering shoppers more value for the way they live. Customers tell us they appreciate the entire spectrum Kroger's unique value proposition offers, including friendly service, quality products that they trust, good prices, a pleasant shopping experience, and a personalized reward for their loyalty.

As a result, both the total number of families and the total number of loyal households we serve continues to grow. Equally important to us, our most loyal customers are buying more with us. We are building momentum through our multi-dimensional strategy, which serves Kroger customers, associates and shareholders well in a variety of economic conditions.

Several factors continued to influence Kroger's business in the first quarter. They include aggressive competition, rising commodity costs, and the slow and inconsistent pace of the economic recovery, and consumer confidence. Kroger continues to perform well, as the economy struggles to recovery. Our loyalty card data and proprietary analysis point to mixed spending behaviors across several customer segments.

Several signs indicate that customers are feeling more optimistic. They are spending more money inside our stores on certain discretionary categories such as organic foods, specialty deli needs, higher in lines. Many non-food categories also show improvement. At the same time, customers who are more price sensitive remain cautious about discretionary spending.

Furthermore, the continued high use of food stamps and government programs is still causing volatility in our weekly sales trends. Our Customer 1st strategy serves all of these varying customer needs in one. Food cost also continued to affect our financial results.

For the quarter, we estimate product cost inflation, excluding fuel, was roughly 90 basis points. Because this figure is an average across several different departments, some additional detail might be helpful to you. When you exclude milk, which was slightly inflationary and of course a big category for us, the grocery department experienced nearly 180 basis points of deflation. This compares to almost 270 basis points of deflation in the fourth quarter last year.

We saw a very different picture in produce where we experienced over 700 basis points of cost inflation due to supply issues stemming from unfavorable weather in some growing regions. This was a trend change in 2009 when we experienced significant deflation in produce cost throughout much of the year. Our results show we are striking a better balance between delivering solid near-term financial results and investing for the future growth of Kroger's business. We are committed to improving this balance as the year progresses and as the industry continues to normalize.

To that end, we have confirmed our identical supermarket sales and earnings guidance for fiscal 2010. We expect identical supermarket sales growth of 2% to 3% without fuel for the year. Net earnings are expected to range from $1.60 to $1.80 per diluted share. We are striving to achieve these results in the upper half of the earnings guidance range, and our incentive compensation plan reflects this objective.

The operating environment remains uncertain, and we believe several factors will continue to influence Kroger sales and earnings performance throughout the year. These factors include inflation or deflation in product and operating costs, the competitive environment, fluctuating fuel margins, and the inconsistency of the economic recovery.

Next I'll turn it over to Rodney who will provide more detail on our performance during the first quarter. Rodney?

**Rodney McMullen**

Thank you, Dave, and good morning, everyone. The Kroger team did a great job during the quarter to set the stage for the rest of the year. Our associates' efforts to control expenses enabled us to maintain a compelling price position relative to both discount and traditional grocery competitors. We are particularly pleased with our associates' continued success in strengthening Kroger's connection with our customers. This truly is a differentiating factor for our company.

As a result, the number of total households we serve continued to grow in the first quarter. Our loyal household count grew at a faster rate, including that our best customers are the primary beneficiaries of the investments we are making in the four key areas of our Customer 1st strategy. We reward our best customers for their increased loyalty. Increasing purchases from loyal families is an important part of our growth strategy.

Our strong partnership with dunnhumby supports this objective by allowing us to use our shopper data to reward our best customers with offers and coupons tailored exclusively for them. No other US grocery retailer offers this level of personalization and reward. Our goal is to earn a customer's loyalty for life.

Growing market share is an important part of Kroger's long-term strategy. We look at numerous resources to evaluate market share changes in our industry. The resources we review all show Kroger continues to gain share, which is consistent with our loyal household growth and our strong identical sales growth relative to most of our competitors.

One of the most reliable and independent resources we regularly review is Nielsen's Homescan Data. Their reporting shows that Kroger's overall market share continued to grow in the first quarter. Our strong corporate brands also strengthen customers' loyalty. We serve millions of loyal households.

All but 5,000 of these households purchased at least one corporate brand item during the quarter. Or in other words, if you think about it, we have millions and millions of loyal households who shop everyday in our stores. Only 5,000 of these households did not purchase a corporate brand item for us. That's less than the number of people that could sit into the Radio City Music Hall. There would still be room left over.

This is an outstanding indicator of the acceptance of our own brands and Kroger's ability to build lifetime loyalty with customers with our exclusive and preferred brands. Corporate brands represented about 26% of our first quarter grocery department sales and approximately 34% of grocery sales units. We are pleased that we have maintained share at this level because we have expected some adjustments in customers' purchasing behavior as the economy improves.

Kroger now has more than 20,000 corporate brand items. On average, approximately 11,000 of these items are available in an individual store based on store format and the specific preferences of customers who shop that store. The overwhelming acceptance of our corporate brands demonstrates customers recognize the quality and price advantage these products offer.

Increasingly, we are introducing items which fulfill an unmet need. One example, and this one I'm especially proud of our team, is our line of Fresh Selections bag salads with food tracing technology. The HarvestMark technology we use on these salads allows customers to trace the origin of the salad through information listed on each bag.

One other new entry includes two cereals without high fructose corn syrup. We developed these cereals based on feedback from parents who wanted cereal options that are free of high fructose corn syrup and include whole grains. Products such as these are mom-approved before they arrive on store shelf because they were created based on what moms and increasingly dads have told us they want for their families.

We also continue to make strong progress on our sustainability agenda, which includes reducing energy use and our carbon footprint, reducing and recycling waste, and engaging our customers by offering them sustainable products to purchase. Our associates also support our efforts to save energy and reduce waste through their actions. In fact, our associates have helped Kroger reduce the energy we use by more than 27% in the past 10 years. This is enough energy to power every single family home in the city of Memphis, Tennessee for one year.

Through another initiative, we have reduced the amount of plastic use in our Big K one and two-liter bottles. As a result, we will remove more than 275,000 pounds of plastic from the waste stream annually. Last month, we reduced another milestone in our transition to using LED lighting in refrigerated cases in our stores. Now, more than 1,700 of our nearly 2,500 stores are using LED lighting in glass door refrigerated cases. This LED lighting uses 75% less energy than traditionally fluorescent lights.

Turning now to labor relations, we completed successful contract negotiations for our associates in Dallas, and we reached a tentative agreement with the union representing our associates in Michigan. Negotiations continue in several markets, including New Mexico, Houston, Portland, and Seattle. We began negotiations soon with the teamsters in Southern California and with the UFCW in Cincinnati, Fort Wayne, Little Rock, and Toledo.

Rising healthcare costs and retirement plan contributions continue to be an issue. Our objective in every negotiation is to balance competitive costs with compensation packages that provide good wages, high quality affordable healthcare, and retirement benefits for our associates.

Now Mike will offer more detail on the first quarter and Kroger's financial strategy. Mike?

**Mike Schlotman**

Thanks, Rodney. And good morning, everyone. As Dave mentioned, Kroger reported positive identical supermarket sales, excluding fuel, of 2.4% for the first quarter. Recall from our comments in March that the timing of the Super Bowl and snowstorms in many regions we serve benefited the beginning of our first quarter identical sales trend.

On the flipside, the timing of Memorial Day negatively affected our identical sales trend at the end of the quarter. Of course, our second quarter identical sales results will benefit from the timing change. Kroger's strong identical sales growth produced solid earnings that were in line with our expectations for the first quarter.

Net earnings totaled $373.7 million, or $0.58 per diluted share, compared to $435.1 million, or $0.66 per diluted share, in the same period last year. Last year's first quarter results benefited from commodity costs, particularly dairy and diesel fuel that were unusually favorable to our business. This year, stronger profits from Kroger's retail fuel operations helped soften this difficult comparison. Our retail fuel operations added approximately $0.04 per share to Kroger's first quarter earnings on a year-over-year basis, as we expected. I'll provide some additional color on our retail fuel operations in a minute.

Let's turn now to some of the details of our first quarter results. Excluding retail fuel operations, FIFO gross margin decreased 77 basis points. Most of this decline was driven by Kroger's investment in supermarket selling gross margin, which declined 71 basis points, excluding fuel. This sequential improvement from the 125 basis point decline in the fourth quarter selling gross margin demonstrates we are seeing better balance between price investment and tonnage growth. Our more moderate margin investment yielded mid-single digit tonnage growth, excluding fuel and pharmacy.

Kroger reported a $15.4 million LIFO charge during the quarter, a decrease of $7.7 million from the same period last year. Excluding retail fuel operations, the LIFO charge decreased 4 basis points as a rate of sales. We continue to anticipate a full year LIFO charge of $50 million for fiscal 2010. Excluding retail fuel operations, OG&A increased 13 basis points from the same period last year.

Healthcare, pension costs, and credit card fees continued to pressure Kroger's OG&A rate. These rising expenses were mostly offset by identical supermarket sales leverage and the benefit from productivity improvement, process changes, and our efforts to reduce energy usage. The higher OG&A rate also reflects expenses associated with the Little Clinic and i-wireless.

Kroger's first quarter operating margin, excluding our retail fuel operations, declined 85 basis points, primarily as a result of the year-over-year changes in FIFO gross margin and OG&A expenses I described for you. The year-over-year decline is a sequential improvement from the fourth quarter of 2009 and Kroger's operating margin declined over 120 basis points, excluding the benefit of a lower LIFO charge.

As Dave said, we are striking a better balance between delivering solid near-term financial results and investing for the future growth of Kroger's business. We are committed to improving this balance as the year progresses and industry conditions normalize. For the 2010 full year, we continue to expect a slight decline to a slight improvement in Kroger's non-fuel operating margin.

Turning now to our retail fuel operations, both sales and earnings were strong. Fuel sales increased at both our supermarket and convenient stores due to higher average retail fuel prices and a strong increase in the number of gallons sold, both in total and on an identical gallon basis. The cents per gallon fuel margin was 11.7 cents per gallon for the quarter compared to 8.2 cents in the same period last year. On a rolling four-quarter basis, the cents per gallon fuel margin was 11.6 cents in the first quarter compared with 14.3 cents in the same period last year. Our guidance for fiscal 2010 assumes a normalized margin for this business of approximately 11 cents per gallon.

I'll now update you on our long-term financial strategy. We are very focused on allocating the substantial cash flow of Kroger's business to reward our shareholders, both today and in the future. We plan to invest approximately $1.9 billion to $2.1 billion in capital projects during 2010 with a strong bias towards remodels and infrastructure projects.

We are doing so because we see plenty of opportunities in this environment to expand Kroger's competitive advantage and generate strong returns through capital investments. These investments are designed to keep our store base fresh and appealing to our customers and reducing operating costs. All of these investments are squarely focused on delivering our Customer 1st strategy and are generating returns higher than our cost of capital.

We are also committed to maintaining Kroger's strong balance sheet and solid credit rating. At the end of the first quarter, net total debt was $7.1 billion, a decrease of $339.8 million from a year ago. On a rolling four-quarter basis, Kroger's net-debt-to-EBITDA ratio adjusted for the Southern California impairment charge in 2009 and Hurricane Ike charges in 2008 was 1.91 compared with 1.77 during the same period last year. Our objective is to manage this leverage ratio in a range that maintains our current BBB rating from three major rating agencies.

While capital investments and balance sheet strength position our company well for future growth, we realize it is important to provide near-term rewards to our shareholders through a program of regular stock buybacks and quarterly dividend payments. During the quarter, we invested $79.5 million of Kroger's free cash flow to repurchase 3.6 million shares of Kroger stock at an average price of $21.89 per share.

After the quarter ended, we purchased an additional 1.9 million shares of stock at an average price of $20.25. Approximately $240 million remained under the $1 billion stock repurchase program announced in January of 2008. During the quarter, we returned $61 million to shareholders in the form of dividend payments. Our Board has increased the dividend each year since it was established in 2006. Kroger's dividend yield adds 1.5% to 2.0% total shareholder return.

Now I will turn it back to Dave.

**David Dillon**

Mike, thank you. Throughout the difficult operating environment, the Kroger team has stayed squarely focused on delivering on our Customer 1st strategy. Kroger has had the courage in this challenging economy to invest in our stores to keep them fresh, to invest in many cost-saving projects, and to invest in improving our customer shopping experience. Our customers have noticed and are rewarding us with their loyalty.

We believe these investments will continue to differentiate Kroger today and will position us well for profitable growth for years to come. As we move forward throughout the year, we are focused on balancing investments in our business and returns for shareholders as we work to create long-term value.

We now look forward to your questions.

**Question-and-Answer Session**

**Operator**

(Operator instructions) Your first question comes from the line of Andrew Wolf. Please proceed.

**Andrew Wolf – BB&T Capital Markets**

Good morning and congratulations on the quarter.

**David Dillon**

Thank you.

**Andrew Wolf – BB&T Capital Markets**

Are you – can you break down the ID sales growth between transactions and basket size for us and give us a sense of how that's been trended into the quarter?

**David Dillon**

I'll give you the sense of the total picture. And I'm not sure, Mike, that we have to turn through the quarter. If you have something you want to add, feel free. But – for the whole quarter, the biggest gain was in customer count. When you take a customer transaction count, that was by far the biggest gain. But our average sale that's the sales running up for each transaction also was up, but it was only up slightly. You want to add anything to the trends?

**Mike Schlotman**

When you look at the trends through the quarter, obviously it started out well because of the factors I talked about at the beginning of the quarter, that being the Super Bowl and the weather. If you were to just look at it in absolute terms at the end of the quarter, the last quarter – the last week of this year was up against the Memorial Day last year. So it was not a stronger comparison. So it gets a little bit murky. I think if you look at – when you look at the transactions on a monthly basis, which is most relevant I think, we continued to have, as Dave said, strong growth in the transactions as well as the number of units those households bought on a monthly basis, which is one of the ways we track it versus each time they come into the store.

**Andrew Wolf – BB&T Capital Markets**

And to follow up, some of your operators have begun talking about unit inflation or deflation, and sort of back of the envelope, seems pretty obvious that your item deflation from – in this quarter from last quarter was kind of a lot. And it's not all – some of it is explained by less deflation and product costs and less investment on your part. But is the rest of it explained by consumer behavior in terms of like a dramatic shift in trading down or can you give us a little light on that?

**David Dillon**

I think the best thing to do is just think about inflation the way we have described it in the material we gave earlier. We saw the average as inflation at 90 basis points, so 0.9%. But that doesn't even begin to tell the story because you have to disaggregate it to see where those pieces fell. Produce tends to run the inflationary number up a bit because it was a 7% inflation in the quarter. Our grocery, you can't even look at by yourself because dairy was slightly inflationary, and that tends – because it's such big category, tends to offset some of the rest of the grocery department. But even in the rest of the grocery department, which is the area that I think actually of biggest interest to your question, in that area, in the fourth quarter, our deflation was 270 basis points, and in the fourth quarter it was 180 basis points.

We had described last year and still believe that gradually as you go through the rest of this year that we will see deflation turn into slight inflation, which it did in the quarter. And we think that trend will continue then through the rest of the year. But it's going to be in different sectors in different ways. Grocery, though, is the one that I look at most closely. And I think taking milk out of it gives you a clearer view as to what's happening. And the rate of deflation in grocery clearly has become a little less. I don't think that's driven more by mix change, which is the question you are asking about customer behavior, I think it's more driven simply by the cost of the products. Rodney, you want to –?

**Rodney McMullen**

Yes, it was just – the only thing I would add, Andy, to that is if you look an awful lot of it, we are starting to cycle a lot of the items that were deflationary a year ago. So if you look at the produce example on the inflation, part of that inflation was created because there was so much deflation a year ago; part of it was created because of the poor quality – poor quantity – amount of produce out there. So a lot of the change is really where we are starting to cycle deflation a year ago. So it's not so much of the change in customer behavior. Now, Dave mentioned in his prepared comments, we are seeing some areas where people are starting to spend a little more money in terms of if you look at our non-food areas, we are having some growth there; organic food and some of those things. But it's really – most of it is driven by cycling deflation a year ago.

**Andrew Wolf – BB&T Capital Markets**

And just lastly in the same vein, what can you tell us about the ability of the market to absorb increases at retail as protein has really shown some inflation lately and dairy as well? Are these being passed through? Dave, you certainly use the term normal, which I'm glad to hear. Are you seeing signs that there is some normal ability of the markets passed are inflating product costs?

**David Dillon**

On the whole, the answer to that question in my view is yes. There is always – when it comes to this question, there is always qualifiers, because it depends on the competitive environment, it depends on the particular items. And when you look, for instance, at produce, when you have high inflation in produce, you clearly have a mix change by customers within produce. Same thing in meat. When you have some inflation or deflation, it tends to drive a different consumer behavior within that department. That's not quite as true in grocery except perhaps in milk.

In milk, you do see – tend to see a little gallon each change, not maybe as much as inflation or deflation, but you see some gallon each change as that changes. But in the whole of grocery – in the bulk of grocery, excluding dairy, general speaking, as costs go up, the retail goes up and follow suit. And so I'd say it is the normal – we would see the current environment as more normal in that sense and we do expect that cost increases will be passed through. In some cases, that may hurt volume of a national brand vendor who raises prices, but they take that into account when they make the decisions whether they are going to raise the cost. But that's certainly our objective.

**Andrew Wolf – BB&T Capital Markets**

Okay. Thank you.

**David Dillon**

Thank you, Andy.

**Operator**

Your next question comes from the line of Chuck Cerankosky with Northcoast Research. Please proceed.

**Chuck Cerankosky – Northcoast Research**

Good morning, everyone.

**David Dillon**

Hi, Chuck, good morning.

**Chuck Cerankosky – Northcoast Research**

When you look at your capital spending of about $2 billion this year, can you give us some ideas on what you are looking to expand square footage and maybe break down how that will be driven between new stores, remodels that go outside the four walls as well as replacements? And are you keeping some powder dry to go after some end market acquisitions, because I haven't heard much about that lately? And then can you give us some examples on what you are doing in terms of infrastructure spending to make you more competitive or perhaps projects that are completed and you are willing to talk about?

**Rodney McMullen**

Thanks, Chuck. I'll handle the questions on the square footage and the like. And I'll let Rodney talk about the infrastructure projects. If you look at our current forecast, we would expect somewhere between 40 and 50 net new relocated and expanded stores, somewhere between 150 to 175 within-the-wall remodels of a major variety. These things are always fluctuating. And that would give us square footage growth.

If you exclude operational closings and any acquisitions of about 1.5% or so, we'd be where we are today. Relative to keeping powder dry, our $1.9 billion to $2.1 billion would exclude any dollars we would spend to buy a property that's currently leased, because as you know, over the last 18 months or so, we've been fairly successful of doing that at pretty attractive cap rates. It would also exclude any dollars we would spend on an acquisition. We would review those acquisitions independent of our normal capital program and look at the return they would generate and the EBITDA they would add relative to the spend.

**Rodney McMullen**

Chuck, remember, one of the reasons why we do that on acquisitions is we don't want to build a business plan around where we have to have acquisitions, deliver what we've committed to from a return standpoint, because we think that causes companies to chase acquisitions rather than only doing acquisitions when it makes sense. And that's the reason why we do what Mike just said. In terms of an infrastructure project, the biggest buckets would be things that we've invested in to improve the shopping experience for the customer, technology, warehouse and energy.

And if you think about the LED lighting that I talked about as an example, that would be something where we allocated capital to support an energy project that has a good return, and it's also good for sustainability. There are several things that we would have done on shopping experience, things like that. Technology, it's really trying to figure out ways to make things easier for our associates, both in our stores, warehouses and plants, to do their daily job. I can't think of any that specifically I can talk about other than if you think about there would be some capital involved to support some of the things we've done with dunnhumby, for example. Probably it would be something that would be reasonably easy to see. And then – go ahead.

**Chuck Cerankosky – Northcoast Research**

Right. I don't mean to imply that you would add acquisition spending buried somewhere in your CapEx budget, but I'm just wondering if there is this pause [ph] in it that suggests that there might be some opportunities breaking loose all of a sudden, say, in the remainder of the fiscal year.

**David Dillon**

We don't see our capital budget as being a barrier to those kind of acquisitions. Those rise and fall purely on their individual merit.

**Rodney McMullen**

Acquisitions so far wouldn't be much different than what we've seen in the past. We see quite a bit of things, but the pricing that people expect is still more than what you can really justify and get a good return on the investment.

**Mike Schlotman**

Chuck, you referenced pass, I think, in your follow-up question there. We don't really – we view our current capital program as standing in the neighborhood of $2 billion a year, which is where we were last year, and we would expect to be in the next two or three – in the next couple of years after this year. Remember, back in March we talked about – at one point in time, that would have been about $1 billion higher over those three years. We just felt in this environment, given what we are trying to do with our balance sheet and maintaining our rating, it was more targeted towards that, somewhat influenced by our results last year and a desire to make sure that we didn't put too much pressure on our organization to maintain the credit ratings where we wanted them, given that our results last year weren't where we wanted them.

**Chuck Cerankosky – Northcoast Research**

All right. Thank you and good luck for the remainder of the year.

**David Dillon**

Thanks, Chuck.

**Rodney McMullen**

Thanks, Chuck.

**Operator**

Your next question comes from the line of Deborah Weinswig with Citigroup. Please proceed.

**Deborah Weinswig – Citigroup**

Good morning. So two questions. First of all, can you talk a little bit more – I think, Dave, you referred to aggressive competition. Are you seeing that across all geographies? And maybe if you can elaborate if that's also across the store?

**David Dillon**

Okay. You are a little hard to hear, Deborah. So there is more to your question in a minute. Talk a little louder –

**Deborah Weinswig – Citigroup**

Okay. I can –

**David Dillon**

I got the first part. The first part was on – what did we mean by aggressive competition? And I think what we are seeing while there has been a lot of marketing noise written about what's happening in the industry, it is very much like what we saw last quarter where it varies widely by market and by competitors. And it's based on the interaction earlier, competitive behavior in each particular market. So we think it's strong competition. It has kept some focused on selected prices. For instance, there are some hot deals out there right now; soft drinks and milk as a couple of examples of categories. But those are – and those are competitively driven. But on the whole, I'd say the environment is pretty much like what it was last quarter. Rodney, do you want to add anything to that?

**Rodney McMullen**

No.

**David Dillon**

Okay. Did you have another part, Deborah?

**Deborah Weinswig – Citigroup**

Yes. And then just in terms of – separate question. In terms of general merchandise performance, maybe you can even focus on Fred Meyer and the multi-department stores, is that kind of – if you maybe just discuss the general merchandise performance and even jewelry?

**David Dillon**

I’ll let Rodney to give any description he may want on both jewelry and on Fred Meyer. But I would like to add just maybe this overall comment on general merchandise. In the past, you will note that maybe a year ago or so, we talked about general merchandise as an indication of customers spending less in discretionary categories. And that was one of the categories. So we feel pretty good about this quarter seeing identical sales and general merchandise being positive. And that’s when we – in the past, it’s often combined HBC and – or the drug and GM categories together. But when we split up GM, it actually was positive in the quarter. So Rodney, you want to add anymore?

**Rodney McMullen**

Yes, I’d just add a couple comments. One, I’m just delighted with our Fred Meyer team and our jewelry team both. If you look at the performance in general merchandise, it’s very broad-based in a lot of categories, which is very exciting. The other thing I find increasingly exciting is the Fred Meyer team is doing a better and better job of working across the whole company on general merchandise to help us sell more general merchandising all Kroger stores, not just the Fred Meyer. And then on jewelry, if you look at the identicals there, the identical there – if you look at the peer groups, they would be the best of any company that’s reported from an identical standpoint. How much of that is driven by the economy and how much of that driven by some of the changes we’ve done, and how much of that is driven because so many competitors have gone out of business, I think would be hard to speculate. But overall, on both fronts, it’s nice to see the continued improvement versus where we were in the fourth quarter.

**Deborah Weinswig – Citigroup**

So, Rodney, is Fred Meyer team helping bring in more season to Kroger or it is improving the overall quality of the SKUs that are in Kroger?

**Rodney McMullen**

Both. And that’s the area where we’re really focused on working together to try to identify those items that customers would really find helpful and a good value for their money. And that’s really both.

**Deborah Weinswig – Citigroup**

That’s great. All right. Well, thanks so much and best of luck, guys.

**David Dillon**

Thanks, Deborah.

**Rodney McMullen**

Thank you.

**Operator**

Your next question comes from the line of Charles Grom with JPMorgan. Please proceed.

**Charles Grom – JPMorgan**

Thanks. Good morning. Just a question on OG&A up 13 basis points on the corn, I think you said healthcare, pension and credit card, just wondering – CostCo has talked about their healthcare costs starting to come down a little bit. I'm just wondering if you could give us a little bit of sense of what you think that OG&A line on the core will look like over the next couple of quarters.

**David Dillon**

I'll let Mike in a second comment about the forward thinking on OG&A. But you identified them correctly, but add to that the way OG&A is calculated for us. It also includes – the other element we included was expenses in our wireless and the Little Clinic, both of which are affected in a negative way too. And we felt that a lot of those costs were offset in part at least by productivity improvements, process change, and what we've done in energy. So we actually felt it was pretty good. Healthcare, though, is problematic. It was at least in the quarter. And it was more problematic in our company plan than in the plans covered by the Taft-Hartley funds, and that's mostly because they are structured differently. In one case, the union plans really – we pay them based upon either hours worked or some other formula. In the company plan, it is self-insured. We basically pay their claims as they happen. But it is true. We experienced higher healthcare cost in the first quarter. Do you want to comment going forward on OG&A?

**Mike Schlotman**

I won't give exquisite specific guidance on OG&A, but clearly our goal is to drive down our operating cost on an annual basis. So our components of our incentive plan were without a reduction in operating cost. And that would be OG&A plus rent and depreciation, as well as the expenses in gross profit. If we don't manage those expenses well on an annual basis, it limits the amount of our potential bonus payout. So we're incentified [ph] to do that. I think Dave's point is the key point. If you look at the operations of the company, yes, pension, healthcare and credit card expenses caused some headwinds at the operating level. But the productivity improvement, the process changes, and the energy savings essentially offset those. So they performed very well. But OG&A line in total did have the expenses from i-wireless and TLC in it, and this is the first quarter we owned all of the Little Clinic versus just a portion of the Little Clinic, which is one of the reasons that would have affected it for the first time like it did.

**Charles Grom – JPMorgan**

Okay. Could you quantify the i-wireless and the (inaudible)?

**Mike Schlotman**

I wouldn't get specific on it. It would be – it would be a good chunk of the 13, but it's not like it's 90% of it, but it's a good chunk of the 13. It's the only reason we called those two out. There really wasn't anything else out there that was remarkable enough to quantify.

**Charles Grom – JPMorgan**

Okay. That's helpful. And then just a follow-up on the core question on the competitive market and just wondering if we could kind of dig into the – obviously a 900 (inaudible) with Wal-Mart, and since they started their rollback campaign on April 1st and then they started to do their deepest counts on May 1st, just wondering in markets where you specifically overlapped with a Wal-Mart supercenter, have you seen any discernable trend since they began that rollback activity?

**David Dillon**

Let me talk just generally about Wal-Mart and how we see our markets just for a moment. We don't often talk about individual competitors, but many of you have asked about them and so it's probably worth commenting. Wal-Mart affects any of the marketplaces in which they operate, like any other competitors affects those marketplaces. Wal-Mart has become publicly more aggressive as what they are saying that they are doing. And if you look at what's happening in the stores and in the markets, just like we said the last two quarters, I think probably in each of the last two quarters, the marketing behavior, merchandising behavior of Wal-Mart is a lot more consistent with a traditional grocery supermarket operation than it is consistent with what Wal-Mart used to do. It's a lot more future items. Sometimes a future is a little longer than a week, but it's future items. And when you operate that way, there are items that come down in price, which get lots of publicity. But there are also items that go up in price, that don't get much publicity.

And so we see the behavior as there is a lot of marketing noise around, but we see the behavior as pretty much what happens in a lot of grocery markets that we've been involved in for our entire history. As a result, the most important thing I think for you to think about is that our behavior in those markets and in every market is based upon our plan and what we believe to be consistent with our Customer 1st strategy and what we think our customers want. We can't do that with a blind eye to what competition does, but we also can't let competition dictate to us what we're going to do in those markets, and we've chosen not to. And so we are approaching this from – clearly from the point of view of what do we think our customers got from us in this kind of environment and we're using our data and insight in order to drive that. Rodney?

**Rodney McMullen**

Yes, I'd just add a couple of other things. It's one of the reasons why in Dave's call – in his prepared remarks he talked about we had positive identical sales in all divisions, to try to give everybody a perspective of our broad base on our strength of our identical sales. The other thing that I would add to that is from our perspective, Wal-Mart really started getting more promotional on specific items, really Thanksgiving last year, when they started running turkeys at $0.40 and some of those things. So they branded it a little differently this year than they branded it last year, but they really did start looking more like a traditional supermarket in the way they go to market late last year by getting aggressive on pricing on a few items from a promotional standpoint.

**Charles Grom – JPMorgan**

Okay. That's helpful. And then just last question will be on the 2.4%. It sounds like there is a little bit of a Memorial Day shift, and just wondering if you've got a chance to go back and quantify that. And then I guess since the Memorial Day period, another sort of a flip-flop in the calendar, just wondering how your June sales are looking so far.

**David Dillon**

Let me address the latter question, and if Mike wants to say anything on Memorial Day, specifically he can, but we've only had three weeks in the quarter so far – 3.5 weeks in the quarter so far. And if you adjust for the fact that Memorial Day is in this quarter now, if you adjust that out, it looks to us that the trend in those three weeks is about the same, consistent with what we had achieved in the first quarter. So that gives you a sense of where we are at this point. Mike, you want to add anything on Memorial Day?

**Mike Schlotman**

Yes. I wouldn't make any adjustment to the first quarter as we saw in the Memorial Day because it really helped to offset the strong start we had right at the beginning of the Super Bowl and the weather. So if you look at the quarter by itself, it negotiated it somewhat. And as Dave said, excluding Memorial Day so far this quarter, we're right in line with where we were in the first quarter alone.

**Charles Grom – JPMorgan**

Okay. Great. Thanks very much.

**David Dillon**

Thank you.

**Operator**

Your next question comes from the line of Ed Kelly with Credit Suisse. Please proceed.

**Ed Kelly – Credit Suisse**

Hi, good morning, guys. And nice quarter again.

**David Dillon**

Thank you.

**Ed Kelly – Credit Suisse**

You've mentioned that you incentivize basically to improve expenses either in the gross margin or the OG&A line. Can you talk a little bit now about how you've tracked against those goals so far in the first quarter? Does that ramp throughout the year and maybe provide some color on the key initiatives that you have in this area?

**Rodney McMullen**

Do you want to comment about – I mean, so far this year, I would say we're not where we need to be to have that limit come off of the bonus plans or with limit our ability to achieve certain payout metrics under our bonus plan. It is early in the year. And we clearly have plans in place to achieve those because we will be mutually rewarded if that occurs. As far as specific items that we have in place, some of those we've talked about and I don't think we will get any more specific on progress and productivity improvements, but we continue to see the opportunity and implement different energy saving projects, for example, to continue to drive those costs down. Rodney talked about the investments we are making and infrastructure, both form a technology and a warehousing standpoint that we were expected to pay rewards as time goes on as well.

**Ed Kelly – Credit Suisse**

Okay. And another question for you on your fuel centers. You've been added each quarter literally somewhere between 15 and 20 fuel centers. It's clearly a strong driver of growth in your gallons sold. My guess though, it's also an important part of – maybe not important part of the comp, but it does help the comp for the source where you add the fuel centers. Is that a fair assessment? I mean, what happens to those supercenters when you add – there is food source when you add a fuel center? And then also what's the runway left for adding fuel centers? There is still a fair amount to do.

**David Dillon**

We've – you've assessed it pretty well, as we see gas. Our customers really like fuel in our stores. So when we add fuel, that becomes an additional convenience. And there is just no reason for people to stop with us. As a result, we continue to add them. Our identical gallonage [ph] growth, which would be just the place as they had fuel in both years, continues to grow in addition to growing as a result of new additional gas stations. We do continue to see opportunities to add. We are going to add 100 or so this year. I don't know that we've given a specific (inaudible) certainly in that ballpark. And that's consistent with what we've done in the last couple of years. We are bullish on it. I think it's a good deal for our customers. They seem to like that added convenience. So it's a benefit.

**Rodney McMullen**

It's an area where convenience stores really helped us accelerate what we can do in the supermarkets. And it's really their knowledge is helping us, and they really help us run across the company.

**Mike Schlotman**

It also helps with sales within the box, so that's driving traffic to the stories, is that fair?

**David Dillon**

Well, it helps a little bit with the traffic in that sense. So yes, there are some benefits there.

**Ed Kelly – Credit Suisse**

And then just last question for you real quick, on the share repurchase side, it looks like you ramp things up a little bit, opportunistically post the end of the quarter. How do we think about share repurchases for the rest of this year, assuming that your business trends do continue to improve? And like you said, if you're hopeful to get towards the higher end of the range, is there any opportunity to get more aggressive there.

**David Dillon**

I want to make sure you understand that the purchases since the end of the quarter, they weren't opportunistic as you describe them. We would have been in a blackout period and precluded from operating opportunistically in that timeframe. As we go throughout the period of time where we're already going to a blackout period, we've put a 10b5-1 plan in place that would obviously – well, maybe not obviously, but intellectually would be designed to book, buy more when the stock is low and less than the stock is high. And we also put a dollar limit on that plan so the things don't get too out of hand from spending cash at deployment time where we really can't moderate our plan.

So while it appears it was opportunistic, it was an independent decisions made every day, which is merely the design of the grid caused us to be in the market. The prices – the stock was on a more regular basis. You had mentioned something about the upper end of the range. Keep in mind, we are talking about the tough half of the range, not necessarily the upper end of the range. I think we view our stock. As we sit here today as attractive. And we'd expect that when our blackout period is lifted, we would then implement a new 10b5-1 plan to continue to be in the market on a regular basis.

**Ed Kelly – Credit Suisse**

Great, thank you.

**David Dillon**

Thank you.

**Operator**

Your next question comes from the line of Scott Mushkin with Jefferies. Please proceed.

**Scott Mushkin – Jefferies**

Hey, guys, thanks. I wanted to go back. I know you commented a little bit on Wal-Mart's activity. And I wanted to explore the idea that maybe Wal-Mart since April, because our data which show that has been more aggressive versus where they were last November. They certainly would think they are. They also made comments that they are having a hard time passing on some of the inflation, which I think, Dave, you mentioned that you are not seeing as hard. I mean, do you think instead of Wal-Mart not doing anything, maybe demonstrating this more loyalty in the customer – in the Kroger customer base. And how do you play that up and play it out? I think you went through some data about loyal households. Maybe you want to talk to that a little bit if that's okay.

**David Dillon**

Sure. First of all, I do think Wal-Mart has made some changes, of course, now from November 1st. But it's a similar kind of a – course of activity. So I wouldn't suggest otherwise. And they have certainly been very visible in public about that in papers, and all of you have written quite a little bit about it. But the most important part to think about here, I think, is what that mean to Kroger for us. And we do think that one of the reasons we don't get as affected by some of our competitors, including Wal-Mart, but others too, is because we are focused on building loyalty for over a period of time. So there are lots of things that cause a customer to shop with us.

Last week, I did a couple of shop-alongs. And that's a case where you go with an individual customer, you meet him and talk through a little, how they shop and then you go see how they shop in the store. And we do a variety of those. Rodney has done some recently, and as we do those, we get a sense of the complexity of how customers behave. It's not generally because of one item or one price. It's generally because of the overall combination of things put together in a store. In our case, we think looking at what we call our four keys is essential. It cannot be just about price. If it's just about price, that really is Wal-Mart's game and not our game. And so we don't focus just on that. And that's one of the reasons even our capital is exiting some other areas too this year, not just about price.

So overall, I'd say we are playing our game, we are on our court, we think it's working well for us. We'd see – we've even identified that even in the fourth quarter, we see our market share has improved. We also identified in the first three weeks of this quarter that our sales continues similar to what they were in the first quarter, all of which should describe to you that since the time period you are saying that we don't – we are not seeing a particularly large impact or some big sea change of events.

**Scott Mushkin – Jefferies**

So Dave, on the same lines, some of the (inaudible) had a call this morning, called Wal-Mart's activity very disruptive. And the idea here that maybe you honestly benefit that as the promotion that the people that aren't involved in the promotions that are going on as your biggest competitors, maybe willing to help you out a little bit. I mean, have you seen a step-up in health from the channel, now that Wal-Mart is doing what they are doing?

**David Dillon**

Well, I think we saw not for their reason, but I think we saw as we have described before that many of the national brand vendors wanted to get their tonnage moving again, have been out in the market generally with more promotional dollars. And even when they may raise their list prices, they often don't have money out there to promote the products. And we've already indicated we had a very solid quarter on national grand tonnage. Very pleased in those results. And the vendors who have worked with us on partnerships. Common deal was joint projects to produce better sales have shown really good results. So anybody who has partnered with this, I think we'd go away saying, "Hey, that's worked really well, and I want to be more." But I wouldn't say it's just about us or just about Wal-Mart is really what are they doing to try to drive their sales, and it's not – I don't think it's focused right here at describing.

**Scott Mushkin – Jefferies**

So then my final question, thanks for taking them, is I just want to make sure I understood what you were saying about the consumers is all mix signs, vis-à-vis had a sequentially last quarter. Do we think things have slowed down with the consumer improving, or is it just – because I know food stamps were taken off a little bit again? I mean, where do you think the consumer is? Are we at a plateau or are things still slowly improving? I'm just trying to gauge what you said.

**David Dillon**

Well, actually what we were describing is that we look at customer segments. And that there is gurgling going on in some of the segments that would tend to confuse a person because the customers in those segments are a little confused themselves. So we've pointed out some things on the positive side. So for example, we talked about some of the higher end lines being better. (inaudible) meat has improved for us. We did not identify, but it's true. SarbOx has improved for us. We identified I think organics, natural foods have improved; floral has improved; general merchandise sales I talked about a little bit before.

All of those are signs that people are spending some discretionary money. And – but it is by segment where that happens. We are also seeing though, on the other side, a lot of week-to-week swings, much of which was driven by food stamps and other situations where people have money one week and not have money the next. And within the segments, we are seeing them – the people we interview on those segments describing the world a little different. So the consumer confidence in some of the upscale customers is stronger than the consumer confidence in some of the people who are more price sensitive. And that affects their behavior. And so I think it's – you almost have to look segment-by-segment and see what's happening. And we certainly do that, and we even design our marketing plans around the different segments.

**Scott Mushkin – Jefferies**

So do you think sequentially it's improving or not really?

**David Dillon**

Scott, thanks for your questions. We want to move on, so we can get to more folks and have their questions asked.

**Operator**

Your next question comes from the line of Robby Ohmes with Bank of America-Merrill Lynch. Please proceed.

**Robby Ohmes – Bank of America-Merrill Lynch**

Thanks. Hey, guys. Just a quick follow-up actually on Scott's question. I think you guys are now coming up upon the time last year where your tonnage really picked up. And just curious, sort of related to where Scott was going on the vendor support outlook, are you planning – or how are you thinking about those comparisons in terms of maintaining the comp trend through the next couple of quarters? Do you expect the tonnage trend that you put up the sort of mid-single digit tonnage gains you've put up in this quarter you just reported to sort of continue or will the way you get to your (inaudible), the way you are planning, should that shift a little bit? Thanks.

**David Dillon**

I think we've talked generally that in our minds that tonnage for the year would be a little less of a growth than what we experienced last year. That's only natural, and you can see it in certain areas. Take produce as an example. The inflation we are experiencing in produce, we would expect and have seen, it only shifts a little as customers change what they buy. Same thing in milk. As the cost of milk and the retailer milk goes up and where it does go up, we see the gallonage decline a little bit. Our hope is though and our expectation is, is to keep tonnage in the positive range. And in order to get our identical sales to come out where we targeted for this year, we actually need to have some growth in tonnage. But no, we do not expect it to be as robust as we experienced last year.

**Robby Ohmes – Bank of America-Merrill Lynch**

So you are baking in ticket and/or inflation improvement as you move sequentially through the rest of this year?

**David Dillon**

Well, we said all along that we expect the deflation we experienced last year to gradually turn into a modest inflation. And so that was baked into what we have said on the subject, yes.

**Rodney McMullen**

And we would expect tonnage growth more traditionally what we would have had two or three years before last year. We thought last year was an unusually high tonnage growth and not what we would typically have. And we would expect tonnage growth to get more what we had had in the past.

**Robby Ohmes – Bank of America-Merrill Lynch**

And just very quick follow-up. The vendors, I would assume, recognize the tonnage comparisons. You guys are up against this. There are a little extra just related to that that you guys are seeing over the next few quarters. A little extra help?

**Rodney McMullen**

Well, like I said, the vendors see the tonnage growth that they get when they partner with us on various promotions and even longer-term programs and they like what they see.

**Robby Ohmes – Bank of America-Merrill Lynch**

Great. Hey, thanks a lot, guys.

**Rodney McMullen**

Thank you. I think we have time for one more question.

**Operator**

Your final question comes from the line of Karen Short with BMO Capital. Please proceed.

**Karen Short – BMO Capital**

Hey, congratulations on the quarter.

**Rodney McMullen**

Thank you.

**David Dillon**

Thanks, Karen.

**Karen Short – BMO Capital**

Just wondering – not to continue to belabor this, but – you did a better job of balancing margins obviously this quarter. Can you maybe talk a little bit about what you did differently in the first quarter versus the fourth quarter because you obviously seem to get the same tonnage growth on being less promotional? So I wonder if I could dig into that. And I just have one quick follow-up.

**David Dillon**

Well, let me describe – if I go back to the third quarter, what we said on that call was that we had began a process to try to balance this out a little bit better. But that we believed changes that we needed to make needed to be gradual and gentle so that they did not disrupt what the customers saw of our programs. In the fourth quarter, you may not have felt you saw it, but it was actually a present event in the fourth quarter where we had begun to make some changes and it influenced the results, but they were gradual. Those changes began to take a little better hold in the first quarter and you see the results of those.

We do think it's important for the programs that we develop, particularly price programs, that we not pull the customer one way or the other abruptly, because it gives them the wrong impression about what we are trying to represent. And so you will see, I think, gradual trend changes on what we try to do in this area, either direction based on how we see the market and the situation at the time. And I think that's what you saw rather than some big difference between the first quarter and the fourth quarter. First quarter had the full quarter, having some changes in it, and the fourth quarter did not have a full quarter with some of those changes in place. But it was not a fundamental change in our plans. It was not a fundamental change in our strategy. It was not a fundamental change in the targeted areas we have in place. So I –

**Rodney McMullen**

And it's continuing using our dunnhumby data and other data sources to understand what promotions are working and what things don't work and adjust for those as we go along, also so it's using [ph] the insights that we have.

**David Dillon**

And trying to be more effective and how we spend our money.

**Karen Short – BMO Capital**

Okay. Great. And then just for Mike, it's totally switching gears. Looking at your cash flow, inventories and expenses and trade accounts payable, they were all pretty cash flow generative. Just wondering if you could comment on was there a timing issue or what was the cause.

**Mike Schlotman**

Not really a timing issue. If you look at the way we look at working capital, our net operating working capital improved by about $25 million this year versus last year. When we look at that, we kind of throw out the taxes on those and short-term debt and the things that really don't – you really can't have any influence over. But we've clearly – we are focused on trying to reduce our investment in net operating working capital. And it was nice to see that we actually generated $25 million of net cash on the way we measure that. And off line, I'd be happy to give you the definition. You know us. We can't use a traditional definition. We have to come up with our own. But it's actually a definition that our divisions feel as though they can manage day-in day-out, because if you put – if you put deferred taxes in there, they can't do anything about that. So we try to look at it from the standpoint of something they can manage day-in day-out.

**Karen Short – BMO Capital**

Okay, great. Thanks a lot.

**David Dillon**

Karen, thank you. And before we end the call today though, I'd like to share just a few additional thoughts with our associates who we encourage to call in. First, I want to thank you for getting us off to a solid start for the fiscal year. Our performance is a result of your individual efforts, and we really appreciate all you do. And as you know, safety is one of Kroger's core values. We continue to strive to achieve our goal of zero accidents in our stores, plants, distribution centers and offices.

Over the past 14 years, we have reduced our accident rate by more than 70%. There are several great teams to celebrate for their outstanding safety record, and each – for example, each of the following plants received – recently received an award, which indicated they achieved more than a year without an OSHA reportable injury.

These six plants are America's Beverage Company in Irvine, Texas; Pace Dairy in Crawfordsville, Indiana; Riverside Creamery in Riverside, California; Tamarack Farms Dairy in Newark, Ohio; Vandervoort Dairy in Fort Worth, Texas; and Westover Dairy in Lynchburg, Virginia.

We also had many stores that have achieved outstanding safety records. 185 stores – 185 stores have gone a year without an OSHA reportable injury. Several other stores have gone at least three years without an associate injury. The top six stores that have gone without – gone full three years without an accident are Central Divisions, Number 462 in White Hall, Illinois; QFC Store, 804 in Seattle, Washington; Mid-South, Number 906 in Whitley City, Kentucky; Delta, Number 391 in Paris, Tennessee; Mid-Atlantic Division, Number 300 in Lynchburg, Virginia; and Smith's Store, Number 131 in Ogden, Utah. That is exceptional.

Congratulations to the associates in all areas of the company for keeping your focus on safety, both at home and increasingly – at work and increasingly at home too. We really appreciate your efforts. Have a great summer everyone. This completes the call today. Thank you for joining us.

**Operator**

Thank you for your participation in today's conference call. This concludes the presentation. You may now disconnect. Good day.