The Kroger (NYSE:KR) Q2 2012 Earnings Call September 7, 2012 10:00 AM ET

Executives

Cindy Holmes - Director of Investor Relations

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

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

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

Analysts

Deborah L. Weinswig - Citigroup Inc, Research Division

John Heinbockel - Guggenheim Securities, LLC, Research Division

Charles X. Grom - Deutsche Bank AG, Research Division

Meredith Adler - Barclays Capital, Research Division

Edward J. Kelly - Crédit Suisse AG, Research Division

Karen F. Short - BMO Capital Markets U.S.

Brian Cullinane - Jefferies & Company, Inc., Research Division

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Mark Wiltamuth - Morgan Stanley, Research Division

Charles Edward Cerankosky - Northcoast Research

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

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2012 The Kroger Co. Earnings Conference Call. My name is Janeda, and I will be your operator for today. [Operator Instructions] Later we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to Ms. Cindy Holmes, Director of Investor Relations. Please proceed.

Cindy Holmes

Thank you, Janeda. 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 www.thekrogerco.com. After our prepared remarks, we look forward to taking your questions. [Operator Instructions]

On behalf of all of us at Kroger, we thank many of you for participating in our June survey. We strive to be exceptional listeners at Kroger, whether listening to our customers, our associates or our shareholders. We appreciated your time and honest assessments. We are also hopeful that you can join us for our 2012 investor conference on October 16 in New York. We look forward to seeing many of you next month for this important session with Kroger leadership.

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

David B. Dillon

Thank you, Cindy, and good morning, everyone. Thank you for joining us today. With me to review Kroger's second quarter 2012 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 Kroger's strong performance in the second quarter. Kroger's shareholders once again benefited from our Customer 1st strategy. Increased customer loyalty and solid cost controls allowed us to grow sales, profitability and shareholder value.

In the second quarter, we reported record second quarter earnings per share. We increased identical supermarket sales for the 35th consecutive quarter. We increased identical sales in every operating division and every store department. We grew the number of loyal households in all divisions. We increased FIFO operating profit by $47 million. We increased tonnage over last year. And we put Kroger's strong free cash flow to work for shareholders by repurchasing 23.7 million shares.

Based on the strength of our second quarter results and the higher-than-anticipated share repurchase activity, we have raised our earnings per share guidance for the year and expect to achieve toward the upper end of our identical supermarket sales growth and earnings per share guidance. Mike will have more to say on our guidance in a few minutes.

Our associates controlled costs and improved productivity in the second quarter, saving money in places not important to customers so we can reinvest in places that are. We target investments in the 4 keys of our strategy, people, products, shopping experience and price to increase relevance with our customers. Greater relevance inspires customer loyalty and grows both sales and profit as our second quarter results demonstrated. This is what makes Kroger unique among food retailers, our unrelenting focus on solving our customers' needs. That we've achieved consistent ID sales growth demonstrates that our strategy resonates with customers and our increased earnings guidance demonstrates how this creates shareholder value.

Rodney will now discuss Kroger's positive business trends in the second quarter. Rodney?

W. Rodney McMullen

Thank you, Dave, and good morning, everyone. Kroger leveraged operating expenses in the second quarter as OG&A costs plus rent and depreciation without fuel were down 59 basis points as a percent of sales. On this basis and excluding one-time items, we have had 7 consecutive years of reductions in this metric. And our year-to-date results set us up to achieve our eighth consecutive year.

We do this consistently through a determined emphasis on productivity improvements. For example, we've gained efficiencies in our 1,948 pharmacy locations by utilizing new technology that helps our pharmacists to better manage workflow, prioritize prescriptions and allocate work between pharmacists and pharmacy technicians. The increased productivity reduces customer wait times and provides an enhanced pharmacy experience.

One of the most important measures of our business is loyal household growth because it lets us know how well we are connecting with our best customers. During the second quarter, our loyal household count grew at a faster rate than total household growth, which was also up for the quarter. We also achieved positive identical sales for both total households and loyal households. Identical sales growth among loyal households was stronger than total household result. Customers continue to visit our stores more frequently, purchase fewer items on each trip and buy more on a monthly basis. This is consistent with what we've seen for the last several quarters.

We're very pleased with the improvement in our tonnage trend for the quarter as total units sold were up compared to last year. I'll just repeat that. Our total units, our tonnage, was up compared to last year. This is an example of how we continue to gain market share in the overall food retailing industry by focusing on our customers. The rate of product cost inflation in the second quarter continued to flatten faster than originally anticipated. Identical supermarket sales growth exceeded the rate of inflation, which we estimate was 2.2%, excluding fuel. Every store department had inflation with the exception of produce and seafood, which were deflationary.

Our market share gains are a result of our investments in all 4 keys of our Customer 1st strategy. People often talk about investments we make in price, but there are many ways we have invested in our nonprice keys, people, products and shopping experience, to strengthen our connection with customers in our stores. For example, over the last several years, we've set out to improve the shopping experience by reducing customer wait time at checkout. Customers have told us they do not like waiting in long lines. Based on that feedback, we developed a solution that has reduced the average amount of time a customer waits in line to check out to about 30 seconds today compared to around 4 minutes in the past. Our customers tell us they noticed the difference, and we are delivering a shopping experience that makes them want to return.

Our people and products keys are equally important. We want our customers to say our associates provide helpful, friendly service, that they can always get the products they want plus a little at our stores. A great example of how we are strengthening these 2 keys is through our partnership with Murray's Cheese. Our stores are home to about 51 specialty Murray's Cheese shops. In these locations, we provide associates with the opportunity, training and tools to become certified Murray's Cheese master, associates like Jimmy Mraz [ph] from King Soopers store 33 in Boulder. He participated in an in-depth, 5-week training program that includes a basic skills class, certification and an orientation at the original Murray's Cheese shop in New York City. Jimmy [ph] returned to his Murray's Cheese shop with new skills, a passion for sharing knowledge with our customers and the distinct red jacket that signifies his status as a cheese master. Customers love the extra service and product expertise, not to mention the incredibly selection of delicious cheeses, of which I've tried many of. As a result of these efforts, our customers tell us that our associates are doing an increasingly good job of providing services. That is why we consider our nonprice investments to be as central to Kroger's strategy as the price investments.

If you look at nearly any food retailer who is succeeding right now, including the regional players, they are doing something unique that resonates with customers. We know from our 35 consecutive quarters of positive identical sales and consistent market share growth that our focus on all 4 keys of our Customer 1st strategy is driving loyalty, which creates value for shareholders.

In the second quarter, Kroger's corporate brands represented approximately 26.3% of grocery department sales dollars. Grocery department corporate brand units sold were 33.5% compared to the same quarter last year. These results continue to show improvement since the economic downturn began. The mix between national brands and corporate brands fluctuates in any given quarter, but corporate brands continue to gain share over time. We continue to offer our customers choices and variety and value to meet their needs. To complement the assortment of national brand single-serve coffee products we offer, beginning next week, we're launching our new line of Private Selection single-serve coffee pods. The new line is compatible with Keurig coffee machines and will include a variety of 100% Arabica roasts and blends, including breakfast blend, Guatemala, Swiss Water, decaf and Venetian Reserve.

Yogurt is another popular and high-growth category with great potential. Kroger's self-manufactures most of our yogurt selection. We recently added 15 new varieties, including new flavors such as Blueberry Pomegranate, Caramel Spice Cake and Vanilla Bean. For toddlers, our new comfort yogurt bites [ph] are great and full of vitamins A, C and E. And I can tell you on the new yogurt flavors, they taste great, and I've tried over half of them already.

I'm happy to share that Kroger continues to advance sustainability initiatives. We released our sixth annual Sustainability Report earlier this week, and I'd like to share a few highlights. We are using significantly less energy today than we were just 12 years ago. In fact, we've reduced our overall energy consumption in our stores by more than 31% since the year 2000. 19 of Kroger's manufacturing plants sent 0 waste to landfills in 2011. And Kroger increased fleet efficiency by more than 9% in the past year and by more than 25% since 2008. These are just a few examples of how we're working to make sure the world is a better place. We are very proud of our progress and our associates' hard work to make these results positive -- possible.

Finally, an update on labor relations. Associates in Louisville and Dayton both ratified labor agreements. We continue negotiations on many contracts, including in Arizona, Columbus, Indianapolis, Memphis, Nashville and Portland. Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide good wages, a quality, affordable health care and retirement benefits for our associates.

Next, Mike will share additional detail on Kroger's second quarter financial results and guidance for 2012. Mike?

J. Michael Schlotman

Thanks, Rodney, and good morning, everyone. Our identical supermarket sales increased 3.6% in the second quarter, which contributed to net earnings totaling $279.1 million compared to $280.8 million in the same period last year. Net earnings per diluted share showed strong growth to $0.51 from $0.46 per diluted share last year. Prior year net earnings benefited from a 27.6% tax rate compared to a tax rate of 34.5% in the second quarter this year.

Our earnings per share growth was driven by strong performance in sales and EBITDA and higher-than-anticipated share repurchase activity. FIFO EBITDA was up $56 million for the quarter or $55 million excluding fuel. FIFO gross margin was 20.63% of sales for the second quarter of fiscal 2012. Excluding retail fuel operations, the FIFO gross margin decreased 43 basis points from the same period last year.

Kroger recorded a $34.7 million LIFO charge in the second quarters of both 2012 and 2011. Operating, general and administrative costs plus rent and depreciation were 18.01% of sales. Excluding retail fuel operations, OG&A plus rent and depreciation declined 59 basis points as a percent of sales. And as Rodney said, we accomplished this for the last 7 years. And based on our first half results, we expect to achieve our eighth year. Identifying and delivering sustainable operating cost reductions allows us to invest in all 4 keys of our Customer 1st strategy consistently over time.

Second quarter FIFO operating margin dollars increased $47 million, both with and without fuel. Excluding fuel on a rolling 4 quarters basis, the company's operating margin rate was 3 basis points lower compared to last year. This is an 8-point improvement in the trend from the first quarter. We expect that slightly increasing FIFO operating margin excluding fuel for the full fiscal year.

Turning now to retail fuel operations. Our supermarket fuel centers and convenience stores produced positive identical gallon growth for the quarter. These outlets earned approximately $0.164 per gallon compared to $0.174 in the same quarter last year. The benefit to second quarter earnings per share was the same as last year.

Now I'll update you on our financial strategy. During fiscal 2012, Kroger plans to use cash flow from operations to fund capital expenditures, repurchase shares, pay dividends to shareholders and maintain its current debt rating. During the quarter, we purchased 23.7 million common shares for a total investment of $525 million. There is approximately $476 million currently remaining of the $1 billion share repurchase program authorized on June 14, 2012. Over the last 4 quarters, Kroger has used its strong free cash flow to return more than $1.9 billion to shareholders through share buybacks and dividends.

Capital investment, excluding acquisitions and purchases of leased facilities, totaled $447.7 million for the quarter compared with $428.5 million for the same period last year. We continue to expect full year capital expenditures to be in the $1.9 billion to $2.2 billion range.

Net total debt was $8.1 billion for the second quarter, an increase of $1.2 billion from a year ago. On a rolling 4 quarters basis, Kroger's net total debt to adjusted EBITDA ratio was 1.96 compared to 1.71 during the same period last year. Our objective is to maintain a net total debt-to-EBITDA ratio of approximately 2.00. We took advantage of what we believe to be an undervalued stock price in the second quarter to buy back shares.

Our experience through the first half of this year is that the external environment has been a little better than in 2011. We continue to monitor changes in gas prices and inflation. And as the headlines continually remind us, macroeconomic issues will continue to affect consumer sentiment throughout the year. We are confident in our ability to make tactical adjustments as needed to successfully navigate these factors while continuing to deliver on our Customer 1st strategy.

As a result of strong first half performance and higher-than-anticipated share repurchase activity, Kroger is increasing its fiscal 2012 earnings guidance to a range of $2.35 to $2.42 per diluted share. The company continues to expect identical supermarket sales growth for the full year, excluding fuel, of 3% to 3.5%. Kroger expects to achieve in the upper end of the range for both earnings per share and sales growth. The previous earnings per share guidance was a range of $2.33 to $2.40. We continue to expect the growth rate in the third and fourth quarters will be higher than our long-term growth rate of 6% to 8%, and the fourth quarter will also benefit from the 53rd week. Now I'll return it back to Dave.

David B. Dillon

Mike, thank you. There's no doubt that Kroger has a bright future because of our growing connection with our customers. Since we've changed how we managed our business about 8 years ago, we have seen significant success. Every day, our associates are delivering better shopping experience for our customers and our customers continue to reward us with their loyalty.

Kroger's increased earnings per share guidance for the year reflects our confidence that our Customer 1st strategy will continue to create value for our customers and shareholders alike. Of course, an ever-changing environment requires vigilance and constant evaluation. And with that in mind, we hope that you'll join us for an important discussion of our plans for continued success at the upcoming October investor conference in New York.

So now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from the line of Deborah Weinswig with Citi.

Deborah L. Weinswig - Citigroup Inc, Research Division

Can you just help us understand the growth in tonnage this quarter maybe versus the past 3? It sounds like it's improving in terms of overall growth. But maybe just help us understand the actual numbers.

David B. Dillon

Well, the tonnage trend and growth has increased because as we said in the last 2 quarters, I believe, we were essentially flat, and now we're seeing actual growth. We did see a little bit more growth in national brands than we did Kroger brands, but we saw growth overall. And that's probably the extent of the color. Rodney, you want to add anything?

W. Rodney McMullen

I'll just say it's very broad-based. Most categories had growth. And it's really been driven by the increased loyalty from the customers with the household count flowing through to buy in more products. That's what's really driving it.

Deborah L. Weinswig - Citigroup Inc, Research Division

Can you point to anything specifically that you're doing? Or what do you think at this point in the game is driving it?

W. Rodney McMullen

Well, I think it's multiple things. I think the lower inflation rate is certainly helping some. Certainly, if you look at some of our work with dunnhumby and targeted mailings, there's certain segments we weren't satisfied with the result we were getting. And we've worked real hard on making some targeted offers for those customers, and they're rewarding us with increased purchases. So it's really both of those pieces together, and then just an overall improvement in household count shopping with us.

Deborah L. Weinswig - Citigroup Inc, Research Division

When did the queuing initiative start? And how have you been communicating that to existing customers and maybe nonexisting customers?

W. Rodney McMullen

It really started probably about 3, 3.5 years ago in terms of learning how to do it. It involves a tremendous amount of work with our associates and technology behind the scenes to support our associates. So it's really both working together. It probably took a year or so to get to where all of that was working together, and then it took a couple of years to get it rolled out across the company. The way we communicate it to our customers is really letting our associates in the advertising tell -- our associates tell our customers what they're doing for them.

Deborah L. Weinswig - Citigroup Inc, Research Division

Because I would say as somebody, myself, who's in your stores a lot, I mean, now you go in and you're like, "Where is everyone?" And when you get to the front of the line, it's just that they're getting to your line so quickly. I mean, that's the experience. And so I just wondered if you thought that was having any impact on the tonnage as well.

W. Rodney McMullen

Certainly, it has to help some because the customer realizes they can come to Kroger and get out really fast, so it has to help.

David B. Dillon

Everything we're doing, Deb, is designed to cause customers to want to shop with us more of their shopping trip. And this is certainly one really good example. But there's, of course, lots of other things we're doing. But all of those contribute to that trend.

Deborah L. Weinswig - Citigroup Inc, Research Division

All right. One last question out there. Any plans with regards to bringing your corporate brands available to consumers outside of where you have stores through e-commerce? I was just thinking about how great that coffee pod sounded.

W. Rodney McMullen

At this point, not directly now. From using a website, I would expect sometime in not the forever future that you'll see that.

Operator

Your next question comes from the line of John Heinbockel with Guggenheim Securities.

John Heinbockel - Guggenheim Securities, LLC, Research Division

So 2 things. One, if you think about the expense opportunity, I assume the bulk of it is going to be in the store right where the bulk of the costs are, where do you think there's still a large opportunity to take some costs down? You've done some work at the front end. But if you think about backroom, if you think about just some of the perishable departments, maybe grocery, if you do think about it a little more like that, where do you think the 1 or 2 biggest opportunities are to continue to take labor out?

David B. Dillon

Well, it won't surprise you, John, that we won't identify the specific things going out there. But I will identify a couple of observations. First, the best way to save in our kind of business is in lots of different ways. They can be multiplied by the number of stores and by our volume. And by the way, it's definitely not all focused on just taking labor hours out. In fact, more of what we're trying to do is find ways to reduce the labor required for some tasks that don't matter to the customer, and then spend those same labor hours on things that do matter to the customer, like getting them through the front end quicker. So it's not so much -- in fact, we've grown number of employees this year. We've end up growing hours in our stores. All of that is on the upswing. So really what we're trying to do is be more effective in the tasks that just simply don't matter and apply the resources in places that actually do. We see plenty of opportunities out there, not all of them have to do with things that people do. A lot of them have to do with things that are not involving labor. Rodney?

W. Rodney McMullen

Well, if you look at the sustainability that we talked about, obviously, for the environment, it's a tremendous improvement in sustainability and helping make the world a better place. But it also saves a lot in cost because if you think about the 19 plants that have 0 waste to landfill, well, we're not taking stuff to landfill so that cost is no longer there. So it's not just labor in the stores where we're able to find costs, and we have a long list of opportunities. And it's really prioritizing in terms of how many can you do at a time.

John Heinbockel - Guggenheim Securities, LLC, Research Division

Because I think -- tell me if I'm wrong, but I would think just on a kind of normalized basis, normal cost inflation in your cost items, you'd be 2% to 3%. So I guess, the question is, because you've done a much better job the last couple of years, can 1 to 2 -- can you grow -- and then some of this will depend on the comp. But if 2% to 3% is the right number on an ongoing basis, should O&A grow lower than that as you take some of these costs out? Or was that too optimistic?

W. Rodney McMullen

Well, you'll see us work awfully hard not to have a 2% to 3% base inflation. And we do an awful lot of partnering with our suppliers and vendors to try to understand how can we work together to take cost out of the system, both for them and for us. So as of right now, I wouldn't -- you shouldn't assume that we'll have a 2% to 3% cost increase.

John Heinbockel - Guggenheim Securities, LLC, Research Division

All right. Then just finally, just describe where do you think the M&A environment is right now? I know you want to do more in-store or in-market transactions if you can. But where's the environment? And is there any appetite for entirely new markets or not really, in the economic environment we're in today?

David B. Dillon

I feel like I ought to just pull out the script from speech number 47 because the same thing we've said for many quarters in a row is still true today is that we look at lots of stuff. We find that end-market things seem to be more successful and appealing to us. Big things are things we're going to be very selective about, and that we don't comment on anything that we're taking a look at. Now you just need to recognize that we are regularly looking at things that are out there. I don't really see the environment any different and I don't see our strategy or plans any different than they have been for the last several quarters.

Operator

Your next question comes from the line of Charles Grom with Deutsche Bank.

Charles X. Grom - Deutsche Bank AG, Research Division

Dave, just wondering if you could share with us how the ID trended during the quarter. And if you could, how quarter to date trends are looking so far.

David B. Dillon

Let's see, if I remember correctly -- I'm looking for confirmation -- but I think it was gently down through the quarter. And some of that though, you should recognize and it's what I'll also say about current quarter is that one of the big effects this year has been the switch to generic from national brand on some of the prescription items. And in prescriptions of pharmacy particularly that has a huge dollar impact. So that swing drives not only pharmacy, but it's big enough actually to show up in our numbers. So that could actually be part of what we saw in the trend in the quarter. If you look at the current quarter to date, so far we are slightly down from where we were last quarter. But I wouldn't read too much into that for these kinds of reasons. One was the example I gave before is we do see the pharmacy generic shift gaining steam as the year goes by, and actually, every week it does. We see volatility between weeks, which is what we described last quarter. That volatility is driven this year a little bit more than normal at the end of the month because of the 2-day shift with having an extra day in February. That 2-day shift makes it more pronounced. This last month end was quite similar to the things we've experienced earlier in the year. But it does cause those volatile shifts. And then finally, we see electronic benefits in some states as shifting to smooth the way in which those benefits are paid out to the community at large and no longer headed up just to the person above. So that tends to smooth it out a bit and give us that variability. So that's maybe a picture for you to understand where we are so far.

Charles X. Grom - Deutsche Bank AG, Research Division

Okay. And there has been a lot of chatter throughout the past couple of months on the competitive landscape and just wondering if you could give us your sense of things.

David B. Dillon

Competitive landscape is what it always is in our business. It's always changing in where the aggressiveness is coming from and in what markets it's in. But it certainly is competitive just like it has been for a long time. You've read and seen a lot of noise about some competitors who have been out there, and certainly that's true. But there are other competitors who maybe are a little less aggressive than they were. And like I said, there's just always a change over time, but it's always going to be competitive. And that's the way it is right now.

Charles X. Grom - Deutsche Bank AG, Research Division

Okay. Fair enough. And then one for Mike. Just any thoughts on the dividend yields only around 2%, pretty low relative to many of your peers and other CPG companies. Any thoughts on raising that down the road?

J. Michael Schlotman

We regularly talk about the dividend with our Board of Directors, and our stated policy has been that this is -- we only have been paying a dividend for 6 years, and we've continued to grow it over time. And we would expect to continue to grow our dividend over time.

Operator

Your next question comes from the line of Meredith Adler with Barclays.

Meredith Adler - Barclays Capital, Research Division

Question about generics, which you mentioned is having a negative impact on sales. Obviously, it should be having a positive impact on gross margin. First, I'd like to confirm that, that's true.

David B. Dillon

That's definitely true. Now we're talking about pharmacy. And that is absolutely true.

Meredith Adler - Barclays Capital, Research Division

I was just wondering how you look at that. It's obviously not going to continue forever. It didn't happen as much last year. Do you see that as a windfall and that you are happy to spend that extra gross margin to the extent that there was a lot of it in better pricing or some other investment, 1 of your 4 keys?

David B. Dillon

We wouldn't be as specific only looking at one item. We would be looking at everything together along with what cost reductions we feel like we can achieve. And then working with dunnhumby, we would look at where's the most effective use of improving our pricing position for our customers. So it's part of helping out in terms of what dollars we would have to invest. But it's not specifically oriented just to that one item.

Meredith Adler - Barclays Capital, Research Division

Okay. Great. And then just a question on your labor negotiations. I just was wondering if you could kind of talk about kind of the tone of the negotiations, where the focus is. Are there particular concerns in particular markets about health care, pension? And some of the contracts you mentioned that you're still negotiating, have any of those gone beyond their contract expiration?

David B. Dillon

I'll let Rodney comment on any specifics he wants to add. But let me just tell you generally that our working relationship with the unions generally continues to be good, and it's something that we're committed to making sure that we have that good working relationship. And I think a lot of that is driven by the fact that as a company, our objective is to be balanced in what we end up with in our agreements. We're not out to just cut costs and cut expenses. Our objective is to make sure our employees, our associates, end up with a really good compensation package and we end up with a cost structure that makes us competitive. And that continues to be true. Now in individual contracts, of course, those end up being negotiations with the local presidents. And often those will end up individually being different than maybe that overall trend. And it's really up to whatever those local situations are. Sometimes there are particular issues in the contract that are problematic. Now overall, if you look at pension and health care, those have, for many years and continue for many more years, to be a focus of attention because that's where a lot of the growth of expense is. And in some of those parts, it's where some of our uncompetitive expenses are. So we've paid a lot of attention in the negotiations. So Rodney, you want to add any color to that?

W. Rodney McMullen

Just a couple of small comments. Many of the contracts are passed expiration. The thing that all of us have been very pleased with is our associates, the union and us just trying to make sure that we work through the issues on a constructive basis. And the dialogue and discussion has been very constructive. Obviously, with health care and the changes going on there, a lot of discussion in terms of how to do it right. One other point that I would just remind everyone, if you remember the pension for most of the east part of the U.S. has been already negotiated because of the agreement that we did last year, where 4 of the major plans came in and we are now managing those plans. And as part of that change, there was a 10-year agreement on the pension part of those plans.

J. Michael Schlotman

Yes. Of the 6 contracts that we mentioned in the prepared remarks, 4 of those, Columbus, Indianapolis, Memphis and Nashville, those 4 locations have the pension benefits solved for the next 10 years.

Meredith Adler - Barclays Capital, Research Division

Well, that's great. That's very helpful.

Operator

Your next question comes from the line of Edward Kelly with Crédit Suisse.

Edward J. Kelly - Crédit Suisse AG, Research Division

Could I just start off with the gross margin. The FIFO gross margin x fuel this quarter, down 43 basis points, is probably a bit more than I expected it would be because your comparison is easier. Could you maybe just talk about how that line item played out throughout the quarter and what influence, for instance, the cost savings you got this quarter, went into that or promotional environment or just initiatives that drive tonnage and how we should be thinking about that in the second half?

David B. Dillon

Well, I wouldn't suggest in the numbers that there is anything particularly unusual or erratic in terms of the merchandising plans or anything. Maybe one thing that does stand out is that we had less success and strength than we have had in the previous year. And that will tend to hurt the gross margin and make it look like there was a greater investment than there actually was. That was -- and that was true in the quarter, something we're focused on. So that may be important to call out. Rodney or Mike, anything else you want to add?

J. Michael Schlotman

The other thing to keep in mind at, as you know, we try to manage the company on what operating profit margin is, not just gross. And while you're right, the FIFO gross margin without fuel was down 43 basis points, the operating costs were down 59 basis points. So we actually had a nice expansion in operating profit during the quarter, which are the dollars that we actually have to take to the bottom line.

David B. Dillon

Yes. That is something we look at a lot more closely than just in isolation what the gross margin was.

Edward J. Kelly - Crédit Suisse AG, Research Division

Yes. I understand. And then just maybe related to SG&A then. And John, I think, kind of asked this question a little but your SG&A growth this quarter in dollars was only 1.3%. And if I go back and average the last 5 years or so, right, that number is more like 4%. So the question is, is there anything unusual on this quarter, number one? And then second, as we think about that line item going forward, should we be thinking about a lower run rate than what you've had historically?

David B. Dillon

Well, I'll let Mike talk if there's any specifics that he had to call out. But before he does, well, I like the way in which you characterized it, as look at the growth of the dollars in our OG&A and we look at really OG&A and rent and depreciation together. But as you look at those dollars growing -- but the only basis that, that metric, that percentage has any value at all is to look at it in the context of how much did the sales grow and how much did the gross profit dollars grow. Because if you don't do that, if you had a high sales growth period of time, we have a lot of variable expenses. And so that will tend to create a higher growth in expenses and make it look like we have expense issues when, in fact, all we had was really good sales. Well, our sales growth these last several years, we've had some higher quarters in sales growth than what we had just these last couple of quarters. And that will drive some of it. Mike, you want to add any color to the specifics?

J. Michael Schlotman

Yes. There's always lots of things going on in the SG&A line. And obviously, inside any 12-week quarter, lots of things can drive it. I will keep in -- I want to remind everybody to keep in mind going back to the pension benefit we talked about a second ago, when we consolidated those 4 plans, we took that charge in the fourth quarter of last year for over $900 million, and we increased our guidance this year because of the benefit of the reduction on an annual basis that, that was going to give us during this year. Now as we start to lap future years, that comparison goes away. So we are benefiting this year from lower pension expense for those 14 contracts and 4 different plans that were consolidated into one. But that was baked into our guidance. And if you go back and see what we talked about on guidance, we actually promised more than our normal growth rate because of that benefit because we made you eat the charge last year, so we have to give you the benefit back this year. Otherwise, it wasn't a smart thing to do for shareholders.

Edward J. Kelly - Crédit Suisse AG, Research Division

Okay. And then just last question for you. With the resolution of the Walgreens and Express Scripts dispute, can you maybe talk about the benefit that you saw there this year and what plans you have in order to try to retain or keep that business?

David B. Dillon

I'll let Rodney comment on the plans we have there because obviously, that's been an important trend for our pharmacy business. Rodney?

W. Rodney McMullen

Yes. Obviously, I won't go into the specifics because starting September 15, it will start playing out, and we won't want to share what our plans are before September 15 and the customers see it. The one thing that you should know is that we have done a lot of research to make sure that we understand those customers, what they like about Kroger, what they liked about Walgreens. And we've aggressively worked on trying to make sure the things that those customers liked better about Walgreens, we've changed that. The thing that they incredibly overwhelmingly told us they liked was the one-stop, the value, the pricing that we offer and those things, customers are really satisfied with where we are there, which we think will really help on the stickiness for those customers. But we're working really hard. Our pharmacy teams from the store to the folks in the divisions and general office are working really hard to make sure they have a good plan to retain that customer.

Operator

Your next question comes from the line of Karen Short with BMO Capital.

Karen F. Short - BMO Capital Markets U.S.

Just going back to generics for a second. I know you've given us directional comments on the third and fourth quarter in terms of how generics will impact your ID. I guess, I just was wondering, it sounds like that there will be a greater impact in the fourth quarter than there will be in the third. So can you just talk about that? And then was there actually an impact this quarter? And can you quantify it?

J. Michael Schlotman

Well, as we've said all along with our guidance, we expect the effect of the generics to grow over time. And a lot of it was going to be back end-weighted. We talked when we gave guidance that it could be as much as a 40 to 50 basis point effect on idents for the year. And again, that could be back end-weighted. So clearly, it could be higher in the year. I will tell you that the annual -- or the weekly effect of the generics on top line sales is a little over double, almost triple on a weekly basis in terms of dollar sales now as it was earlier in the year. So it is growing just as we expect it. But again, as Meredith's question, we continue to see strong gross margin out of those. And that 0.5% is on total identicals for the company, not just pharmacy identicals.

Karen F. Short - BMO Capital Markets U.S.

Okay. And then actually, following on that then in terms of generics, can you maybe quantify how much the benefit of the generic shift will be on gross margins, how much it was this quarter and how much it might be in the back half?

J. Michael Schlotman

I don't think we want to get that granular on the pharmacy business. We believe we've baked into our guidance and expectations for the year both the drag on the top line and what that will do to the leverage in the income statement as well as the better gross profit rate from those as we go throughout the year. To get that specific on any one department gets really, really difficult because there's all kinds of things that go on inside of a quarter in a particular department.

David B. Dillon

I would add that don't overestimate that effect. It certainly is positive, clearly positive for the pharmacy. But the dollars themselves are not significant enough to move the total company numbers much. Not like what happens with the sales.

Karen F. Short - BMO Capital Markets U.S.

Okay. And then on your square footage growth, I know you commented earlier this summer at a conference that you might look to accelerate unit growth. And you have kind of raised your guidance just a little bit this year. What kind of unit growth might we think of for next year? Or how do you think about that?

J. Michael Schlotman

Yes. It's a little too early to get into what I think we may have as far as unit growth this year. The new relocated and expanded stores we're doing, it is a little more than last year. The remodels are about the same. One of the things that's driving that is it looks like we may have a few fewer operational closings this year. And our mid-year look at our store count, it would project us to be up slightly at year end on store count. And if you look at the square footage, our guidance in the 8-K, we said we expect square footage, excluding operational closings and any acquisitions, to be up about 1.5%. So we continue to invest those dollars to grow our core business, while on the other hand spending some time cleaning up things that aren't producing a satisfactory return. We've done that, we haven't had any one-time charges for those. As we've closed those stores, they've just flown through normal operations.

Operator

Your next question comes from the line of Scott Mushkin with Jefferies & Company.

Brian Cullinane - Jefferies & Company, Inc., Research Division

Cullinane in for Scott. Some of this has been touched on, but kind of wanted to look at uses of cash as a whole and how you think it's best to maintain or build your business in your core or adjacent markets. You've been buying back a lot of shares, and maybe -- clearly if confidence is high in the business you could increase the dividend or also use the cash to solidify market positions in places like Southern California or add new stores into adjacent markets. Can you give us some flavor on your thoughts on current uses for cash and your priorities, given the current climate?

J. Michael Schlotman

Well, I think right now we're fairly balanced in how we plan to use our free cash flow. And keep in mind, it's not necessarily just free cash flow. I'll remind you that our net total debt-to-EBITDA ratio is at 1.96 now, it was 1.71 last year. So we've actually increased our debt level as well to the debt level we feel comfortable at maintaining. And I think we've done a very balanced approach between paying a dividend, which we've increased every year since we've had one. We've been very active in repurchasing shares when we think there's significant weakness in the stock, which we've demonstrated so far this year. And we continue to expect to spend $1.9 billion to $2.2 billion on capital this year. So I think we've had a very disciplined and very balanced approach to how we spend our capital and try to reward all constituents, whether it's building new stores to create new jobs, paying a dividend and buying in shares to reward shareholders, but also making sure that our debt and leverage ratios are appropriate for our bondholders.

Brian Cullinane - Jefferies & Company, Inc., Research Division

Okay. Appreciate it. And then just wanted to touch on some competitive openings. Walmart has stated they're going to open a number of new stores over the next few quarters and hinted at the possibility of kind of accelerating their small-box openings. How do you view if there's a lot more small-box openings to come online next year? And secondly, you've obviously operated for a long time very well with Walmart in your backyard. Any change in approach if there were to be a significant acceleration in any small-box openings?

David B. Dillon

I think I feel like you answered the question for us by saying we've operated quite well when Walmart has been a significant factor in our markets. I see it exactly that way. And sure, there's some change in what their strategy is. But it's the same issue is making sure that we stay attentive to what our customers want in those markets and respond appropriately. Rodney, you want to add anything?

W. Rodney McMullen

No. I mean, just your comment on really focusing on the customer. And our customers tell us there's a lot of things that we do a lot better than Walmart and we have to make sure that we keep doing that and delivering against that.

David B. Dillon

Yes. In fact, I would add one other element maybe is that in this last quarter, in the second quarter, some of the things that you just described about Walmart planning to do, they actually have already done some of that in several of our markets. And that's reflected and contained in the overall results that we achieved in the second quarter. So think about it in that context.

Operator

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

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Just a few quick follow-ups. One question I had was just on your fuel business and the CPG assumption that you're using in your guidance for the back half of the year. It looks like that this was a really good CPG quarter. And I'm assuming also if you could tell us was it above-planned CPG quarter for you against such a strong result last year. And then also related to your gas business, how does the competitive environment look? Walmart's brought back the Murphy's deal. I think they just announced that this week. And I think some others, like Safeway, are going to be aggressive again with using fuel as an offering. And any color on that would be great.

J. Michael Schlotman

Well, on the fuel business relative to the CPG, the cents per gallon were obviously down a little bit compared to last year, as we said in the prepared remarks, almost $0.01 or actually right at a $0.01.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Yes. But I'm assuming you were -- that was a great CPG last year. I'm assuming that you might have been planning it down even more than what you saw.

J. Michael Schlotman

Well, I mean, actually it's not dramatically different than what our expectation was for this time of the year looking at the dollars of EBITDA that the fuel centers generated during the quarter. And earnings per share were exactly flat. And that was really driven by the ID gallon growth as well as unit growth, multiplied by the lower cents per gallon. So it's not just that cents per gallon, it's also our expectation of how we can grow identical gallons and the fact we continue to build more units.

David B. Dillon

And then your additional question related to the promotions of fuel rewards at Walmart and Safeway are the 2 that you called out. And I would just put that in the same terms of what we talked about the competitive environment. There are always things happening with your competitors and with you. One of the advantages we have is over 1,000 fuel stations that are at our stores or just right down the block from our stores that are ours. And we also have a partnership, of course, with Shell, as you are probably aware. And then I don't want to lose track of the fact that we've got hundreds of convenience stores around the country, too, many of -- most of which have gasoline.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

And just one quick follow-up on the last question. So with the Walmart Market Basket Challenge ad campaign, so are you sort of saying you have seen an impact in the markets that they've run against you with those ads?

David B. Dillon

Actually, that's not quite what I meant to say, if that's what I said. What I meant to say was Walmart has done those activities that were being described, adding new stores, growing their neighborhood stores, and now you'd add to the mix the advertising program on pricing, and that those were out there last quarter. And that our results as a company for the last quarter include the fact that, that has happened in those markets. I wasn't trying to describe that it had an impact, I'm just trying to describe that it was included within the overall results that we achieved. We, of course, have seen the same ads that you've seen. And Walmart has, as they've described, been more aggressive in their advertising on those themes.

J. Michael Schlotman

And keep in mind all of our geographies had, all of our divisions had positive idents.

David B. Dillon

Yes. I think that's important for us to call out is how broad-based our results were. It was all divisions, all departments. And we even called out that every division grew loyal households as well, which is quite important when you think about the competitive environment.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

And the 55 neighborhood markets that they're opening over the next 6 months here, so pretty good acceleration for them. Do you have a sense if a lot of those are going to be targeting your markets or not? They won't tell us, so I was just curious if you guys are expecting...

David B. Dillon

And so you think we'll tell you? Sorry. But we, of course, watch that very closely and we know in markets what's being built and what's being planned. We pay close attention to that. But that's not something we're going to talk about on this call.

Operator

Your next question comes from the line of Mark Wiltamuth with Morgan Stanley.

Mark Wiltamuth - Morgan Stanley, Research Division

I wanted to ask about the inflation outlook. You mentioned that inflation cooling had helped your volumes in the quarter. Given the drought, where do you think inflation is going in 2013? And maybe just give us a little color on the current quarter on the branded inflation versus the perishables.

David B. Dillon

I'll let Mike comment in a second about our forecast on inflation. But I would just add a little bit of color. Last quarter, when we talked about this, we commented that we did expect -- continued to expect inflation to decline during this year. Our LIFO estimate certainly suggests that. And we did see that in the quarter. We also described that we expected last quarter, we described that as inflation came down, we expected some tonnage to improve because there would be less resistance by customers to buy the product. But we acknowledged that it wasn't deflation, that prices weren't going down. It's just that they weren't going up at the same clip. And I think that's proving out is that the inflation was down this quarter. Our tonnage has gradually begun to improve a bit. And that's all good news and in the direction that we had expected it to be. Mike can give a little bit of color to what we expect going forward. And you may want to add to his question about perishables and national brands if you want to add any color to that.

J. Michael Schlotman

Yes. It's a little early to start giving guidance for 2013. But just relative to the drought, I don't think the drought is going to have a huge effect on our inflation expectations for this year. And if it does, it would be very late in the year. I think a lot of the things like proteins and that will probably go down before they start to go up next year. I do think that the current situation will have some effect on inflation next year. I would look for things like proteins to get higher, mill prices will probably get higher, the cost of raw milk will probably get higher as the cost of feed goes up. But you also have to keep that in mind and balance it that the whole inflation picture isn't driven just by corn and wheat and soybeans. You have coffee out there, you have sugar out there, you have orange juice out there. You have other commodities out there, all of which go into a lot of food products that are in the mix of what inflation does that have gone the other way. So when you balance it all out, and we called out the produce and seafood, for example, this quarter had deflation. So when you balance it all out, I don't -- I want to have a little bit more time to see what the crop actually comes in at. But I'm not overly concerned about it at this point, but it's certainly something that as we start thinking about 2013, what effect it could have in certain areas of the store and the effect on the consumer.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. And how about any of the growing regions where your perishables are coming from and maybe color on the current quarter on perishables versus branded items?

J. Michael Schlotman

If you look at the perishables, particularly in the produce department, it continued to be a fairly good growing season for those products, and the products were plentiful. I'm just trying to remember what produce inflation -- actually produce continued to be deflationary in the second quarter. So when you talk about perishables singularly in the produce category, it was deflationary. Meat was less inflation and seafood was deflation. Milk costs today are down from where they were last year and actually below the 5-year moving average. But as we get later this year and into next year, most forecasts would have milk prices going back up above the 5-year average and probably back up above where they were last year.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. And the center store inflation is cooling? Or what's going on there in center store?

J. Michael Schlotman

Yes. Grocery continued to decline. Keep in mind, grocery does include milk on a trend basis. It's not deflation, it's less inflation.

Operator

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

Charles Edward Cerankosky - Northcoast Research

If we could look at the second half of the year, what are you thinking about the impact of rising fuel prices on 2 things, the effectiveness of Fuel Rewards programs and a tolerance among consumers for shelf price inflation?

David B. Dillon

Well, as we've talked about before, while I always worry about what happens with fuel pricing because of its impact on the psyche of the customer and the actual cash that they have in their wallet, we actually think it's probably a net-net slight positive in our direction. Fuel Rewards, of course, helps us. And having those over 1,000 fuel stations at our stores helps us. Our street prices on gas are quite competitive. And as a result, we are a place that customers find some reprieve really, to the extent they can get any reprieve as the cost goes up. So I think that's how we see that. I don't think from the grocery store point of view, it's pure and simple, to what extent does the customer have money to spend in the grocery store. And if it were to go up substantially, a big sharp increase, I think the customers would see less money in their pockets. And I think you'd see some reaction overall in retail. But I think we would be less affected if that were to occur.

W. Rodney McMullen

The only other thing I would add is any time when fuel prices hit new highs, that's when customer reactions change. So if whatever the last cycle was, the last cycle, a lot of people had the $4 mark in their mind. Well, if fuel goes up to $4.25 or $4.50, the reaction will probably be different than just the price difference. And then the other thing in terms of Dave mentioned overall, we think it would be -- it's slightly beneficial to us that just the absolute convenience of our stores, when fuel prices are high, our stores are so close to most of our customers, most of our customers only have to drive 1 mile, 1.5 miles to get to our stores. So it's incredibly convenient, and it's a one-stop shop. So that is also another thing that we think helps.

Charles Edward Cerankosky - Northcoast Research

Switching subjects a little bit. The tax rate versus a year ago was quite a bit higher. Mike, what kind of guidance can you give us for the full year or the second half on Kroger's tax rate?

J. Michael Schlotman

Yes. Well, what we said in the 8-K this morning is we expect it to be around 36% for the third and fourth quarter.

Operator

Your last question comes from the line of Stephen Grambling with Goldman Sachs.

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

I just had a quick follow-up on some of the questions earlier. First, on the pharmacy side, last quarter, you had provided some good detail on the comp rate and what was attributable to Express Scripts. I think you had referenced double-digits and about half. Is there any way you can give us an update on that in the second quarter?

W. Rodney McMullen

If you look in the second quarter, it would be right at half again, maybe just slightly higher than half. And then I'd just remind everybody, Mike's comment, if you look at -- the generics obviously had a big impact, and Mike mentioned that's negatively affected by 0.5% on our total identicals from the generics.

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

And so that was -- okay. And then second follow-up, I guess, would be on the cost side. Could you maybe quantify the percentage of your cost basis that is variable versus fixed? And is that variable on tonnage? Or is that on total sales growth?

David B. Dillon

Well, I remember when I took a cost accounting class that it seemed pretty simple that costs were either fixed or variable. But in fact, in our business, most costs have elements of each. And so it's really hard to describe it. So take labor as an example. One of our biggest cash expenses, but it's also one of our most important investments. You look at labor, and there's a high variability component to it, but there's also a certain fixed component to it, too. So we have to have a certain amount of staff there to open a pharmacy. But as volume grows, you don't have to add quite as much staff as it goes. So I can't really help you with your modeling in that sense, but you can almost do it just by looking over a course of years what our expenses have done.

J. Michael Schlotman

One of the things to keep in mind -- and we've obviously been very focused on driving our sales, which results in higher sales per square footage over the last several years. Stores at a certain sales level, almost all of the costs are fixed because you have to have that certain amount of labor. Once you get sales above a certain weekly amount or a certain sales per square foot, everything becomes variable. And that's where you really start to leverage all those fixed costs just to run a store regardless of what the sales are. And that's one of the reasons that as we continue to have more and more consecutive quarters of ID sales growth, why that's been so important in being a big lever in helping us leverage those costs because a big piece of them are fixed, just to turn the lights on every day.

David B. Dillon

Before we wrap up, I do have a couple of closing comments. I often like to share additional thoughts with associates because we encourage our associates to listen in. So let me close with these thoughts.

Later this month, we will begin our annual Giving Hope a Hand campaign to support the fight against breast cancer. This year, 48 of our associates shared their personal stories of survival and hope. And that will be featured on specially marked packages of national and corporate brand products. These items will be sold exclusively in our stores across the country from September 23 to October 10. Since this campaign began in 2006, 249 brave women have shared their experiences, inspiring many others to fight breast cancer and survive. And I'm always grateful to their courage to do so. And in that same time, we've also raised more than $20 million for breast cancer treatment, research and education. And all of the donations go to local organizations fighting breast cancer and the communities that we call home.

In 2012, with the help of key vendor partners, we will raise $3 million more. Our associates and their stories will also be featured on sharingcourage.com later this month, a special website that includes a Wall of Hope, where visitors can post messages of support and share their own experiences. I encourage you each to read our coworkers' inspiring stories. They are truly remarkable. That completes the call today. Thank you for joining us.

Operator

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