Kroger Co. (NYSE:KR) Q4 2016 Earnings Conference Call March 2, 2017 10:00 PM ET

Executives

Kate Ward - Director, Investor Relations

Rodney McMullen - Chairman and Chief Executive Officer

Mike Schlotman - Executive Vice President and Chief Financial Officer

Analysts

Stephen Tanal - Goldman Sachs & Company

Chris Mandeville - Jefferies

Karen Short - Barclays

Rupesh Parikh - Oppenheimer

Vincent Sinisi - Morgan Stanley

Ken Goldman - JPMorgan

Shane Higgins - Deutsche Bank

Alvin Concepcion - Citi

Robby Ohmes - Bank of America Merrill Lynch

Ed Kelly - Credit Suisse

Chuck Cerankosky - Northcoast Research

Kelly Bania - BMO Capital

Operator

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

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

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

Kate Ward

Thanks, Carrie. 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 fourth quarter press release and our prepared remarks from this conference call will be available on our website at ir.kroger.com. After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question and one follow-up question, if necessary. Thank you.

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

Rodney McMullen

Thank you, Kate, and good morning, everyone, and thank you for joining us today. With me to review Kroger's fourth quarter and fiscal 2016 results is Mike Schlotman, Executive Vice President and Chief Financial Officer. As we all know, sometimes are just more challenging than others and last year certainly didn't end the way we expected at the start of the year, but 2016 still had its bright spots. Of course our associates and our customers are always at bright spot and I'm so proud of this team for their continuing focus on taking care of our customers each and every time they interact in our stores.

Despite the challenging operating environment, our team pulled together to deliver some results that we should take stock of. Over the past year, the Kroger team delivered our 12th consecutive year of market share growth, overall tonnage growth, record high unit share in our corporate brands portfolio, which was lead by another blockbuster $1.7 billion year for Simple Truth.

A strategic merger with specialty pharmacy leader ModernHEALTH and reached an agreement to merge with the world's greatest purveyor of specialty cheese Murray's Cheese. And we created more than 12,000 new American jobs in our stores and hired more than 9,000 veterans and military family members. That's a lot to be proud of.

We're obviously disappointed with our identical supermarket sales number in the fourth quarter and our performance on several other KPIs, including FIFO operating margin and return on invested capital, which were driven by the deflationary environment.

Kroger is always focused on executing against our long-term strategy. We are lowering cost to invest those savings in our people, our business, and the technologies to position Kroger to deliver the value proposition customers are seeking today and in the future.

One example of our efforts to control administrative cost is making the very difficult decision to extend the voluntary retirement offer for certain non-store associates that we announced in December. Approximately 2,000 non-store associates were eligible for the offer. And at this point, we estimate approximately 1,300 will accept it.

As our customers change and evolve, we are taking steps to meet them where they are and more importantly where they are going. We're making meaningful investments in digital. We feel great about these investments because customers tell us they are important to them.

We've aggressively added more than 420 ClickList and ExpressLane locations in 2016 bringing our total online ordering locations to more than 640. This effort was based on learnings from our merger with Harris Teeter. We are also experimenting with ways to solve the last mile equation. We're testing with Uber delivery in several locations with plans to expand in 2017 where our customers can order through ClickList and choose to have their groceries delivered by a local Uber driver. We have a couple of other home delivery tests as well.

We're building our digital experiences today so that customers can engage and shop for anything, anytime, anywhere with us in the future. The excellent service they get from our associates in the stores will carryover seamlessly to the digital platforms whether shopping online, finding great promotions and recipes that are personalized and relevant to them, or downloading one of the more than 1 billion digital offers loaded through shopper cards each year.

More and more customers are connecting digitally with Kroger. We are leveraging refined customer insights from 8451 as well as years of online shopping experience from both Vitacost.com and Harris Teeter to develop a sophisticated understanding of our customers' behavior when shopping with us online, in store and both.

We're utilizing this rich data set to make decisions about where the right locations to offer ClickList, what are the right assortments and promotions to engage customers online and how can we offer the quality and convenience online that customers' have come to expect from a Kroger brick-and-mortar location.

We are also keenly aware of gowing customer trends like health and wellness and high-quality fresh and prepared foods. Our initiatives in these areas are designed to deliver convenience to our time-starved customers and will continue to be a big focus at both our capital and customer first investments.

Now we could stop all of these investments given the headwinds our industry is facing. That might make our results look better today, but we are playing for the long-term. And that requires being deliberate and determined. There are a lot of companies out there right now investing in digital and e-commerce in opportunistic ways that will likely never create value for their shareholders.

Core strength of Kroger is our ability to both create shareholder value today and to make meaning strategic investments for the future. We remain determined to execute on our strategy and we are deliberately investing to grow and create long-term value for shareholders.

Our corporate brands business was another real bright spot in 2016. Our brands are in more homes than ever before. In fact, our customers fill their carts with more than 1.25 million corporate brand items every hour. We are incredibly proud of the quality of our corporate brand products. Our quality is only getting better and that showed clearly in the corporate brands performance last year when we sold a record number of units and in the fourth quarter when corporate brands had an all time high unit share of 29.2%.

Simple Truth grew at an impressive rate again in 2016 reaching total sales of $1.7 billion. Simple Truth Organic accounted for more than $1 billion of that figure last year and we still see more growth ahead in our Simple Truth and Simple Truth Organic lines. In fact, we began offering Simple Truth to even more customers throughout the United States by making it available on Vitacost.com. Today, you can find online we conveniently ship to home many of our Simple Truth food, snacks and supplements as well as household and personal care products. Interestingly, New York City is already the number two Simple Truth online sales market for us even though we don’t have store physical presence there.

As you know, we always build our business plan assuming the environment is going to get more competitive the next year and not less. We also don't run a business model that relies on inflation returning. Rather we proactively make the changes we need to remain competitive well into the future. Kroger's core steps remain on most valuable assets. On the people front, we have great associates, an effective and experienced management team, and a deep bench of future leaders.

On the financial front, a strong balance sheet and the flexibility to create sustainable shareholder value and on the customer front, deep customer insights through our data analytic experts at 8451, and above all an unwavering commitment to putting our customers first. What also remains unchanged is our commitment to long term growth that investors can count on. Over the last five years, Kroger's annual net earnings per diluted share growth rate was 16.3% excluding one-time items. Over the last three years, it was 14.2% excluding one-time items. We remain committed to delivering our long term net earnings per diluted share growth rate of 8% to 11% plus a growing dividend.

And now, Mike will go into more detail on our fourth quarter and fiscal 2016 results. Mike?

Mike Schlotman

Thanks, Rodney, and good morning everyone. Kroger's market share grew for the twelfth year in a row. Our consistent market share gains drive both top and bottom line growth and generate blasting shareholder value. We report our market share annually and look at it the way customers would look at it where they spend the money. According to Nielsen Plus data, Kroger's overall market share with the products we sell in the markets where we operate grew approximately 20 basis points in 2016 with 14 of 22 markets up too flat and six markets down. Starting in 2017, we plan to begin using IRI point of sale data to measure market share. While we expect there to be some differences in share reporting between Nielsen and IRI, we expect those differences to be minimal. Regardless of the source, we use market share data as a directional measure and not a specific one. It is also worth noting that market share data is calculated based on total sales and not ID sales.

Looking at ID sales, deflation was the primary driver of our negative results for the quarter. Inflation adjusted ID sales were positive in the fourth quarter. Deflation excluding fuel persisted at 1.3% compared to 1.1% in the third quarter. During the quarter, we saw decline in pharmacy inflation and acceleration in produce deflation and a slowing in grocer deflation. Another headwind to ID sales was our capital program. Over the last four quarters, we relocated or expanded 35 strong performing stores taking them out of our identical supermarket sales calculation. This caused about 70 basis point headwind to ID sales in the fourth quarter.

Tonnage was positive during the fourth quarter and we continue to focus on the areas of highest growth like natural and organic products which by the way hit nearly $16 billion in sales in 2016 in areas where we are saving customers time such as ready-to-eat and ready-to-eat meal solutions. We always give a little insight into our ID sales data. Visits per household and price per unit were down in the fourth quarter but those were slightly offset by basket size and household growth. Loyal households continue to grow at a faster rate than total households which was true for both the quarter and the year. It is interesting to note that loyal household had slightly positive ID growth in the fourth quarter.

Operating, general and administrative costs as a rate of sales excluding fuel, recent mergers, and a $30 million contribution to the UFCW Consolidated Pension Plan in the fourth quarter of 2015 declined by 11 basis points; rent and depreciation with the same exclusions increased by 24 basis points. While this result was better than the third quarter, we can and will do better. We are working diligently to pull costs out of the business and improve processes to lower cost as a rate of sales and deliver value to customers.

Now, for an update on retail fuel, in the fourth quarter, our cents per gallon fuel margin was approximately $0.172 compared to $0.169 in the same quarter last year. The average retail price of fuel was $0.0218 versus $0.0192 in the same quarter last year. For 2016 in total, we are at $0.171 for the year and $0.174 in 2015. Our net total debt to adjusted EBITDA ratio increased to 2.31 times compared to 2.08 times during the same period last year. This result is due to the merger with ModernHEALTH and increases in working capital.

The increase in working capital is driven by higher inventory in four locations where we open new or expanded distribution centers. When doing this, we duplicate inventory for a period of time to ensure a smooth transition. Also, accrued liabilities are lower due to lower incentive plan payout accruals. This fortune will reverse in the first quarter when incentive plan cash payments will be lower. It is worth noting that over longer time horizon, we do expect our net total debt to EBITDA ratio to grow. This is because we continue to work with our unions to modify pension plans. We continue to negotiate restructuring of troubled multiemployer pension plan obligations to help stabilize associates' future benefits as we did in the second quarter. These restructurings do not change the total obligations of the company because the debt we add is offset by a reduction in the amount of our off-balance sheet multiemployer pension plan obligations.

In 2016, Kroger used cash to repurchase $1.8 million in common shares, paid $429 million in dividends, invest $3.6 billion in capital and to merge with ModernHEALTH for approximately $390 million. Capital investments excluding mergers, acquisitions and purchases of lease facilities total $3.6 billion for the year compared to $3.5 billion last year. The flexibility to return value to shareholders is a core strength of our financial strategy. Return on invested capital for 2016 was 13.09%. This result was affected by current year results and recently merged companies. We are committed to growing return on invested capital with the long term.

I will now provide a brief update on labor relations. We recently agreed to a new contract with the Teamsters for our Roundy's distribution center and with the UFCW for North Carolina clerks and meat associates. We are currently negotiating contracts covering store associates in Atlanta, and Michigan. Our objective in every negotiation is to find a fair and reasonable balance between competitive cost and compensation packages that provide solid wages, good quality affordable healthcare and retirement benefit for our associates. Kroger's financial results continue to be pressured by rising healthcare and pension costs with some of our competitors do not face.

Kroger continues to communicate with our local unions, which represent many of our associates with importance of growing Kroger's business and doing it profitably, which help us create more jobs and career opportunities and enhance job security for our associates.

Turning now to our guidance for fiscal 2017, we anticipate identical supermarket sales, excluding fuel, to range from flat to 1% growth for 2017. We expect net earnings to range from $2.21 to $2.25 per diluted share, including an estimated $0.09 benefit for the 53rd week. We anticipate the operating environment in the first half of 2017 to be similar to the second half of 2016. Our results in the second half of 2017 should show improvement as we cycle to previous year.

We recognize that this is an unusual year and that's why we are going to provide a quarterly cadence relative to last year rather than compared to our long-term guidance rate as we've done in the past. In fact for the first quarter, we are going to give you an earnings per share range, which is not something we plan to do over the long-term, but we think it's important to be very clear about how we think the year is going to progress.

For net earnings per diluted share, we expect the first quarter to be in the $0.55 to $0.59 range, the second quarter to be slightly up compared to last year, the third quarter to be up strongly compared to last year and the fourth quarter to be up high-single digits compared to last year without the benefit of the 53rd week.

Our guidance for the year excludes the estimated cost of the voluntary retirement offer, but does include the anticipated expense savings, which we will reinvest in the business. Over the long-term we are committed to achieving a net earnings per diluted share growth rate of 8% to 11% plus a growing dividend. We expect a LIFO charge of $25 million for the year. We expect capital investments excluding mergers, acquisitions and purchases of leased facilities to be in the $3.2 billion to $3.5 billion range for 2017.

Capital expenditures in 2017 will be focused on sales generating initiatives, remodels, upgrades to our logistics network and merchandising systems and digital and technology initiatives. As we invest more in these areas, our investment in stores will be reduced. As we anticipate Kroger's full year FIFO operating margin in 2017, excluding fuel, to decline approximately 10 basis points compared to 2016 results.

Now, I will turn it back to Rodney.

Rodney McMullen

Thanks, Mike. We've never been more determined about our future. We continue to focus on gaining a larger share in the $1.5 trillion U.S. food market. We are working on process changes to lower cost and use those savings to invest in our people, our business and technologies that will enhance Kroger's competitiveness in the future.

We will continue to deliver for our customers today while setting the company up for our next phase of growth and customer-first innovation. We know that when we deliver for our customers, we create long-term value for our shareholders.

Now we look forward to your questions.

Question-and-Answer Session

We will now begin the question-and-answer session. [Operator Instructions] The first question comes from John Heinbockel of Guggenheim Securities LLC. Please go ahead.

Q - John Heinbockel

So, Rodney, let me start with ClickList. Generally speaking, what's the roll out plan for 2017 or do you want to study the 420 a bit more? And then what have you learned from the 420 you did last year in terms of driving new customer acquisition and in building share wallet with loyal households? Anything you can share on that?

Rodney McMullen

Okay. If you look at the 2017 plan, at this point, we would expect probably to open a few less in 2017 than 2016, but it's not driven by the enthusiasm for ClickList, it's driven by findings stores with the space and incorporating it getting zoning changes and anything else that we need to do. One of the things – probably the biggest learning that at least been a surprise to me, may probably not for others, is customers continue to shop inside the store even when they become a ClickList customer. And they will buy certain products via ClickList, but they still come into the store.

If you look at the more mature locations, you can start seeing more financially they start getting to the point where really indifferent in terms of whether somebody shops in store or online. Obviously, that's just the early ones that have been opened more at Harris Teeter than at Kroger. So we continue to have that headwind and we will continue to have that headwind in 2017 just because of the sheer number that were opening and the number that we opened late in 2016, but they continue to mature and we can clearly see it at a point where we're actually indifferent on how the customer shops with us.

John Heinbockel

Okay. And then just shifting gears to maybe not related to financial questions, FIFO gross margin ex-fuel, a little more pressure in the fourth quarter than prior quarters. Where did that come from? And then the first quarter when you look at the cadence in the first quarter earnings number, obviously, substantial deviation from the rest of the year. So, curious is that driven by – you would think it's driven by aberrational, I don't know if that's pension or shrink or what drives that?

Rodney McMullen

I will let Mike talk about the quarter stuff, but on the – if you look at the gross, it's really a combination of several things. Some would be driven by pharmacy continues to be a headwind on gross; other areas, there we have definitely become more promotional and more aggressive on some pricing as our sales were softer. So it's really both of those elements together. Mike, I will let you answer the quarter comment.

Mike Schlotman

Sure, John. As I've said in the prepared remarks, we do expect the first half of the year to be much like how 2016 ended and it's really just carrying the current trends out through the first – as you know this is a 16-week quarter for us – through those first 16 weeks of the year. And we see the clarity to some of the programs Rodney mentioned and the fact that we continue to drive unit growth. We do expect to see the recovery in the sales later in the year.

John Heinbockel

Okay, thank you.

Rodney McMullen

Thanks, John.

Operator

The next question comes from Stephen Tanal of Goldman Sachs & Company. Please go ahead.

Stephen Tanal

Hi, good morning, guys.

Rodney McMullen

Good morning.

Stephen Tanal

I guess I want to just ask what you guys are seeing in a competitive environment to start, clearly, there is at least some chains that are putting up slightly better comps or better comps and obviously versus Nielsen, it looks like you're gaining share, but I wonder what you're seeing and if you feel like there is a certain customer you may be losing or if there's something you can comment on markets where you're competing with more online, challengers, just any color there in terms of where you think some of the traffic may be headed?

Rodney McMullen

If you look at from a competitive environment, most of the changes that we would see is competitors running better stores. I don't think there's any doubt that they are, most of you and lot others have read about it. Certainly, it wouldn’t – there isn’t anything that would show that it's going to online at all. So it would be more driven by some of the competitors running better stores versus other aspects. I don’t Mike anything you'd want to add to that.

Mike Schlotman

No.

Stephen Tanal

I guess, is that – can you give a sense for whether it's a lower-end customer or higher-income consumer or right in the middle or any color you can provider there?

Rodney McMullen

If you look – on one of the comments that Mike mentioned in his prepared remarks was when you look at our loyal shopper, we actually had positive identicals with our loyal shoppers, so it's really the customer though. What isn't very loyal to us is where we're seeing it. That would be more driven by value shoppers or shoppers on a budget than mainstream and customers that really value the experience in the freshness of our product and other aspects.

Stephen Tanal

I guess, so it's safe to say you're probably not seeing anything all too different in sort of a bigger, denser, more affluent cities that you are in where there are more home delivery options and I just have a couple of more follow-up on that – one more after that.

Rodney McMullen

We are really not seeing it from that aspect at all. And the other thing I think is important to note, we aggressively increased the amount of capital we were spending and increased the number of stores that we were relocating and remodeling. Mike mentioned it. But if you look at about 35 stores, we relocated or expanded which took amount of the identical calculation which actually hurt our total company identical by 70 basis points. So I think that's other thing that's important to remember.

Stephen Tanal

That's helpful. And just a last one from me maybe for Mike, the impact of the early retirement offer on OGNA if you could sort of quantify that perhaps maybe is that ramping through the year, is that maybe why the year looks little more back half waited and then we need a guess there.

Mike Schlotman

Sure. As I said in the prepared remarks, as we finalize what the expense of that will be, that will be reflective in the first quarter. The offer is not entirely close so we won't know until next week exactly how many people ultimately accepted the offer. And there will be varying times when people ultimately retire so that does go throughout the year as those folks ultimately retire. Do keep in mind as I said in prepared remarks was we do not have the expense of the plan in our estimates. We do have the savings in their plan and/or a portion of what we plan to invest to increase the value proposition for our customers.

Stephen Tanal

Okay. Thanks so much.

Rodney McMullen

Thanks, Steven.

Operator

The next question comes from Chris Mandeville of Jefferies. Please go ahead.

Chris Mandeville

Hi, good morning guys. So just maybe sticking with the guidance here, is it fair to assume that gross margins will be done in a similar fashion for the first half this year which is kind of given, a4 results and commentary for the full year being down 10 basis points. And then I guess for the back half of the year, that would imply – I would assume some gross margin expansion to some degree. I guess maybe Q4 but can you help us understand why Q3 should be implying 20% EPS growth. And lastly, how does deflation or inflation for that matter play into 1H versus 2H? Thanks.

Rodney McMullen

Yes. I mean there is a variety of contributing factors. Obviously going back to the first quarter where cycling one of if not the strongest quarter from the prior year, we had high-teens earnings per share growth with 2.4 IDs in the first quarter of last year. So we are up against our toughest compare for one thing. Also, as we go through the year, I'm not going – I won't break down gross profit by quarter. We try to stick with ID sales and operating profit. We do plan to continue to make the investments as I said in the value proposition for our customers which we think will continue to drive IDs back into the positive range.

Operator

The next question comes from Karen Short of Barclays. Please go-ahead.

Karen Short

Hi, thanks. Just on the guidance, just to clarify one or two things, so guidance does include buybacks correct?

Mike Schlotman

It does.

Karen Short

Okay. And I would assume that maybe given that you'll have more free cash flow this year than last, the priorities will be skewed to buyback?

Mike Schlotman

We did not give any specific guidance on the level of buyback we'll do and obviously it depended on market conditions as well as our Board being willing to give us incremental authorization. We will run out of our existing authorization here in the very near term. We've been buying shares since late last year and all through so far this year off of the greatest average

10b5-1. So we're somewhat predicated and our Board given this incremental authority.

Karen Short

Okay. That's helpful. So, Rodney, is there something?

Rodney McMullen

The other thing that Mike mentioned in his prepared comments, if you look at the range of estimated capital investment, 2017 is lower than 2016 as well.

Karen Short

Great. Okay, with that in mind, I guess when I look at your guidance and I try to kind of back in operating profit growth, it does look like you can get there but with some pretty meaningful offsets to SG&A in terms of SG&A per week. And SG&A peek has been growing pretty meaningfully and I know you point into that as an area of opportunity and he talked about that a lot in this call. But I guess I'm just trying to reconcile like how much you actually have to get that done to achieve your guidance, but also reconciling that with the EU, you want to invest for the long term? So I wonder if you could talk to that a little bit.

Mike Schlotman

I can tell you there were lot of efforts we have underway to reduce our total cost of doing business and it's in a variety of areas. We can do better on shrink, we can do better on store productivity in some areas, we can certainly do better on in stock in some areas. And one of the great things about being in a company of this size and breadth of Kroger is, there is not an initiative we have out there that we don't already have, a very large group of stores achieving. We don't have to go outside the company and point to competitor actually doing this so we are. Every metric we have out there for our storage to do better on, we already have a group of stores achieving those results, and as we get better at achieving those over a broader base of stores, that's one of the things that we think is going to give us incremental fuel for the engine to continue to invest in the four piece.

Karen Short

Got it, that's helpful. Thank you.

Mike Schlotman

Thanks, Karen.

Operator

The next question comes from Rupesh Parikh of Oppenheimer. Please go ahead.

Rupesh Parikh

Good morning and thanks for taking my question. Two questions related to our deflation, first I wanted to sense of what you guys are assuming for deflation or inflation this year and whether you expect to return a positive growth or positive prices later this year. And then secondly related to that, we are hearing more and more announcements from Target, Wal-Mart and others just talking more about price investments. Do you expect I guess the deflationary impact of competitor actions to be potentially more this year than what you've seen in recent years?

Mike Schlotman

I think you're doing what a lot of people do including this morning when I was on CNBC of mixing inflation and deflation at cost and retail. When we talk about our inflation or deflation it's our product cost inflation or deflation. You kind of through and what's going to happen to retail product cost inflation or deflation. And overall, we do think that we will return to a slightly inflationary environment in the back half of the year. It is interesting to note that despite the fact that we pretty much add, I think Rodney was talking before with one of the callers, nine quarters in a row of deflation, declining inflation/deflation. I'll be there inflation coming down or actual deflation, it's nine straight quarters now but that trend volume would be down. So it's been obviously fairly persistent. Despite that, even though we had a lot lower pharmacy inflation in the quarter that still generated a very large LIFO charge, it was offset by other areas that had deflation. So it's a completely mixed bag. Even in the fourth quarter, grocery inflation over the course of the quarter was basically half of what it was in the third quarter but produce inflation went up 600 basis points or deflation expanded by 600 basis points, and that was over 7% deflation in the quarter. So it's a huge mixed bag of what's out there and I'm not going to pinpoint an exact number because I've proven over the years that I can predict a totally inaccurate number on inflation or even LIFO, but we continue to manage through the process that we have.

Rodney McMullen

As we mentioned in our prepared comments, we do expect the market to get more competitive. We've assumed that for a long period of time. We continue to see great opportunities for process change and taking cost out of the business, and the last couple of calls I've mentioned that we're doubling down on those. In the fourth quarter, we made more progress on those than we did in the third quarter and you can begin to see some of those things paying some fruit. As Mike mentioned, we are starting to cycle actual deflation. We think the first part of the year will still look awful lot like third and fourth quarter but once you get to the third quarter you start cycling some of those strong deflationary numbers and we didn't see it. The other thing that I think is important to note if you look at cost of goods, there is all kinds of things that we are doing to finance and pay for some of that for cost of goods savings and other pieces of business as well.

Rupesh Parikh

Great. Thank you for all the color.

Rodney McMullen

Thanks.

Operator

The next question comes from Vincent Sinisi of Morgan Stanley. Please go ahead.

Vincent Sinisi

Hi, good morning guys. Thanks very much for taking my question. Just wanted to see, with the promotional environment any further color on promotions by categories, is it fair to say that the most deflationary is also getting the most promotions. And then also just in relation to that if you could give any further color around the cadence expected in addition to the very helpful EPS guidance by quarter? Thank you.

Mike Schlotman

The promotions by category, we would use our 8451 insights for that and it would really be different by customer, some of it would be things that you would do personalized one-on-one. So, it actually – if you go into the store from checking the retail price you wouldn't see it because of its offers that are made directly to customers, sums via coupons. It's all the above because different customers react different ways to different promotions, so it’s becoming increasingly personalized offers based on what that particular customer wants and desires are. And it would be a mix of national brand, corporate brands and fresh product and others, so it's really a mix on the comp by quarter. Mike, I will let you…

Mike Schlotman

Yeah, if you to repeat your question, I want to make sure I’m answering the question you are asking, not what I have in head.

Vincent Sinisi

Yeah, sure, Mike. Just wondering if you could kind of give us in relation to your full year ID sales guidance, how you are thinking about that on a quarterly basis, maybe if any color around kind of where things are now and/or just how you are kind of thinking about that as we go forward each quarter?

Mike Schlotman

Well the comment about we expect the first quarter to look a lot like the first quarter, I guess, would be a little bit of coat for ID sales continue to be a little bit negative right now, which means we expect ID sales to recover as we go throughout the year. And that's going back to the questions that we've gotten on the cadence of how we expect to see the underlying EPS is that is predicated on an improvement in ID sales throughout the year.

Vincent Sinisi

Okay, perfect. And if I could just get a quick follow-up in there. Just any updates worth highlighting with you partnership with Lucky's? Thanks a lot.

Rodney McMullen

Sure. Bo and his team out there in Colorado continue to do some exciting things inside their stores, some of the new storages they've opened. We're pretty excited about the sales levels they’ve been able to generate. Bo continues to look at his book of business and his stores, and they are a very new company. He's learning as he goes and he continue to make tweaks to his model and stop doing some things that aren’t working and try some new things that seem to have – should be bearing fruit. But we're very pleased with what we see out of Bo and his team and continue to be enthusiastic about that kind of a format.

Vincent Sinisi

Okay, great. Thanks very much. Good luck.

Rodney McMullen

Thank you.

Operator

The next question comes from Ken Goldman of JPMorgan. Please go ahead.

Ken Goldman

Hi, thank you. The 70 basis point headwind from removing some of these high performing stores from the ID sales base, I'm just trying to figure out, I don't think you've divulged that number in the past very often, maybe you have and I missed it, but how does that compare to what you saw in recent years? I'm just trying to figure out is it an unusually high impact because you didn't do necessarily more relocations than you normally did. So was it just that the stores were so much better in taking them out of the base just hadn't that much more of an impact or maybe 70 basis points is similar to what you normally experience? Just trying to get a sense there.

Rodney McMullen

It's not something we've talked about a whole lot and it's one of those things when you – if you have 3% or 4% IDs and you have a strong capital program and it's 30 or 40 or 50 basis points of headwinds from sister store impacts, the effect of that is dramatic as it is when you are close to 0 ID sales and negative. So, we haven't really talked about it. We did in the third quarter – 20 to 30 basis points…

Mike Schlotman

Is what it typically is.

Rodney McMullen

So it is a bit higher today because we have been doing more stores. A couple of three years ago, we were under $3 billion in capital and we were above $3.5 billion in capital this year. So we have ramped up our capital spend. We are touching more stores, we're opening more new stores, which causes sister store impact and expanding and relocating some very strong stores, which continue to perform very well, but haven't been brand reopened long enough to be into our identical store base yet.

Ken Goldman

So that's hopeful. Just to clarify, so it sounds like incrementally – it is rough, I know, but you're talking 40, 50 basis points of a headwind versus what you normally experience from this effect and just curious…

Mike Schlotman

And when you look at the number of stores we did over the last year compared to two or three years ago, it’s about double, major store projects.

Ken Goldman

So then looking ahead, is it safe to assume we will still seeing roughly a 70 basis point impact over the next three quarters or so and then how do we think about that in years beyond, is that – this is an unusual effect or do you continue to think that you're maybe – just again generally going to be relocating, expanding some of your higher performing stores in the future?

Mike Schlotman

Well, as those stores are open long enough they will flip back into our ID store base. And we would hope they continue to perform the way they are in the tailwind ID sales. And as I’ve said in the prepared comments, we are taking capital down from what we would originally plan to spend in 2017 because we've been guiding folks to think about 2017 and even 2018 to be a similar spend level that we did 2016 and most of that will come out of new store. And we will continue a strong remodel program, so when we remodel a store, it does not come out of IDs, it's only an expansion or relocation or a net new that winds up affecting it.

Ken Goldman

Right. And then, relocation. So just to clarify, Mike, those, is it reasonable to assume that sort of 70-ish basis point headwind will continue for the next few -- three quarters or so?

Mike Schlotman

I think it will continue for a while, but it will decline over time as those stores become identical again.

Ken Goldman

Okay, thanks so much.

Rodney McMullen

Thanks, Ken.

Operator

The next question comes from Shane Higgins of Deutsche Bank. Please go ahead.

Shane Higgins

Good morning. Just want to get a better understanding of the cadence of your tonnage growth and your nonfuel IDs during the fourth quarter, if you guys could kind of talk about what happened after early December when you guys were seeing or expecting trends to be slightly positive, just want to try to get some color there.

Rodney McMullen

If you look at during the quarter, it started out slow when we had the earnings call, it actually during the holidays improved and then January it slowed down again. So if you look at during the quarter, that's kind of the cadence within the quarter. I always hate to use weather as an excuse, but we had absolutely no weather benefits this year. The negative of that is we had no weather benefits. The positive is next year if we have any weather at all we cycle that.

Mike Schlotman

And if you look at the prior year, we didn't have much weather either and in fact the only one big weather event we had was the last weekend of the year in last year's numbers. So our year ended against the only weather event we had in the prior year with no weather this year.

Rodney McMullen

Tonnage growth cadence remained positive, but it's because of the deflation, but obviously around the holidays was stronger than two sides of the holiday.

Shane Higgins

Okay. Thanks for that. And then just, Rodney, back to your earlier comments that you guys were a bit more aggressive on your pricing and promotions during the quarter. Was that kind of a decision based on some of the insights that you're getting from your customers that you decided to make greater investments in price versus maybe investing in other areas of the store? And were those concentrated in any specific regions in response to the competitive environment out there? Any color there would be great.

Rodney McMullen

They were very broad-based and anything like – anything that we would do, we would use our insights to decide what our approach is.

Shane Higgins

Okay. All right. Thanks so much.

Rodney McMullen

Thank you, Shane.

Operator

The next question comes from Alvin Concepcion of Citi. Please go ahead.

Alvin Concepcion

Thanks and thanks for taking my questions. Just a follow-up on the competitive environment. I think you mentioned earlier you're seeing it from competitors running better stores. What about in the form of pricing or promotions? Are you seeing major changes there since the quarter ended?

Rodney McMullen

I wouldn't say changes since the quarter ended. I would say that definitely are seeing some pricing in certain pockets. I never tried to calculate on a percentage basis, but any point in time you will always have competitors doing things from a pricing standpoint.

Alvin Concepcion

Great. And just a follow-up on some things about your delivery initiatives. You mentioned you'll be expanding Uber in 2017. Wondering if you could speak to that. Is that something that's been driving incremental sales and profitability and how many stores are covered by Uber at this point in time and how many do you expect in the future?

Rodney McMullen

Well, it's a pretty small test. We're early in the process. And it would – the same comment that I made earlier about – on ClickList, it's a headwind, but you can see as they mature it becomes where we're neutral in terms of how a customer engages with us. In terms of specific numbers that we would expect for this year, we're not to the point where we'd be willing to share it other than obviously we're working hard to scale it if it makes sense in ways that it makes sense.

Alvin Concepcion

If I could sneak one in, just related to that, Vitacost, it sounds like you've expanded it with Simple Truth. Just wondering about your future plans to expand beyond Simple Truth into other categories and is this a preferred delivery method versus Uber?

Rodney McMullen

Well, we would look at all the delivery options together and really leaving it up to customer how they want to engage with us. We'll continue to add items to Vitacost that make sense and the Simple Truth product is obviously the initial part of that.

Alvin Concepcion

Great. Thank you very much.

Rodney McMullen

Thanks, Alvin.

Operator

The next question comes from Robby Ohmes of Bank of America Merrill Lynch. Please go ahead.

Robby Ohmes

Good morning, guys. Just two quick things. Thanks for the color on the first quarter trends to date. I was just curious or maybe, Rodney, you can remind us, do delayed tax refunds, are they having an impact on your business and maybe give us some history on that? And I have a follow-up question.

Rodney McMullen

On the delayed tax refunds, I don’t know – I really don't have very much insight into it. If you look, most of our products aren't as discretionary as some of the other retailers that have talked about it.

Mike Schlotman

Robby, I would be in Rodney's boat from an insight standpoint. My conclusion, without meeting with some other folks and having conversation, would be that the timing of those doesn't affect us in a big way like it does other folks because over my time here at Kroger I've never heard anybody talk about I can't wait till tax refunds drop so we can get a boost in sales. So it just doesn't – I agree with what Rodney's conclusion is based on most of what we sell.

Rodney McMullen

Yeah. And the only exception would be like in Alaska where you get paid to live in Alaska and it's based on the size of the check, based on fuel profits or gasoline profits for the state.

Mike Schlotman

Pipeline.

Rodney McMullen

From the pipeline. And that you can clearly see when the checks go out and the size of the checks from year to year.

Mike Schlotman

But those are all great big Fred Meyer stores with a lot of general merchandise.

Robby Ohmes

Got it. That's helpful. Then just the other question the Roundy's integration, can you just give us maybe more update on that and was it a drag to the fourth quarter and when could Roundy's become a year-over-year sort of tailwind for you guys?

Mike Schlotman

So if you look at the – if you look at Roundy's overall, we continue to be very happy with what Michael Marks and team were doing in Wisconsin as well as Don Rosanova and team in Chicagoland with the two banners. Mike and team have cycled through the first set of store remodels and offerings to the customers who are now in second market getting remodels completed and then we'll put a full campaign in that market. And then if we continue to see the positive reaction from the customers from ID sales dollars and units, we’d expect to continue to roll that out throughout the state. From an ID stand sales standpoint, it really didn't affect it very much in the quarter certainly not as much as it did earlier in the year.

Robby Ohmes

Great, thanks. It's really helpful.

Rodney McMullen

Thanks, Robby.

Operator

The next question comes from Ed Kelly of Credit Suisse. Please go ahead.

Ed Kelly

Yeah, hi, good morning, guys.

Rodney McMullen

Good morning.

Ed Kelly

Thanks for taking my question. Rodney, could we start – I just have a big picture question, if we think back over the years what the analysts meetings that you've had, you used to put up a slide showing the gap between your ID growth and your peers highlighting what's really been very remarkable consistent share gains. And as we think about the fourth quarter now and you think about the results that some other players are putting up, specifically, Walmart is a good example, it just doesn't seem like that type of share gain is continuing. And I just wanted to get your thoughts on why you think this momentum is changing importantly how is it impacting the way that you're thinking about strategy and specifically the cadence around price investments going forward?

Rodney McMullen

Yeah, well, I'll answer the question a little broader than just one specific competitor. But with the comment that I made earlier, there is no doubt, several competitors are improving and running better stores. So that is really clear when you go into their stores and it's much broader than just a Walmart. In terms of the things that we're doing, we're really doubling down on the customer experience; we're getting even more aggressive on process change and taking costs outward, it makes sense to take costs out and improving the competitiveness of our model.

So, in terms of what are we doing about it, those would be the things that we're doing about it, because what we find is certain customers are interested in price, but all they want is a fair price, they're really, really interested in having fresh produce fresh meat and a great experience and those are things that we have competitive advantages on and will continue to focus on that and our store teams and our folks – our associates across the whole company will continue to focus on those.

Ed Kelly

As we think about the industry now going forward, it certainly seems like the next five years could certainly be more challenging than the last five just given what we're hearing from competitors around what they're doing from a pricing perspective, you've talked about players being better at actually just running stores. We've got online to deal. We've got hard discount the deal with. Do you think that it makes sense that the industry could enter another wave of consolidation and how are you thinking about M&A versus organic store growth now from here?

Rodney McMullen

Well, if you look, I've been around for 30-some years and I always would tell you that we've always felt that the next five years are going to be more competitive than the last five. I would definitely agree with that comment today. We definitely believe the next five will be more competitive than the last five because only the strong survive.

If you look at in terms of – we feel very excited about the opportunities that we have to continue to grow our business and I put it in two buckets, some of it is operational driven where if you look at the historical business that we're in, getting better at that, but if you think about the comments that you hear us increasingly talk about looking at the opportunity in the $1.5 trillion total food business, we continue to get more, more aggressive in terms of fresh food, fresh food prepared, what's for dinner and picking things up and that continues to grow well for us.

So we really see that that continues to be a large growth opportunity. And I would say, at the moment, we can see the opportunity more than the things that we're doing. When you were out for our investor meeting you saw some of the things we're testing, but we really continue to improve and get better and better about that part of the business. And one of the things that we've been very pleasantly surprised is the willingness that our customers are to eat in one of our stores and we believe that that will be an opportunity to grow the business and create a new leg, a platform for growth. So it's really both of those things together.

Ed Kelly

And M&A any more, less important for you going forward do you think?

Rodney McMullen

I would say it's kind of the same. If the right opportunity became available we would be very interested, but we don't – we haven't changed in terms of we design a model where M&A is not required and if the right opportunity comes available, we would sit down and talk to somebody. But it's not something that we're out proactively trying to change that.

Ed Kelly

Great, thanks, and good luck guys.

Rodney McMullen

Thanks, Ed.

Mike Schlotman

Thanks. We have time for one more question.

Operator

All right. Our last question comes from Chuck Cerankosky of Northcoast Research. Please go ahead.

Chuck Cerankosky

My question was previously asked, so I will pass it on to someone else.

Rodney McMullen

All right, thanks, Chuck.

Operator

Our last question goes to Kelly Bania of BMO Capital. Please go ahead.

Kelly Bania

Hi, good morning. Just wanted to ask a couple of questions about volume as of late. I think there has been – our industry data and a lot of industry data seems to suggest some pretty weak volume and I think a lot of that data is skewed towards center store categories, but I'm just curious what your assessment is if you feel like you're seeing any similar surprisingly weakness in volume particularly quarter to date and if you think it has anything to do with channel shifting or change in consumer behavior or just may be a result of this prolonged deflationary environment?

Rodney McMullen

Well, we continue to see very much where people are increasingly spending money in the fresh departments. So there is no doubt there is a shift in tonnage from the center store to the perimeter and that's been a long term shift and that hasn't changed. If you look at the center store, we would still see tonnage growth there but remember that's an organic part of what's driving that growth. Natural organic is not – there is few public companies where you can just see that by itself and if you look at even for us, Mike talked about our total natural organic business at about $16 billion. Our Simple Truth brand by itself is $1.7 billion of that, so over 10% and those are things that you really don't see in some of the other measures. So the center stores have been soft for a long period of time but we've continued to getting share in the center store and we also continue to change the mix of what's inside the center store.

Mike Schlotman

And different category reinventions with coffee and pet and baby where we've totally redone to look and feel those departments for our customer.

Kelly Bania

Got it, that's helpful. And then I guess lastly the shift to IRI, is there any reason or anything you can tell us about kind of making that shift from Nielsen to IRI?

Rodney McMullen

We announced earlier in the year and the relationship with IRI that we didn't talk about a whole lot, and it's really just furthering that relationship with them. And they have a few nuggets of data that Nielsen may not have but we think it's going to be helpful to us overall as we look at our volume in the overall food industry not just the integration store industry.

Kelly Bania

Great. Thank you.

Rodney McMullen

Thanks, Kelly. Before we end today's call, I'd like to share some additional thoughts with our associates listening in today. Thank you for continuing to connect with our customers every day. They are rewarding us with their business. With your help, we gain more the market and improved our customer satisfaction scores in 2016. Thank you for your hard work. For those associates who are choosing to accept the voluntary retirement offer, thank you for your contributions to Kroger. I know for some the decision to retire was not an easy one. You should note Kroger would not be the company it is today without your years of dedicated service. Each of you has made a difference in the lives of our customers, our communities and each other, and we are very grateful for all of your contributions. Thank you.

That completes our call today. Thanks for joining.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect your lines. Have a great day.