Kroger Co. (NYSE:KR) Q1 2017 Earnings Conference Call June 15, 2017 10:00 AM ET

Executives

Kate Ward - Director, Investor Relations

Rodney McMullen - Chairman and Chief Executive Officer

Michael Schlotman - EVP and Chief Financial Officer

Analysts

John Heinbockel - Guggenheim Securities LLC

Karen Short - Barclays Capital, Inc.

Zachary Fadem - Wells Fargo Securities, LLC

Kenneth Goldman - JPMorgan

Erica Eiler - Oppenheimer & Co. Inc

Stephen Tanal - Goldman Sachs & Co.

Scott Mushkin - Wolfe Research

Andrew Wolf - Loop Capital Markets

Vincent Sinisi - Morgan Stanley

Kelly Bania - BMO Capital Markets

Charles Cerankosky - Northcoast Research Partners, LLC.

Operator

Good morning, everyone, and welcome to The Kroger Company's First Quarter Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please also note today's event is being recorded.

At this time, I'd like to turn the conference call over to Ms. Kate Ward, Director of Investor Relations. Ma'am, please go ahead.

Kate Ward

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

Both our first quarter press release and our prepared remarks from this conference call will be available on our website at 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. Good morning, everyone, and thank you for joining us. With me to review Kroger's first quarter 2017 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

As we all know, there is a lot of change in the food retail industry – both in terms of the operating environment and competitive landscape. The best thing that we can do is to stay on the offense by continuing to focus on our customers – what they want and need today and what we anticipate they will want and need tomorrow – and executing our strategy.

We continue to manage our business for the long-term and to deliver earnings growth on a three-year to five-year time horizon. We are making meaningful investments in our digital and online growth. We believe that customers of the future will want to shop with us for anything, anytime, and anywhere.

In the first quarter, we saw more than 30% growth in new digital customers and a more than 30% increase in digital visits – with faster growth in mobile compared to last year. We are also building on our personalization expertise to benefit our customers. An example of this is My Magazine, which delivers personalized content like recipes to loyal households based on their shopping behavior and interests.

In fact, we delivered more than 6 million unique My Magazine offers in the first quarter alone. This also allows us to offer personalized lower prices to our loyal households in addition to the low prices everyone can see. This is another example of how we leverage 84.51's expertise. We are investing in our people. We are improving customer service by both increasing labor hours in certain areas and increasing starting wages in certain markets. Taken together, these steps will improve the customer experience and improve retention.

I share these examples to demonstrate that we are laser-focused on providing our customers with the right value proposition. This is our Customer 1st Promise - our commitment to provide friendly service, fresh foods, and low prices, every day. And this is what we will continue to do, regardless of the external factors, because it's what our customers deserve and what we know ultimately that delivers shareholder value.

These investments both maintain and enhance our position in our markets. And while it is still early in 2017, we are starting to see some traction. We are happy with the better identical sales trend in the first quarter compared to the fourth quarter, and we are pleased to see that our current identical sales trend is positive. The last nine weeks of the first quarter were positive, and so is our second quarter to date.

Our teams continue to innovate in new and exciting ways that reflect where our customers are going. Recognizing the demand for convenience, high quality, and best value, Kroger's Culinary Development Team launched an incredible collection of Prep+Pared meal kits that we are currently piloting in Cincinnati stores. We can hardly keep them on the shelves! And it's easy to see why as soon as you try them.

Kroger's Prep+Pared meal kits offer restaurant-quality meals that are easy to cook in about 20 minutes. We think customers will love knowing they are available in stores when they are wondering along about 2 o'clock in the afternoon what's for dinner. Our Brands are one of the primary means we have to differentiate ourselves from our competitors.

Last year, we commissioned an independent third-party to conduct research that would give us an objective view of how our customers view Our Brands. This included blind taste tests with national brands and other private label foods. Our research showed that the most-loved brands sold in our stores are Our Brands above even the national brands! And in the blind taste tests, Our Brands outperformed competitive national brand and other private label products almost 100% of the time.

Our products in Private Selection and Simple Truth and Simple Truth Organic brands rated significantly above their respective competitive offerings. Of course, our journey is never done so our customers will continue to see rising quality and better value on Our Brand products in the future. By having brands our customers love that are only available from us, we gain loyalty and advocacy from our customers.

Our Brands represented approximately 28% of total units sold, and 25.6% of sales dollars, excluding fuel and pharmacy, during the first quarter. Our customers' needs are constantly changing. What doesn't change is their desire for a welcoming customer experience with an abundant variety of food, available when and how they want it, all at a great value. That's why we regularly evolve the execution of our Customer 1st Strategy, while the core strategy itself doesn't change.

Too often, American consumers have to make a choice between low prices and a great experience, compromising one for the other. Kroger is uniquely situated to eliminate the need for that compromise; serving customers who are hungry for more than food, who want to be nourished in ways that help them live their lives best.

Kroger's purpose is to Feed the Human Spirit and we are more confident than ever that by living our purpose and delivering our Customer 1st Promise, we'll deliver long-term shareholder value that you can count on. We remain committed to delivering our long-term net earnings per diluted share growth rate of 8% to 11%, plus a growing dividend.

And here is Mike to go into more detail on our first quarter results. Mike?

Michael Schlotman

Thanks, Rodney, and good morning, everyone. Like Rodney said, we were glad to see the better results compared to the fourth quarter for identical food store sales and for the second quarter-to-date, our ID sales are positive. Tonnage continued to be positive during the first quarter. We continue to focus on the areas of highest growth like natural and organic products as well as areas where we are saving customers' time, such as ready-to-eat and ready-to-heat meal solutions.

Visits per household were flat in the first quarter. Basket size and price per unit were down, but those were offset by household growth. Loyal households grew 3.2% compared to last years first quarter and our loyal households had positive ID sales growth in the first quarter.

In the first quarter, our gross margin was down, operating costs were up, and FIFO operating profit was down. While this is not representative of our typical expectations, it is important to keep in mind that we are making very deliberate and targeted investments in line with our Customer 1st Strategy.

As Rodney outlined earlier we’ve made conscious decisions to increase starting wages in certain markets to improve associate engagement and retention that will create a better experience for our customers. We continued to invest and grow our digital business. Our digital revenue more than doubled in the first quarter compared to last year. This includes revenue from ClickList, Harris Teeter’s ExpressLane and Vitacost.com.

As we continued to invest in price, we also remind you, Kroger’s investment in price can be seen very clearly if you look at our gross margins in the early 2000s compare to today. Kroger has invested more than $3.8 billion to lower prices for our customers over that time period. We have no intention of giving up the momentum we’ve gained on low prices. These investments enable us to connect with our customers in a deeper way and increase our market share over time.

We are pleased that Kroger’s market share, as traditionally calculated, was up in the first quarter. That said, we recognize there is no perfect metric for capturing market share. We are doing a lot of work to better define or perhaps redefine the market as share of stomach rather than share among traditional grocery stores.

We see food as a massive, $1.5 trillion market, and we have a substantial growth opportunity in that market. I also want to stress that we are committed to lowering costs as a rate of sales. Many of the things we are doing to pull costs out of the business today set us up for savings in the future. We will only further intensify our process improvement efforts.

Now for an update on retail fuel. In the first quarter, our cents per gallon fuel margin was approximately $0.171 compared to $0.143 in the same quarter last year. The average retail price of fuel was $2.28 versus $1.92 in the same quarter last year. Our net total debt to adjusted EBITDA ratio increased to 2.33 times compare to 2.12 during the same period last year.

This result is due to the merger with ModernHEALTH and the repurchase of shares.

Over the last four quarters, Kroger has used free cash flow to repurchase $1.5 billion in common shares, pay $438 million in dividends, invest $3.4 billion in capital, and merge with ModernHEALTH for approximately $390 million. The flexibility to return value to shareholders is a core strength of our financial strategy. We are committed to balancing the use of cash to maintain our current investment grade rating.

Return on invested capital for the first quarter, on a rolling four quarter basis, was 12.75%. On the labor relations front, we are currently negotiating agreements with UFCW for store associates in Atlanta, Dallas and our Food 4 Less Warehouse Stores in Southern California. Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality, affordable health care, and retirement benefits for our associates.

Kroger's financial results continue to be pressured by rising health care and pension costs, which some of our competitors do not face. Kroger continues to communicate with our local unions, which represent many of our associates, the importance of growing Kroger's business and profitability, which will help us create more jobs and career opportunities, and enhance job security, for our associates.

Turning now to our guidance for fiscal 2017. We had previously indicated that the environment during the first half of this year would be similar to the back half of 2016, and that is what we're seeing. As Rodney said, there is a lot of change in the retail food industry. That, coupled with the transition from deflation to inflation creates a challenging operating environment.

The deflationary environment was less severe in the first quarter compared to the fourth quarter, coming in at 20 basis points deflationary without fuel. Grocery was essentially flat during the quarter but had fluctuations up and down during it. Meat continued its deflationary trends. And produce, while deflationary for the quarter, showed inflation in the last four weeks of the first quarter and pharmacy was inflationary.

As a result we increased our expectations for LIFO to $80 million; a $55 million increase over our initial expectations. We have also made some incremental investments in price in certain markets that had very hot features on milk and eggs. While this affects gross margin in the short-term, it is less expensive than regaining a customer’s loyalty. These two, plus the incremental investments in hours and wages, are the primary factors causing us to lower our guidance for the year.

Our GAAP net earnings per diluted share guidance for 53 weeks is now $1.74 to $1.79. Our adjusted net earnings guidance range is $2 to $2.05. The previous adjusted net earnings guidance range was $2.21 to $2.25. See Form 8-K we filed this morning for additional information on guidance. Because this is an unusual year, 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.

For net earnings per diluted share, we expect the second quarter to be down compared to last year, the third quarter to be up slightly compared to last year, and the fourth quarter to be flat, excluding the 53rd week. We continue to expect identical supermarket sales, excluding fuel, of flat to 1% growth for 2017. And we continue to 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. Over the long term, we remain committed to achieving net earnings per diluted share growth rate of 8% to 11%, plus a growing dividend.

Now, I’ll turn it back to Rodney.

Rodney McMullen

Thanks, Mike. We are making the investments necessary to continue being the best food retailer in the country. We know there is a lot of upheaval in the food retail industry. Our strategy is to focus on our customers as their wants and needs change, we'll be right there with them. We are confident that we will continue winning with our people, our food, and the customer experience, and we will not lose on price.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question today comes from John Heinbockel from Guggenheim Securities. Please go ahead with your question.

John Heinbockel

So guys, just to start off, if you think – is there any way to quantify maybe directionally the investments in labor, in SG&A versus the investments in price? Labor being some multiples of the investment in price or maybe it's equally split. And then when you think about the investments in price, is a lot of that proactive on your part? You talked about dairy or is that more reactive given what competition is doing?

Rodney McMullen

I'll start and Mike just fill in, the mix between labor and price as you look forward, I would think it's probably pretty close to 50-50 plus or minus 10%. In terms of price, there would be – as you know, we would not be leaning on price as a strategy, but we're not going to let somebody have price. Now if you look at some of the competitive changes and what we see going on in those situations, we would be proactive versus reactive. And Mike anything you want to add to both of those comments?

Michael Schlotman

No, I absolutely agree. And the whole trick here, John, is how quickly the lines cross on our price investments create more gross profit margin dollars.

And as we said in the prepared remarks, there's really two things relative to the labor, one is adding some hours to certain service departments as well as increase in starting wages, which we believe over time will reduce our turnover, which has a great payback when we can have a higher retention of our associates who then are more productive and give a better shopping experience. So that one has a little bit longer runway relative to when we see the benefits of those investments.

John Heinbockel

And then as a follow-up, if you think about what's different versus March, is it primarily the cadence of reflation? And then as you think about – it does sound like you do expect higher inflation this year than you had before, you didn't reflect that in your comp. Is that just higher cost inflation offset by price investments gets you kind of to a zero net impact from that?

Rodney McMullen

Yes. The biggest thing, if you look in terms of anticipation of identical sales going forward and the improvement of that, we would expect that improvement will continue, but the improvement will be a little bit slower than what we had expected. From an inflation standpoint, Mike, went into a little bit of detail on the LIFO, but that would be a big chunk, obviously the change in LIFO affected, I think, what, Mike, about $0.04 a share as well.

Michael Schlotman

Yes, Rodney, $0.035, $0.04 in that range. John, it's not necessarily that it’s dramatically different today than we’re expecting, but when we look forward based on the movements we’re seeing in the lot of the underlying commodities. We do think there could be a little more inflation by the end of the year than we originally thought, but the accounting convention is whatever your year-end estimate is, you expense that ratably throughout the year. So it's really more reflective of where we think the end of the year is going to be not necessarily what happened in the first quarter, but we’re required to ratably expense that over the year.

John Heinbockel

Okay, thank you.

Rodney McMullen

Thanks, John.

Operator

Our next question comes from Karen Short from Barclays. Please go ahead with your question.

Karen Short

Hi, thanks. Couple questions, I guess, in general since you are taking the opportunity to lower guidance – I guess I have two questions, one is why not take the opportunity to widen the range to give yourself a little more wiggle room? But, I guess, more importantly why wouldn't you have lower guidance more because if I look at your revised guidance, I still would say this seems pretty optimistic, especially given the competitive landscape has only really just begun to heat up. And within your guidance, originally, there were some assumption that there would be operating expense opportunities and it now sounds like that’s off the table which makes me even more confused about how we get to the full-year numbers?

Michael Schlotman

We talked about all of those and deciding exactly where to set the guidance range. We spend a lot of time taking where we are today, looking at the forecast for the rest of the year, trying to understand the gives and takes and settled on the $2 to $2.05. A wider range, perhaps we could have done that. The only answer I had to that is we decided that we feel good about the range we put out there.

We do feel good about the traction we are getting in ID sales that we think will help us support that ID guidance range. Relative to the operating cost reductions, I think – I don't have any concern that we aren't going to continue to get the operating cost reductions we're getting. We have made an independent decision to add some service hours to some departments as well as in some markets increase starting wages to try to reduce the turnover we have, which hurts the customer experience as well as creates its own cost in friction when you are constantly hiring training people.

We didn't do that across the country. It's in select markets, but it's not an inexpensive proposition. So we try to factor all of those in. In fact, what we call enabler savings are actually pretty close to tracking to exactly what we expected in total to save on our cost savings initiatives for the year.

Rodney McMullen

And couple of other things, Karen to – and Mike and I both mentioned that our identical sales continue to improve and we would expect that trend to continue. If you look at quarter-to-date and realize it's only three weeks plus a few days, we would be higher than the midpoint of the range that we gave for the year and that's continued to improve over the first quarter and the first quarter was an improvement over the fourth quarter and it improved during the quarter.

And then Mike's point on expenses, there were some items where it's more of a one-time type of expense item. If you look at some of the changes in the logistics and some other places, we would expect as we get throughout the year that some of the investments we've made it will flip, so you won't have the start-up costs. And then if you look at the digital, obviously you have a lot of start-up costs initially when you turn on digital in the store, and if you look at the maturity of those stores over time that becomes a tailwind versus a headwind.

Karen Short

Okay. But just so I understand in terms of the operating expense reductions that you've identified that we did not see any of that really in this quarter, but we will see more in the second, third and fourth?

Rodney McMullen

I would say we saw some in this quarter and what we have saved in the quarter and the run rate we have for the year is right in line with what our original expectation in our business plan is. There were other – as I said that the hours and the dollars investment in starting wages were something that was incremental to the plan, but we think it's prudent to do that.

We try to run the business dynamically and not sit back and say, well, it's not in the plan, so even though we think it's good, we're not going to do it and sometimes those are pluses and sometimes those are minuses. The investments we made in milk and eggs do not lose the customers to people trying to draw our customers into the store. That by itself, if milk and eggs were normal kinds of retails, so we probably would have had positive IDs in the first quarter not negative, which also affected gross margins in the first quarter.

So there's always gives and takes, but we – the thing we're trying to get across is we've made some conscious decisions to make an incremental investments in our Customer 1st Strategy, plus the effect of [Indiscernible] and higher LIFO charge.

Karen Short

Got it. That's helpful. Thank you.

Michael Schlotman

Thanks Karen.

Operator

Our next question comes from Zach Fadem from Wells Fargo. Please go ahead with your question.

Zachary Fadem

Hey. Good morning, guys. Is there any color you can provide on the ID sales impact from digital orders at this point? I believe you mentioned you doubled your digital sales, so when looking at your data, how are you thinking about what's incremental versus what might be coming at the expense of in-store volumes?

Michael Schlotman

Yes. It's a great question Zach and it's – one of those it's always hard to answer, because you don't know what a customer would have done. The best we can tell, if you would give a range of between 40% to 60%, you're probably within that range, but it is a hard, hard number to guesstimate, because you really don't know for sure – incremental or that you would have guided anyway either way.

Zachary Fadem

40% to 60% incremental you said?

Michael Schlotman

Yes.

Zachary Fadem

Okay.

Rodney McMullen

It is clear that those ClickList customers spend incremental dollars with us. To put your finger into the exact number would they have grown their loyalty with us without ClickList perhaps, but you try to take the household trends as a whole and see where they’ve been going and where they are today.

Zachary Fadem

And is it large enough to say that it's having a meaningful impact on the ID sales line yet?

Rodney McMullen

No, when you look at the total, the cost of the startup would be a lot more painful than the tailwind from it. But as you know when we merged with Harris Teeter, Harris Teeter, have been doing it for 10 years and when you look at the maturity that we are having with the Kroger versus the maturity that Harris Teeter had the maturity would be very similar, but it's a headwind for while.

Zachary Fadem

Okay. And I also wanted to address the headlines around all of the Lidl, conceptually how do you think about the role of the hard discounters in the U.S. and how that compares relative to the UK? And in your mind, what are the structural differences between the two markets that you would call out and given that, do you think that those guys would have the same competitive advantages here versus the UK market, any thoughts on that?

Rodney McMullen

Yes, exactly a lot of the question – couple of things for sure. One, just obviously the sheer size of the countries are different. I think the biggest structural – I guess two big structural differences, if you look at the cost that it takes to operate a supermarket in the U.S., it's meaningfully less than the UK.

If you look at the price spreads that they're able to achieve in the UK versus the U.S., the price spreads isn't as much either. So you have both from a cost standpoint and a retail advantage for the customer standpoint, not as big as spread.

Also if you look at the base experience of the supermarket in the U.S., we would typically offer more services in terms of every show would have a butcher that's there ready to help. The produce would be much more variety fresher. So there is a lot of aspects from the experience standpoint that would be different in the U.S. than the UK as well.

Zachary Fadem

Okay, that's helpful. Appreciate the time guys.

Rodney McMullen

Thanks.

Operator

Our next question comes from Ken Goldman from JPMorgan. Please go ahead with your question.

Kenneth Goldman

Hi. Good morning, everyone.

Rodney McMullen

Good morning.

Kenneth Goldman

Rodney, one of the first things you said and I'll paraphrase was that the environment for food retail has changed, so I guess I’m curious why was it surprising given that to see these hot promotional prices on milk and eggs, shouldn't that have been sort of expected given that the environment has changed or maybe you were talking about something different, which is why I’m asking the question?

And I guess for my follow-up, I'm curious what is in your guidance in terms of what you're assuming for competitive pricing as we look ahead because if things do get worse and as Karen Short was pointing out, they likely will in terms of competition. I just want to understand what you guys are thinking, and how much that's factored into your numbers at this point?

Rodney McMullen

Okay. In terms of the environment is changing, I wouldn't tie directly to milk and eggs. To me that's just one example. But as you know people are changing the way they eat and we're committed and we will support the customer in changing the way they eat. So if you think about the comments on prepared, if you think about the comments on digital and using where our customer can engage with us digitally or in-store, what we find is a customer does both. So it's all of those things together, when I talk about the way customers are eating is changing and we intend to be there and take care of the customer, the way they change. In terms of guidance, Michael you…

Michael Schlotman

Again in response to Karen’s question, you never know when somebody in select markets is going to run some hot feature, and you have to make independent decisions as those features hit the street. Is it somebody just run an ad for a couple of weeks trying to get some business in the store or they going to do something longer term.

And when those kinds of ad stay there for a little bit longer, particularly when it's two important commodities like milk and eggs, ultimately we're going to react and not allow our customers to think they have to go somewhere else to get the best value for those kinds of products.

Just so happens those two commodities are big commodities and its expensive when hot features hit versus some other commodities and to say we do or don’t have something exactly built into our business plan. So that's difficult to say, but we did make the decision to react to those prices and to keep the customers inside of our stores.

Rodney McMullen

That's our best guess in terms of what we see happening going forward in terms of at this point in time.

Kenneth Goldman

Can I just sneak one quick one and to make sure I understand is the message of then that and Mike and Rod that is helpful, but is the message of that you can't really predicted, so you're not necessarily factoring in as a general rule, more competitive prices or is the message maybe that you are, but it's harder to be that specific about it?

Michael Schlotman

I think we all believe that the industry is going to continue to get more competitive because every year, it does get more competitive. I think the price investments that we've made so far from our original pricing plan are taking good hold and good effect and we always still dollars in and to try to allow us to react to competitive pressures. So I think the guidance where we've lowered it to certainly have some [indiscernible], everything that may happen. As Rodney said, it’s our best guess at this point in time.

Kenneth Goldman

Understood, thank you very much.

Rodney McMullen

Thanks Ken.

Operator

Our next question comes from Rupesh Parikh from Oppenheimer. Please go ahead with your question.

Erica Eiler

Good morning. This is actually Erica Eiler on for Rupesh. Thanks for taking our questions. So I guess should the environment remain challenging from here. Can you maybe just talk about your flexibility to further reduce CapEx and perhaps redeployed buybacks or other avenues to increase shareholder value?

Rodney McMullen

But as you know from a capital investment standpoint, we continue to adjust and over the last year we've reduced the amount that we invest in store increasingly invest increase the amount we're spending from a digital standpoint and infrastructure standpoint. We will always want to keep our stores up-to-date and fresh in terms of the four walls themselves. What we find is that what the customer wants and needs are, it’s constantly changing, so some of the things that I talked about will need to make changes in the store to support that.

If we would believe that we can continue to reduce the amount of capital we're spending, if we're not getting a return on that capital, we would still be looking at it like a hawk in terms of every dollar we spend are we getting a return for that dollar that we're spending and over time does that create value.

As for some reason, it doesn't. We would reduce – we have continued to increase the focus on the infrastructure, digital and some of the other parts and deemphasized stores in terms of the net new stores. I don’t know Mike, anything you….

Michael Schlotman

[Indiscernible]

Erica Eiler

Okay. That's helpful. And then just switching gears to private label. You talked a quite about – bit about private label in your prepared remarks, seems that a lot of groceries out there or increasingly pushing private label lately, some cases select players that even lowering prices on private label. So are you at all seeing step up efforts from the leading CPG players to support there products whether it's through more promotional dollars or through other avenues? It just seems that there would be much more of sense of urgency at this point, given what seems to be this increase retailer focus on private label?

Michael Schlotman

Yes, well our brand has been incredibly important to Kroger since the founding of the Company. And the research that we did last year, we want to make sure that we weren't just biased because we're so close to it and we did the research with our customers and our customers gave us glowing feedback on how strong our brands were, how great the products were in a blind panel. So they didn't know it was us.

If you look at our Private Selection and Simple Truth and Simple Truth Organic, we just crushed the competitors in that space. So for us, our brands has always been massively important and we will have a world-class our brand approach and it's important for our customers, it's important in terms of being able to make money as well. So we don't look at it in terms of trying to do something versus a CPG, we really look at it is our brand and building our brands and doing the things that customer wants.

Erica Eiler

Okay. Thank you very much.

Rodney McMullen

Thanks.

Operator

Our next question comes from Stephen Tanal from Goldman Sachs. Please go ahead with your question.

Stephen Tanal

Thanks guys. Good morning.

Rodney McMullen

Good morning.

Stephen Tanal

I'm sort of thinking through the cut to the guide, I'm curious to know how you're planning food margins for the balance of the year relative to Q1. Do you think the year-on-year gross margin pressure is bottomed are you planning for that to get worse?

Michael Schlotman

Yes, I would say that when we look at gross margins overall, there's a variety of factors that wind up going into that. I think you'll continue to see us over time, reduced gross margins. If you think about my prepared comments over the last 12 years or 14 years, we've invested $3.8 billion in price by the drop we've made in gross margin.

And I think over time, you'll continue to see it go down, it's typically what happens in that any segment of retailing to get laser focused on one particular year or one particular quarter. I probably wouldn't get that specific, but certainly when you look at it over time. We built our business model, assuming that gross margins will go down. We need stronger IDs and we've had the last few quarters and we need to get back of the productivity loop of allowing our operating costs to come down as a rate of sales to grow that operating profit margin.

Obviously as I said in my prepared remarks, these are representative of the results we expect to deliver over time. But every once in a while you run through cycles, where you have to step back and adjust many of the metrics inside the company and we feel that we've done a good job of react and I'll sensibly and proactively to the environment around us, both from a labor standpoint, from a price investment standpoint and what makes sense to grow the business for the long-term.

Stephen Tanal

I guess two related sort of follow-up questions. The first would be the milk and eggs example. How widespread is that issue? And the second would be maybe qualitatively, as you think about the guidance and passing through the cost inflation that you're seeing, what's generally built in, like how long are you sort of guiding, so that you can hold the line on price longer than you think others well or is that a little different for any reason?

Michael Schlotman

Well, as Rodney said in response to an earlier question, we typically don't lead our market down on price, accepting categories where it's one of our strategic investments we're making. You typically won't see us anymore maybe in the 1990s we did this. But you won't see the kind of reaction where we have very, very hot features that in the end don’t drive any kind of loyalty in your store and just tries to drive foot traffic and get them to buy other things. Will we react to those types of things and make investments, so that they don’t attracting of our customer stores, absolutely we will. But I think if you look over time, we’ll continue to be proactive on how we make the investments.

Stephen Tanal

Okay, fair enough. And just lastly on meal kits I know it was about four stores some weeks ago, how fast is that being rolled out? How fast can it be rolled out and if you give us a feel for how incremental the sales are maybe how your pricing is versus kind of the group of ingredients in those kits that would be helpful as well? Thanks.

Michael Schlotman

Yes, a great question that I won't get into all the specifics because obviously competitors would appreciate that knowledge as well. What we're finding is the quality of that meal is the same as going to a restaurant and getting the meal, but people like to prepare something at home and they find it easy and they love the variety that we offer.

So lot of the price comparisons is what the prices versus going to a restaurant, but being able to do it at home and when it takes to 20 minutes, it's just as fast as Kroger's that is going to a restaurant and going through all that household when you're at a restaurant, and we're getting great feedback. We'll continue to roll it out based on the ability for the facilities to handle the volume, and so far it's been very good and we appreciate and looking forward to work out.

Stephen Tanal

Okay. Thank you.

Rodney McMullen

Thanks.

Operator

Our next question comes from Scott Mushkin from Wolfe Research. Please go ahead with your question.

Scott Mushkin

Hey guys, thanks for taking my questions. I just wanted to kind of like broaden out a little bit and try to understand kind of where you guys think your business is and I heard Mike talking about gross margin pressure. As we look at the market, it seems like it's almost like the headline would be more Amazon moving into consumables, more Walmart price investments, more Walmart click and collect, more Aldi, more Lidl.

And so with this natural pressure on gross margins there's also seemingly a natural pressure on cost. And so as you look forward, I know you guys kind of reiterated your 8% to 11% EPS growth rate. I'm just trying to understand over a number of years, how that's going to be possible in this environment. And do you need to make more aggressive, more offensive moves here with the business given this environment?

Rodney McMullen

It's really making sure that we're using the advantages we have, obviously the data that we have. Our average customer only has to drive a mile to get one of our stores. So it's using that personalization to connect with the customer directly on a one-on-one basis and having where they can engage with us anyway they want to, so if they want to pick up their groceries, if they want to delivered or if they want to shop and go at the old fashion way for lack of a better word.

We continue to add services and all of those services as part of the model in terms of making it easy place to stop, so if you think about fuel and some of the others. So it's really the sum of all those pieces together that we're offering and we're doing it in a seamless way.

So I don't disagree with the more and more and more, but there's also things that are a huge advantage for us. And when you look at all those things when a customer comes into our stores, we still give him a great experience on a friendly face. We have incredibly fresh product and it's important for us to continue to improve on those aspect because that's what will be a point of difference.

Scott Mushkin

So my follow-up question would be regarding the scale, this Kroger have enough scale in your minds to compete in this environment against the likes of Walmart and Amazon, which are just produce tremendous amounts of cash both companies. So, I was wondering as you look at the business, obviously you’re a large company, but a lot of investments need to be made, do you need more scale?

Rodney McMullen

From everything - from our perspective, we would have plenty of scale and certainly $115 billion revenue Company, we would have the scale. The other thing is, if you look at like our own brands, the strength of our own brands and the strength of the experience the customers enjoy, all those things obviously add to that scale as well.

Scott Mushkin

All right. Thanks guys. Good luck. Appreciate it.

Operator

Our next question comes from Andrew Wolf from Loop Capital Markets. Please go ahead with your question.

Andrew Wolf

Hi, good morning. Thanks.

Rodney McMullen

Good morning.

Andrew Wolf

So I just want to clarify, you did say tonnage was positive, but if you just take out the inflation or the deflation rate, it looks like it might have slowed sequentially.

Rodney McMullen

I didn't catch the first part of your question, what was tonnage…

Andrew Wolf

Just want to know if the tonnage slowed and if so – tonnage growth, you said tonnage growth is positive, but just doing given the numbers you provide us it looks as if it slowed sequentially.

Rodney McMullen

Yes. I'm not going to get into – we typically don't give exact tonnage numbers and if you at ID sales compared to inflation, deflation it really skewed results when you try to add those two numbers together because of the mix of product that wind up being inside of those categories. When you have inflation in certain categories and deflation in other categories, it's not necessarily an apples-to-apples comparison.

Just stepping back from exact tonnage and things like that when you have the number of loyal households we have and you add 3.2% growth in the loyal households and your ID sales with your loyal households is on a positive trend. Those are all great signs of help for our business over time. Without giving – we're very happy with our unit growth in the first quarter let's just stay with that.

Andrew Wolf

Okay, great. Last quarter you said whatever market – the market share growth at least as you've given it out annually was a little less in the 2016 than it had been in prior years. What I am really trying to get to is – in last quarter you said that was more store-based, your traditional store base competitors running better stores. And meanwhile, you're talking more about the changing environments, so I just want to check in with you is that still what mainly you see is creating a heightened competitive environment here? Or is it starting to be, as [Scott] was alluding to what's going on digitally whether it's Amazon or other offers?

Rodney McMullen

On the estimating market share as you know is always difficult, but our growth in the first quarter, certainly on the analysis would indicate that our market share growth in the first quarter was better than the fourth quarter. And as Mike said, we're pleased with what our unit growth was. We're pleased with our improvement in trend and we're pleased with the improvement in market share trends as well and the lower household growth.

Andrew Wolf

Great. Well that's encouraging. Do you want to comment on weather – where you're seeing competitive – it's obvious the new entrants coming in the market, but some of them are store-based folks like Lidl and Aldi and some are online like Amazon? So just in terms of what you're reacting to and so forth or how do you see things in the future? What is your perspective? Is it still going to be a store-based competitive landscape or do you see being digital including perhaps home delivery with certain click and collect more of Kroger's future really what you're stepping up to?

Rodney McMullen

Yes. If you look, we really see the customer – all our strategies and things are where do we anticipate the customer going. Everything that we could see and see and doing what we're building our infrastructure for is to be able to serve the customer the way they want to be served. And everything that we can see, we find that the customer likes the combination of everything versus just one approach and we continue to partner with third-party on doing deliveries, we have that in a couple of markets and we continue to expand that. We continue to expand the number of items that are offered and obviously we continue to expand the number of ClickList ExpressLane stores we have.

But everything that we can see the customer wants to shop on their terms, the way they want to, but they still for certain items like to come into a physical store, because they like to interact with people. And we think it's incredibly important to continue to have a strong physical presence, but it's the sum of all parts rather than just each one individually.

Andrew Wolf

Thank for the color. I just want to follow-up if I could on the regional price and hot pricing in dairy. Could you tell us what regions is that more in the east where is a proactive to Lidl's entry more so than not and just generally how widespread that is?

Rodney McMullen

Yes, I won't comment on exactly where we sell, other than it was not concentrated only there.

Andrew Wolf

Okay. Thank you. Appreciate it.

Operator

Our next question comes from Vincent Sinisi from Morgan Stanley. Please go ahead with your question.

Vincent Sinisi

Hey. Good morning, guys. Thanks very much for taking my question. Wanted to just go back to the pricing philosophy, obviously been talked about a lot, but I think warranted, given the fact that for investors today probably the line that jumped out most within the release was we will not lose on price. So you talked about obviously being – certainly a part of that is proactive, I'm sure some of it and given markets is reactive, but can you just give us a little bit better sense on kind of the true kind of philosophy around balancing that kind of strict price versus obviously a lot of the other factors that Kroger has going for it and kind of who that maybe kind of most aimed after, that'd be great? Thank you.

Rodney McMullen

Yes, I think it's important for people not to over play the price comment. As you know, we do a ton of work on understanding where the customer wants and needs are, and we're incredibly focused on differentiating our experience versus our competitors in terms of the service our associates provide the products and the quality of the products, the quality especially in the fresh areas and produce and meat and seafood and our deli, and the shopping experience itself, so how long does it take me to get into the store?

How long does it take me to get through the checkout line? What type of experience? Those are the things that we're focused on, and that we will differentiate ourselves. We're increasingly differentiating ourselves in terms of the ability to do engage with us anyway you want. Price, we're just making sure we don't lose customers because of price. So it's really – those pieces together, is where we're focused on and focused on delivering for the customer.

Vincent Sinisi

Okay. And maybe just a follow-up to that, maybe more on the promotional environment and obviously a big kind of more theoretical question for everyone on the call is, how much of this is more kind of permanent shifts and pricing versus more of just kind of that weekly blockbuster promotions kind of like what you mentioned.

So I guess how do you think about particularly in the second half of this year with the commodity costs, showing signs of improvement? How much of kind of maybe some of those this weekly promotion did you expect on your side to kind of moderate versus how much of this may just be more kind of permanent in nature? Thanks a lot.

Michael Schlotman

When you look at how people are going to promote and what will be features are going to be, I wouldn't have enough time to step back and think about how our merchants develop their marketing plan, they’re well out, the multiple weeks out. We certainly make assumptions about how customers or how other competitors reacting around holidays, how they may react in weeks, during the summer when there's a lot of vacations going on and maybe fewer people at home shopping and what kind of promotions they may do.

But to be able to sit here and say, this is exactly what we're expecting from a promotional standpoint will be very difficult to say I have X, Y or Z built into the plan. Other than we know there is always going to be markets and there always are markets where there are a lot of hot features going on.

There's other markets that are kind of in the middle, there is high low kind of activity kind of normal traditional grocery store pricing. And then there is other markets that are relatively benign where you go back to daily that fortunately for us, we have the number of markets we're in the breath of those markets that not every market is high for competitive at the same time in some of the ones that aren't quite as competitive help offset that. So to sit here and try to project what the competitive environment are more specifically, the promotional environment maybe would probably not be any significantly prudent.

Vincent Sinisi

Now that's helpful to hear as well. So best of luck. Thanks.

Rodney McMullen

Thank you.

Operator

And our next question comes from Kelly Bania from BMO Capital Markets. Please go ahead with your question.

Kelly Bania

Hi, just some more questions on margins and the price investments. I guess it seems fair to ask where – of these hot ads are of these traditional supermarkets. Are there any different kind of behavior that you would expect to get better over the next coming quarters from these competitors with these hot ads and I guess as you respond to them, how much of your response in terms of price investments is going in personalized discounts versus your everyday pricing? And are you seeing any different changes in terms of what you would expect in terms of elasticity to those price investments that you are making? Thank you.

Michael Schlotman

I'm not sure exactly where to start on all those questions. At the end of the day, we always assume this industry is going to get more competitive quarter in, quarter out, year in, year out and unfortunately I guess we're really disappointed with the result of our expectation and that's that – it's always been a competitive market. It's always been a competitive industry.

In our view, it's going to continue to be competitive. There are bursts of time where things heat up and then burst of times where cool down and we know over time that if somebody runs a high feature over the course of the weekend that's one thing.

If somebody appears to be try and to put a stake in the ground on big volume important commodities to drive volume into their stores, the best thing we can do to counteract that is as Rodney say, not lose on price of that commodity, because that takes the advantage away from them and it doesn't get any of our loyal customers or any of our customers, any reason to go anywhere else to shop.

And you have to make judgments throughout the course of a year and a quarter of – is this a short-term thing somebody is doing that you can not necessarily this way, but by and large ignore or is this something you need to react to? How do you balance that with planned price promotions you have?

Nobody on the call can see the advantage we create with our loyal household with the My Magazine, Rodney talked about or there were 6 million individualized offers in the first quarter alone, but offered those households a different price and everybody sees on their shelf edge.

We do that without creating any kind of price impression amongst our competitors because they don't know we're doing it. But that's the way to be able to reward and give a better price to our most loyal customers without putting it on the front page of an ad and perhaps us causing something like that to happen. So we're constantly using those kind of advantages we have primarily through 84.51° to figure out how to reward our most loyal customers the best.

Rodney McMullen

The only other thing I would add Kelly to Mike's point is if you look, typically you'll have consolidation and consolidation happens in spurts and everything that we can see, we're probably at the front end of the next phase of consolidation. You're starting to see some competitors fall out.

And it's one of the things that we think is incredibly important to have the scale that we have and the diversity across the whole country that we have because it allows us to continue to do what's right for our customers. We will continue to work on improving the basic operations and by doing those things. The shareholders continue to get a great return over time as well.

Kelly Bania

Great and I guess my follow-up to that would be just in this environment, are you thinking about M&A any differently that all given what you just said?

Michael Schlotman

I wouldn't say we're thinking about M&A any differently at all. I do agree with Rodney’s assessment of consolidation. I think you'll continue to see us have the opportunity to increase our footprint in markets we're already in by the consolidation of competitors we're going by the wayside, you saw the news reports from earlier in the week in Indiana. And I think there will be a further opportunities like that going throughout the course of the next few years. It's one of the reasons why Rodney’s comment on reducing our capital expenditure on increasing our footprint.

It doesn't worry me too much over the next few years, because I think I can lower my CapEx invested in things are going to drive sales and reduce operating costs and increase my footprint and prices below what it would cost me to build from the ground up. And when they get into those kinds of situations, it sites you really want the fit rate rather than buying an entire chain and trying to do something with that. So I feel really good about that part of what's going on around this.

Kelly Bania

Thank you.

Rodney McMullen

And we have time for one more question.

Operator

And our final question today will come from Chuck Cerankosky from Northcoast Research. Please go ahead with your question.

Charles Cerankosky

Good morning, everyone.

Rodney McMullen

Good morning, Chuck.

Charles Cerankosky

Rodney, could you talk a little bit about how prepared foods did just as a category all the forms and which you sell in market prepared foods did versus a year-ago?

Rodney McMullen

It continued to grow nicely versus a year-ago. It would be one of the strongest departments and it's one of those things, as you know we think it's more and more customers will go in that direction and as you know we went to the upside to hire some talent there and we really feel good about the opportunity in terms of the growth opportunities and we love the progress we're making.

Charles Cerankosky

Is that an area that is going to get more capital dollars when Mike spoke earlier of infrastructure spending?

Rodney McMullen

Yes, they will get more capital dollars, but more importantly, it will get more attention and just the discretionary effort of organization, we will. It's not as capital intensive to make the changes we need to make there. The key thing is changing, and keeping the menus fresh and up to-date and the attention that we spend in that area.

Charles Cerankosky

And then switching to some of the offsets, Mike hinted about operating cost, projects to reduce operating expenses that might be overshadowed this year by some of the wage investments, but could you highlight some of the projects that are going on please?

Michael Schlotman

I wouldn't get through specific. One of the bigger areas that just always particularly of late, we have a lot of projects going on in/and around shrink, some tests going on and a handful of markets trying to reduce the trends on shrink. It's early on in those handfuls of markets, but early signs are the customers doing seems to be encouraging and hopefully as we get to the end of the year and it starts to be – end of the year and then the next year something that becomes a little bit of a tailwind instead of the headwind.

Charles Cerankosky

But headwind, you mean the wage investments this year are going to cover up a lot of the other expense reduction efforts?

Michael Schlotman

Or just shrink not being exactly where we wanted in these projects being able to turn the trend on shrink.

Charles Cerankosky

Gotcha. All right, thank you.

Rodney McMullen

Thanks, Charles.

End of Q&A

Rodney McMullen

Appreciate it. Before we end today's call, I just want to make a couple of comments. First of all, the changes that we talked about today and the direction we're headed in, we're making those changes proactively. And it's really based on where we see the customer is going and we think it's incredibly important to do those changes in advance and we're massively excited about the growth opportunities for the business going forward, I am we really feel good about our team in terms of the opportunities and taking advantage of those.

So I want to make that. And then I also as you know, I always like to share some comments with our associates listening in. As you’ve heard us describe during this call, we’re focused on executing our Customer 1st Strategy and living our Company’s purpose, to Feed the Human Spirit. Feed the Human Spirit is our purpose because both our customers and you, our associates, told us it resonates powerfully with you, and also because it is authentic to Kroger it’s who we are.

We’ve been living our purpose in large ways and small for more than 134 years. Whether it is through providing a billion meals to Feed Hungry Families in our neighborhoods over the last four years, committing to being a zero waste company by 2020 or simply extending a smile or a helping hand to a customer, we and you make the world a better place one associate, one customer, one community at a time. Thank you for all you do every day for our customers and each other. That completes our call today. Thanks for joining.

Operator

Ladies and gentlemen, the conference has now concluded. We do thank you for attending today's presentation. You may now disconnect.