The Kroger (NYSE:KR) Q1 2013 Earnings Call June 20, 2013 10:00 AM ET

Executives

Cindy Holmes - Director of Investor Relations

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

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

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

Analysts

John Heinbockel - Guggenheim Securities, LLC, Research Division

Meredith Adler - Barclays Capital, Research Division

Edward J. Kelly - Crédit Suisse AG, Research Division

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Operator

Good day, ladies and gentlemen, and welcome to the Q1 2013 The Kroger Co. Earnings Conference Call. My name is Colby, and I will be your operator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to your host for today, Cindy Holmes, Director of Investor Relations. Please proceed.

Cindy Holmes

Thank you, Colby. 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. [Operator Instructions] Thank you.

We are hopeful that you can join us for our 2013 investor conference to be held in New York in October. We will provide details later this year and look forward to seeing many of you then. I will now turn the call over to Dave Dillon, Chairman and Chief Executive Officer of Kroger.

David B. Dillon

Thank you, Cindy, and good morning, everyone. Thank you for joining us today. With me to review Kroger's first quarter 2013 results are Rodney McMullen, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

The year is off to a great start. In the first quarter, we achieved strong sales and record earnings per share. In our investor conference last October, we outlined our long-term strategy and strategic and capital investment plans, which included expanding into new markets and adding square footage in markets where we currently operate.

Based upon these plans, our positive identical store sales growth for the last 9 years plus, and our strong earnings per share results in 2011 and 2012, we raised our long-term earnings per share growth rate guidance to 8% to 11% plus an increasing dividend. These first quarter results give us continued confidence that we will achieve our long-term guidance again this year. Our ability to achieve earnings per share growth of this magnitude puts Kroger in an exclusive class of companies capable of delivering...

[Technical Difficulty]

I'm sure we're live. Are we back on? We must be. Okay, so let me continue. Our ability to achieve earnings per share growth of this magnitude puts Kroger in an exclusive class of companies capable of delivering this level of growth on a consistent basis. I am very proud of our associates for delivering another quarter of inspired Customer 1st performance. We're connecting with our customers better than ever before, and their positive view of Kroger continues to improve.

Our associates also did an outstanding job of keeping costs down this quarter. We continue to find our cost savings in places that do not negatively impact our customer shopping experience so that we can reinvest those savings in ways that create lasting customer loyalty. As a result of this cycle, we achieved our 38th consecutive quarter of positive identical store sales growth. Our solid operating performance continues to support our plans to increase capital investment to grow our business over time.

We continue to monitor how 4 factors are affecting consumer confidence: the overall state of the economy, fluctuating gas prices, payroll taxes and government policy uncertainty. While there are signs of a better economy, the improvement is not robust. Customer sentiment is gradually improving but remains fragile. We continue to see high variability in sales comparisons between days and weeks.

Overall, we are confident that we will meet the targets we committed to in October, both now and in the future. We've raised our fiscal 2013 earnings per share guidance to reflect this confidence.

Rodney will now provide additional details about our first quarter business performance. Rodney?

W. Rodney McMullen

Thank you, Dave, and good morning, everyone. Our first quarter results demonstrate the progress we are making on our long-term growth strategy. We continue to narrow our focus on new markets for future expansion and to add square footage in several fill-in markets.

Fort Wayne, Indiana is a good example of where we've done this successfully. Over the last several years, we've upgraded our position in the market by investing in new stores and remodels, completing an acquisition and making incremental investments in our people through training and leadership development. As a result, we have doubled our market share in Fort Wayne over the last 5 years. We view this as a successful pilot and are well underway with similar strategies in several other markets.

A key growth metric of our business is identical sales because it provides the best measure of our growing relevance with customers over time. We are very pleased with our first quarter identical supermarket sales growth of 3.3% without fuel. This is even better when you look at identical sales without fuel and pharmacy. On this basis, our identical sales grew to 4% versus 3.2% on a comparable basis last year.

Sales growth in the first quarter was driven by loyal household growth, more visits per household and increases in prices per unit. In addition to visiting our stores more frequently, customers continue to buy more on a monthly basis. Items per basket were slightly up on a per trip basis and a monthly basis. As a result, total units sold was up solidly compared to last year.

During the first quarter, we grew the number of loyal households in all divisions. Our loyal household growth count grew at a much faster rate than total household growth, which was also up for the quarter.

The product cost inflation is estimated at 1.7%, excluding fuel. Every store department had inflation, with the exception of seafood, which had deflation.

Our pharmacy business has undergone a lot of change in the last 18 months, and we are thrilled with where we are. The amount of Express Scripts volume that we have -- the amount of Express Scripts volume we retained. As expected, the effect of generics continued in the first quarter, which I described earlier, affected identical sales by 70 basis points. Even with these headwinds, our pharmacy team continues to deliver outstanding performance, including solidly positive script count growth.

I want to echo Dave's earlier comment that our associates did a great job controlling costs in the first quarter. OG&A costs plus rent and depreciation, without fuel, were down 21 basis points as a percent of sales.

Now I'd like to update you on the progress in corporate brand. As we said last quarter, our practice had been to disclose our corporate brand share in the grocery category only. Given the breadth of our corporate brand offerings, we are now comfortable to give you a view of our share across the whole store, excluding fuel and pharmacy.

On this broader basis, corporate brands represented approximately 26% of total units sold, up 30 basis points compared to the first quarter last year. Total corporate brand sales dollars were 23.7%, also up 30 basis points compared to the same period last year.

We continue to see impressive growth in our Simple Truth and Simple Truth Organic brands. We are regularly adding new items. In fact, we plan to launch 75 new items between now and the end of this year, and today, offer 450 honest, easy and affordable Simple Truth options for our customers. And by the way, they're great.

We also continue to make progress to integrate sustainable practices into our everyday business operation. Next week, we will publish our seventh Annual Sustainability Report. As a preview, I'd like to highlight some of the -- our most successful initiatives of 2012.

We have reduced total store energy usage by 32.7% since the year 2000. We also reduced our carbon footprint and made significant progress toward our goal of 0 waste. 21 of our 37 manufacturing plants have now achieved the impressive goal of sending 0 waste to landfills. I'd like to thank our associates for bringing all these initiatives to life through their individual actions each and every day. Their efforts are helping make each community we serve a better place to live.

Finally, an update on labor relations. Our store associates ratified a series of new labor agreements, covering stores in Michigan, Houston, Indianapolis, plus Fred Meyer and QFC stores in Oregon. We have many contracts that have expired or will expire soon, including contracts in Roanoke, Seattle, and later this year in Cincinnati and Dallas.

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 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 and the local unions, which represent many of our associates, have a shared objective. Growing Kroger's business and profitability will help us create more jobs and career opportunities and enhance job security for all of our associates. In fact, over the last 5 years, we've added 33,000 jobs.

Now Mike will provide more detail on Kroger's first quarter financial results and our guidance for the rest of the year. Mike?

J. Michael Schlotman

Thanks, Rodney, and good morning, everyone. Total sales increased 3.4% to $30 billion in the first quarter compared with $29.1 billion for the same period last year. Total sales, excluding fuel, increased 3.8% in the first quarter over the same period last year.

Net earnings for the first quarter totaled $481 million or $0.92 per diluted share. Net earnings for the first quarter of last year were $439 million or $0.78 per diluted share. Several factors contributed to this great result, including strong operations, lower LIFO expense, lower share count and partially offset by our higher effective tax rate this year.

FIFO gross margin was 20.65% of sales for the first quarter. Excluding retail fuel operations, FIFO gross margin decreased 15 basis points from the same period last year. The company recorded a $17 million LIFO charge during the quarter compared to a $46 million LIFO charge in the same quarter last year.

We were pleased to deliver on our goal to grow FIFO operating margin in the first quarter. First quarter FIFO operating profit, excluding fuel, increased approximately $47 million over the prior year. Excluding fuel and the extra week in fiscal 2012, on a rolling 4 quarters basis, FIFO operating margin increased 11 basis points.

On a rolling 4 quarter 52-week basis, return on invested capital was 13.5% compared to 13.4% during the same period last year. We are committed to growing our ROIC over time, even with the higher level of capital spending.

Turning now to retail fuel operations. We disclosed many items with and without fuel due to its effect on operating costs and gross rates, but we view fuel as a core department that, over time, is expected to contribute to earnings per share growth. About half of our supermarkets have fuel centers today. In the first quarter, our supermarket fuel centers margin per gallon was approximately $0.116 compared to $0.121 in the same quarter last year. As it relates to retails per gallon in all fuel outlets, they averaged $3.52

in this quarter compared to $3.65 last year. Total gallons sold showed solid growth.

Our planned uses of cash remain unchanged: Maintain our current investment grade debt rating, repurchase shares, pay dividends to shareholders and fund capital investments. You will notice on our balance sheet that the current portion of long-term debt has increased, and our net total-debt-to-adjusted EBITDA ratio has declined to 1.85.

As it relates to the current portion of long-term debt, we made the conscious decision to fund out our first quarter maturities using the historically low interest rates available in the commercial paper market. Since we have hedged the expected financings, our exposure to fluctuations in interest rates has been mitigated.

The lower-than-expected net total-debt-to-adjusted EBITDA ratio was primarily a result of our stock's recent performance, which took us out of the market for share repurchases based on the 10b5-1 we had [ph] in place at the time. As you know, we modify our grid from time to time. We currently have $447 million remaining on our board authorization and believe that repurchases in the current range are attractive.

During the first quarter, Kroger repurchased 4.5 million common shares for a total investment of $146 million. Kroger's strong financial position has allowed the company to return more than $1.3 billion to shareholders through share buybacks and dividends over the last 4 quarters.

Capital investment totaled $646 million for the first quarter compared to $557 million for the same period last year. We continue to expect full-year capital investments to be in the $2.1 billion to $2.4 billion range.

Now I'll update our growth objectives for fiscal 2013. Based on the first quarter results, we increased our net earnings guidance range to $2.73 to $2.80 per diluted share for the year. Our original guidance was $2.71 to $2.79 per diluted share. The company's long-term growth rate guidance is

8% to 11%, and shareholder return will be further enhanced by a dividend that we expect to grow over time.

The calculation of our growth rate for fiscal 2013 is based on our fiscal 2012 adjusted earnings per share of $2.52, as was shown in Table 6 of the fourth quarter press release. Adjustments include the UFCW consolidated pension plan lability, the credit card settlement and the extra week.

As you look at our expectations for the year, please keep in mind the guidance we gave in March for the fourth quarter. On a 12-week basis, we still expect this year's fourth quarter to be behind the fourth quarter last year. This is because we currently expect a $13 million LIFO charge in the fourth quarter this year compared to a credit of $41 million in the fourth quarter of last year. Kroger continues to expect identical supermarket sales growth, excluding fuel, of approximately 2.5% to 3.5% for fiscal year 2013.

Now I will turn it back to Dave.

David B. Dillon

Thank you, Mike. I understand that at the beginning of the call, several of you were not able to hear our opening comments. And so I know that a lot of the purpose of this call is to give you a sense of how we felt about the quarter. So I'm going to go back and repeat just a little bit of what I think you may have missed.

The most important part you missed was the stunning oratory that Cindy offered of the forward-looking statement caution. But that, rather than read that you, I just want to you know that is posted online so you can find that there.

But the other paragraph that you missed was my initial comments about how I felt about the quarter, and so I want to read those to you, they're important. I said that this year is off to a great start. And in the first quarter, we achieved strong sales and record earnings per share.

In our investor conference this last October, we outlined our long-term strategy, our strategic and capital investment plans, which include expanding into new markets and adding square footage in markets where we currently operate. Based upon these plans, our positive identical sales growth for more than 9 years and our strong earnings per share results in 2011 and '12, we raised our long-term earnings per share growth rate guidance from 8% to 11%, plus an increasing dividend.

These first quarter results that we're here to talk about today give us continued confidence that we will achieve our long-term earnings guidance again this year. Our ability to achieve earnings per share growth of this magnitude puts Kroger in an exclusive class of companies capable of delivering this level of growth on a consistent basis.

So with that background, before I turn to questions, I want to close with these observations. I'm very proud of the Kroger team's relentless focus on delivering on our Customer 1st strategy quarter after quarter. It's what sets us apart from competition. Our customers' positive view of Kroger continues to improve, and they are rewarding us with their loyalty.

We achieved strong sales and record earnings per share for the quarter, controlled costs and delivered on our goal to improve FIFO operating margin. The momentum coming out of the first quarter will continue to drive growth and greater shareholder value. So now we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from John Heinbockel with Guggenheim Securities.

John Heinbockel - Guggenheim Securities, LLC, Research Division

A couple of things. First, did the first quarter come in a little bit better than you guys had planned in light of sort of the quarterly breakdown Mike had given on the last call? If that's true, what may have driven the upside in your mind? And then I know on the last call, Mike, you'd also -- you'd talked about the second and third quarter being up toward the high end of your long-term range. Are those still about right or has anything changed there?

J. Michael Schlotman

Yes, the second and third quarter guidance would remain unchanged, and we didn't call that out in the prepared comments. I focused only on the fourth quarter. Just to make sure everybody remembered that's what we said about the fourth quarter. Relative to the first quarter, yes, it came out a little better than we expected. Sales were a little stronger than we had anticipated at the beginning of the year, so I would say it was primarily a sales-driven beat in the first quarter, and just as well was great execution at store level from a cost control standpoint as well.

John Heinbockel - Guggenheim Securities, LLC, Research Division

Okay. And then secondly, as you think about market share, maybe for Dave and Rodney, when you think about market share, and we give the Fort Wayne example, have you yet had a market, and I'm not sure if it would be Cincinnati or Denver or one of those, a market where you've not been able to increase share, you've hit a natural ceiling. And then when you think about the incremental margin attached to that, does that -- as you get to certain points of share, whether it be 30 or 35 or whatever, does the incremental margin sort of step up, up to a certain point and then flatten out, or how do you think about the economics of that?

David B. Dillon

Well, I'm sure there's some point of diminishing returns, but I don't think we found it yet. And I think we're pleased that at any of the historical references we would have to look at market share, we're not going talk about specific markets in that regard, but we have plenty of examples, some of which you've already listed, that illustrate well how that strategy will work. Rodney, you want to add anything to that?

W. Rodney McMullen

The only thing I would add is one of the things that we continue to expand some of the things we offer in a market, too. So if you look at the core grocery business, you may start getting a cap there or a diminishing return. But one of the things that we've had, and we've had very good results that help our return on investment, is expanding some of the things we're offering. So in some of the markets that you gave examples of, if you look at our marketplace store, we're finding we are getting good returns by expanding what we offer to the customer.

David B. Dillon

That's a really good point because it is a dynamic marketplace, and things will change over time, and even when you think you've hit a peak, you just push yourself to find additional either products or services or remodel the stores or approach the stores differently. It's just a dynamic place.

W. Rodney McMullen

And we do -- every time we do an investment project, we look at the incremental effect that it has on surrounding stores to make sure that their incremental return is there. And so it becomes store specific on each individual investment decision.

John Heinbockel - Guggenheim Securities, LLC, Research Division

Okay. But I guess you haven't hit a peak yet in share as far as you can tell in any market, right?

W. Rodney McMullen

Not that we can tell.

David B. Dillon

Yes.

Operator

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

Meredith Adler - Barclays Capital, Research Division

I would like to just understand a little bit your sales guidance. You're still maintaining the 2.5% to 3.5%, although you hit close to the high end. And I would have thought that generics would have been a particularly negative impact on the first quarter, probably even through the whole first half, and then I think fuel prices were down a little bit. So are you being just very conservative, or is there something about sales for the next 3 quarters that make you believe that you'll stay no more than this range?

W. Rodney McMullen

It's really just so early in the year, and it's just having 1/4 of the year over with. Obviously, so far, we're very pleased with our sales. We continue to strive to be in the top part of that range. We continue to strive to be there. But I would say the biggest thing is it's just early in the year, and it felt too early to change guidance on that given all the uncertainty that's going on in the marketplace.

Meredith Adler - Barclays Capital, Research Division

Okay, I understand that. I guess, I just would like to ask a little bit about inflation. 1.7% is not an excessively moderate number. I don't know what the trends have looked like. And a concern often is that if inflation gets to be moderate enough, some retailers could end up with negative comps, and you could see a heightening of the competitive environment. Are you seeing anything like that anywhere, or is there any reason to be concerned about that?

David B. Dillon

Meredith, I'll have Mike maybe comment on inflation and then Rodney on the competitive environment. But the inflation we saw in the first quarter was very similar to what you saw in the fourth quarter. And while there's a little push and take in what department it fell in, it was very similar and quite moderate. So you want to comment on where you see inflation, anything else you want to add, Mike?

J. Michael Schlotman

No, I think inflation in the first quarter is about where we expected it to be, and it's essentially in line with what we baked in to our expectations for the year.

W. Rodney McMullen

And certainly from a competitive standpoint, we don't see huge changes. As you know, we always try to make sure we stay flexible to deal with competitive changes as they happen. But so far, we haven't seen really any change going on.

Meredith Adler - Barclays Capital, Research Division

Okay, that's great. I guess my just one other question would be about your investments in new stores in maybe new markets or adjacent markets. Is there anything in terms of what's happening with competitors or the real estate market that make you feel better or worse about the ability to generate a good return from those new investments?

David B. Dillon

I think the decision more rides upon our confidence in what we're doing. And I think it's somewhat independent. I mean, I suppose there's some outside factors that could cause you to go a different direction. But more than anything, it's really focused on what we do well and what we have confidence that we can continue to do well.

Operator

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

Edward J. Kelly - Crédit Suisse AG, Research Division

I'm with Crédit Suisse. Dave, could you discuss the cadence of your IDs throughout the quarter, what you're seeing so far in Q2 and how underlying -- I guess, underlying volume is probably the same since inflation is the same, but could you just give a little bit color there?

David B. Dillon

Sure. I'll describe what I think I recall and Beth will correct me if I'm wrong because she's sitting here with me. But earlier in the quarter, let's say through the first half or even 2/3 of the way through the quarter was a little stronger than at the tail end of the quarter. But we still ended up happy and strong at the end of the quarter. And then so far, after 3.5 weeks, we've seen IDs without fuel to be very similar to what they were in the first quarter.

W. Rodney McMullen

The other thing worth mentioning is just Easter.

David B. Dillon

Yes, that's true.

W. Rodney McMullen

The comment early in the quarter is certainly true. Then when you look midway through the quarter, it's a little harder to see because Easter was earlier this year than last year. So some of the cycling of the change in Easter also affected the cadence during the quarter.

David B. Dillon

Yes, I think we -- I'd tell you the same caution I tell ourselves is don't try to overread it because -- the first quarter in particular, because of that Easter phenomenon. Every year, we're in this no man's land of trying to read, are you happy or not happy with your sales? And the week before Easter, the week after Easter and a few of the days surrounding either direction of that have a big impact on how you're going to feel. So I wouldn't overread it.

Edward J. Kelly - Crédit Suisse AG, Research Division

Okay. My next question for you is on the gross margin. Historically, there seems, like our perception at least into the markets, is there has been more volatility in your gross margin quarter-to-quarter. Whereas you may see an opportunity to make an investment, it's probably hurt sort of investor perception of the company historically. But more recently, it felt a little bit more consistent. And I guess the question really is, has there been any change in the way you sort of think about running the company in terms of the investments that you're making in margin and the volatility around that in terms of you trying to take advantage of different opportunities?

David B. Dillon

Well, I think you're well aware that we try to look at this on an annual basis. However, we have also tried to be a little more consistent and conscious of the way in which a quarter might appear, so that we don't end up doing something abrupt in 1 quarter and wishing we hadn't done that, and then the next quarter have to go the other direction. So we have been a little bit more careful ourselves. We also have learned a little bit better how to pace ourselves on those kinds of investments, so that's helped. Rodney, you may want to comment a little bit on just how you see gross generally in the quarter.

W. Rodney McMullen

Yes, I would agree with the comments Dave made. One of the things that, over the last several years, we've worked really hard to make sure that we understand what cost reductions we're getting and trying to make sure that we manage our gross investments, tying in and getting costs out. I would say that probably our internal estimation systems, we feel they're of a little higher quality in terms of giving us really better estimates in terms of what we're seeing on taking costs out because of our operations team and our finance team working together, which then, in turn, makes it a little easier to balance that with selling gross changes too.

David B. Dillon

Now one thing you ought to recognize, too, is that the moderation you saw in the first quarter was at least, in part, helped by the gross margin in pharmacy. Rodney commented on that in his prepared remarks, that pharmacy, because of the change to generics, has -- the sales dollars are down, our script count is terrific, but the effect on gross, it tends to flip it a little bit because the gross margin has been improved. Rodney you want to comment...

W. Rodney McMullen

Well, yes, I was just going to say the change in pharmacy made a huge effect in the total numbers. So if you look at the individual pieces, it would have actually been a little more than what it appears on the total.

David B. Dillon

And I thought that's important for you to know, but that was still on a very planned basis. I mean, we knew exactly where pharmacy was headed, and I could see that completely coming. So it wasn't a surprise to us at all.

Edward J. Kelly - Crédit Suisse AG, Research Division

And one very quick follow-up for Mike. Mike, is your SG&A comparison in the second quarter as difficult as it looks? Dollars weren't -- not up much last year. Should we consider that in the model?

J. Michael Schlotman

Yes, I don't think it's something you should be overly concerned with. I can't think of anything that we're facing right now as compared to the prior year. And it's -- our expectations for the quarter are certainly baked into our guidance.

Operator

Your next question comes from the line of Ken Goldman with JPMorgan.

Kenneth Goldman - JP Morgan Chase & Co, Research Division

A few quarters ago, you had such, I guess, intense promotional spending from your vendors who sell branded food that your share of private label actually went down temporarily. I'm curious, I guess, if you can update us on the promotional dynamic today among your branded vendors in general. And the reason I'm asking is we're seeing some data today from Nielsen that would suggest maybe a broader number of grocery items sold on promotion today, but we're not seeing either way how deep some of those discounts are. So I guess I'm just curious for any color on the promotional dynamic overall among your grocery vendors.

David B. Dillon

I'll see if Rodney wants to give you specifics, but before he does, I would just say the keyword you used was dynamic. And you should think of this as changing all the time, I mean, every month, every quarter. So I don't know that we're going to be able to identify a clear pattern for you. But Rodney, you have any comments on that?

W. Rodney McMullen

I mean, if you just look at over a long period of time, private label or corporate brands have continued to gain share. Usually, what happens is some CPGs will make more money than they should be because the raw material costs haven't increased. And that always provides a huge umbrella for corporate brands to gain share, which happens. Then, the CPGs will get a little more aggressive with promotional dollars, which will bring it back down. But what we find is very seldom does the share ever go back to where it was before. There is a permanent loss when CPGs do that. So it is, as Dave mentioned, it's a dynamic process, but we -- overall, we think that's one of the really important reasons and critical for us to have such a strong corporate brand program that connects with customers.

Operator

Your next question comes from Shane Higgins with Deutsche Bank.

Shane Higgins - Deutsche Bank AG, Research Division

Could you guys just talk about, I mean, obviously, there's been a lot of focus on rates. If rates -- and I guess, Mike, you could -- maybe you can answer this. If rates back up another 50 or 100 basis points, what's going to be the overall impact on your expenses, say, over the next year or 2? Will that actually be a net positive since it could take certain expenses, such as pensions, down a little bit?

J. Michael Schlotman

It'll have some marginal effect on the funded status of my corporate plan. Keep in mind that all the UFCW funds that we participate in actually present value their lability at the expected rate of return, not current interest rate, so it really won't have any affect on my UFCW funded status. And the contributions to those funds are dictated by a contractual obligation anyway, not necessarily an exact funded status. So I don't really see any effect on my operating expenses as it relates to the backup in rates. Even the -- it's interesting to talk about a 2.4% 10-year treasury or so as the backup in rates because it's still a historically low treasury rate. And even if I had to refinance the debt I have coming due at these rates, I still wind up leveraging down the weighted average cost of my debt portfolio. So I'm still comfortable we're going to be able to execute the financial strategy we have. Plus, as I said earlier in my prepared comments, we've actually been utilizing the -- our commercial paper availability rather than accessing the market because we've been able to borrow at such low rates. And it helped the first quarter probably by $0.005. So I don't really see a huge positive or negative at this point from where rates are.

Shane Higgins - Deutsche Bank AG, Research Division

And just a question on the fuel rewards program. Have you guys made any significant changes to the fuel rewards promotions, particularly as more and more competitors roll out these similar programs?

W. Rodney McMullen

We would continually offer different promotions on fuel rewards, things like that. But it -- it's one of the nice things about being first in the market. It continues to connect extremely well with our customers and especially our oil customers. But there's always different offers that you'll do in a specific market from time to time.

Operator

Your next question comes from Andrew Wolf with BB&T Capital Markets.

Andrew P. Wolf - BB&T Capital Markets, Research Division

Dave, I think I've asked you this before, but when you mentioned the variability of sales, not too surprising given some changes in payroll taxes and so on, but has -- or are you trying to tell us the amplitude? Or has that gotten worse, better or stayed the same?

David B. Dillon

I'd say it's about like it had been, that in short-term periods for like a day or a week, often unpredictable, but there's a reasonably clear pattern we've seen once you extend the time period to go to a period or a quarter. So yes, I'd say it's pretty much like what we've been seeing. Rodney?

W. Rodney McMullen

The only thing that I would add and this is if you look at electronic benefit transfers, states continue to change the days that the dollars go out on benefits, which also causes some of the variability. And you don't know how much of that variability is just because of that change or how much of it is broader than just that change.

Andrew P. Wolf - BB&T Capital Markets, Research Division

Okay. So obviously, when it's smoothed out over a quarter or what have you, things are fine. Your IDs are excellent. But how about operationally? I mean, are you trying to say it's harder to set store hours because it's harder to predict who's coming in what day?

W. Rodney McMullen

It certainly is harder to make sure you stay in stock. And I think our teams are doing a great job doing that, but it does -- any type of variability obviously makes it a little more complicated to manage against.

Andrew P. Wolf - BB&T Capital Markets, Research Division

And I also wanted to follow up just on the guidance. You were above your internal expectations and then raised guidance a little bit. So is that -- I just want to underline this or ask you to underline this. Is that more what you're seeing out there either with the consumer or with pricing and competition? Or is it -- it just it -- is it just it's early yet and you just don't want to raise guidance more than you might want -- at this juncture raise guidance more than you did?

J. Michael Schlotman

No, I think we're comfortable with the guidance we gave and it's where we believe we'll wind up on the year. Obviously, we raised the low end a little more than the high end, and that's because of the strength of the first quarter. We think that the low, the potential low end will be better than we originally thought. And I do want to remind folks that the fourth quarter, we do, as we sit here today, on a 12-week, 12-week basis, expect that to be behind because of the LIFO swing. And that's in our numbers, but not necessarily in everybody else's numbers.

Andrew P. Wolf - BB&T Capital Markets, Research Division

Fair enough. And I understand about the guidance. I guess your guidance is your guidance. But I guess I'm trying to say is -- was there any change during the quarter or now, competitively or with the consumer, that has changed your thinking on the year?

J. Michael Schlotman

I think relative to what we see for the rest of the year, we remain committed to what our original guidance was. And we tried to compare to our original expectations. And we flowed that through our annual expectations, and we're comfortable what we -- with what we see from our original expectations for the rest of the year.

Andrew P. Wolf - BB&T Capital Markets, Research Division

And this is probably for Rodney. Rodney, in the past, when you -- people ask you about M&A, you said a lot of the chains don't pencil out because their pricing in the market's too high. Now as I think about the portfolio of banners at Kroger, you actually run some high end and low end, such as Food 4 Less and Quality Foods, one which goes at a discount versus conventionals, one that goes at a premium. So how do you view -- when things come up in the marketplace that are either discount or premium type banners that are for sale, how do you view looking at their relative pricing? Do you still want it to be in line with the market, which you would, I guess, for typical conventional? Or do you adjust that thinking for the type of banner that you're -- that is out there in the marketplace?

J. Michael Schlotman

Yes. I won't give any insight into how we actually analyze any opportunity that comes up. We -- as we've said historically, we look at a lot of things when they come up, act on a very little of that, and actually, when I say act, make an offer on very little of that, and have a deal come to fruition even on less assets than that. If you look at our pattern over the last several years, we continue to be very happy with the fill-in acquisitions we've done. But to give specifics on how we might look at a particular group of stores, I just don't see any upside in going down that path.

Operator

Your next question comes from the line of Kelly Bania with Merrill Lynch.

Kelly A. Bania - BofA Merrill Lynch, Research Division

Just curious on private label now. You mentioned some changes into how you're measuring the units and the dollars in that category. Can you remind us or let us know what categories are now in there? And then I guess related to that, how do you think about the Simple Truth line and shelf space there? I guess what I'm wondering, is there opportunity to add more? It sounds like it still continues to go very well.

W. Rodney McMullen

Yes. If you look at the private label share that I outlined, it includes all the departments except for fuel and pharmacy, so it would include produce, meat, seafood, drug/GM, plus the grocery categories that we've always done in the past. So it's the complete store excluding pharmacy and fuel. Those things we thought would be a little complicated because we're not -- the generic drugs, do you put it as private label or not, and then obviously, fuel, we sell all our fuel unbranded. So that's what's included in the market share and the unit share that I talked about. I'm going to broaden your question a little bit in terms of if you look at shelf space, the model that we use to determine whether an item gets on the shelf is exactly the same for our corporate brands as it is for national brands, because we don't want -- we want to make sure, from a customer standpoint, the same dynamic is driving the location on a shelf and the item itself, whether it even gets on the shelf. The accountability for that has to be the same for our corporate brands just like a national brand. In terms of Simple Truth, it's been obviously a huge home run. It's connected really well with our customers. Because of that, it -- the brand itself is earning more shelf space, and we continue to find new items that will fit nicely into that Free From 101 different ingredients and Simple Truth Organic. So it's working really well, but it's earning its way there because of the connection with our customer.

Kelly A. Bania - BofA Merrill Lynch, Research Division

Great, that's very helpful. And then if I could just follow up with one more question on gas. It looks like your gas margin came in a little bit lower for the quarter year-over-year, and I'm just wondering if you can remind us how you're planning that segment for the year in terms of profitability. And then just remind us, you mentioned that half of your stores, roughly half your stores have the gas offering. Is there much trend -- difference in trend in traffic or IDs right now, particularly with gas prices a little bit lower right now year-over-year?

David B. Dillon

Mike, you want to address that?

J. Michael Schlotman

Well, when you look at fuel, any one quarter can be somewhat volatile on fuel margins in retails, which is why we talked about that. Relative to what we saw in the first quarter compared to our expectations for the year, I would say the first quarter wasn't that far out of the ballpark when you look at the comparisons of the numbers that we talked about at the supermarkets. They weren't wildly different, and it's clearly something that, as I said, we expect fuel to be a contributor to the overall growth of the company. Fuel earned a little bit less in the first quarter than it earned last year in the first quarter, but we experience that from time to time, and my guess is there'll be a period of time this year where it earns more from year-to-year. Relative to the -- why we put them at the fuels -- at our supermarkets essentially, it's just one more thing that we can solve a convenience for and offer a value to the customer, where, when they're already at our store and they come to -- our most loyal customers come to our stores 2, 3 or 4 times a week, and they have the availability of fuel there along with the fuel rewards, it's an incremental reason for them to want to come to Kroger versus a competitor. And it's clearly part of the overall value proposition our customers see.

Operator

Your next question comes from the line of Jason DeRise with UBS.

Jason DeRise - UBS Investment Bank, Research Division

Sorry, if there's background noise here. I'm on the road, and once I ask it, I'll mute. Could you quantify the gross margin impact from the pharmacy? Could you also talk about the impact on gross margins from ending the double couponing in many of your banners? And then actually the follow-up to the last question, if you could actually quantify the difference in same-store sales for your stores with and without fuel stations?

W. Rodney McMullen

In terms of the gross margin effect from pharmacy, I won't break it out separately. It was a meaningful number, but I won't break it out separately. On double coupons, we invested the monies that were saved from double coupons into lower everyday pricing. So if you look in total, it actually had no effect on gross margin. Because what we found was there wasn't very many customers actually engaged with double coupons, and we felt like it was better to give lower prices to all customers, so all customers could get the benefit of that. So it really didn't affect much. And then identical sales with and without fuel locations, that, obviously for competitive reasons, we have not shared and wouldn't think it's appropriate to share at this point either.

Jason DeRise - UBS Investment Bank, Research Division

On the gross margin for the pharmacy, the impact, if I put out a number, will you say if that makes sense or not? Kind of in the 20- to 30-basis-point range as a positive in that result?

W. Rodney McMullen

I won't. I don't know whether, Dave or Mike, if there's any insights that you can help -- that you would think Jason could find helpful.

David B. Dillon

No, I don't think there's anything else to add other than I don't think you would find the quarter and the variations and stuff to be unusual. The only thing that was unusual here is, and you can see with the 15-basis-point investment in our gross margin, that that's a little smaller than where we ran in any of the quarters last year. And we've just identified that the reason it was as moderate as it was, was, in large part, because it was helped from the pharmacy. Now we knew that going in and had that expectation. So, it was part of a planned program, but that's about as far as I think we're going to be able to go.

Operator

Your next question comes from the line of Priya Ohri-Gupta with Barclays.

Priya Ohri-Gupta - Barclays Capital, Research Division

I was hoping that you could provide a little bit more color around how we should think about your long-term debt market needs for the duration of this year. We appreciate the commentary around your shift to CP usage. Should we expect that to continue or is there a potential need for you to come back into the long-term debt markets this year?

J. Michael Schlotman

At some point in time this year, we will access the fixed income markets and term out some of the debt. We just made the strategic decision early on in the year because we have plenty of capacity on our revolver. Our exposure to floating rates over the last several years has actually been relatively modest. So to try to adjust for that, we've termed out in the short -- in the short run on work -- on our commercial -- well, it's the commercial paper that we issued backstopped by our bank revolver. The -- if you look at that trend since then, the balance of that has come in some, because this is really the point in time of the year where we generate a lot of cash flow. And that also gave us the comfort to have it out there on the commercial paper markets. When we think about issuing it at, let's say, between 40 and 45 basis points on a regular basis, as compared even to historically low rates...

[Technical Difficulty]

Priya Ohri-Gupta - Barclays Capital, Research Division

Sorry, can you hear us?

J. Michael Schlotman

We can now. Somehow, we lost the connection.

Priya Ohri-Gupta - Barclays Capital, Research Division

Okay. I think you got cut off right after you talked about issuing on a regular basis at about 40 to 45 basis points.

J. Michael Schlotman

Okay. I appreciate you telling me how much of my wonderful answer I gave. See if I can repeat it now. So Cindy will look at the transcript to see how close the 2 of them compare. But we've been very successful with being able to issue that debt, as I said, in the 40- to 45-basis-point range. The fact of the matter is this part of the year is when we generate a lot of free cash flow. So we felt taking a little bit of risk of terming that -- putting that out on a working capital line made sense. We don't have, historically, a lot of floating rate exposure, and it was really an attempt to gain a little bit more exposure to floating rates. The amount of commercial paper we have outstanding has come in since then. But as you may or may not have heard me say, we do expect at some point this year to term out some of our longer-term debt needs.

Priya Ohri-Gupta - Barclays Capital, Research Division

Do you have any sense or could you give us any guidance on potential size or part of the curve that you might look at?

J. Michael Schlotman

I don't want to give too much insight to it. You can look at our 10-Q or 10-K, and you can see how many dollars we've had hedged to give you some insight to what we think we -- our expectations and needs may be. But as far as the exact amount and what duration those may be, we'll wait and see what the markets are like when we actually access the markets.

Operator

Your next question comes from the line of Tiffany Kanaga with Citi.

Tiffany Kanaga

Can we get an update on how online retail and home delivery is going at King Soopers? And are there any thoughts around expanding it to other markets?

W. Rodney McMullen

As you know, we've been experimenting with Denver for several years. It continues to grow at a modest rate. We're working on it as much in terms of understanding the economics and trying to get a model that actually is profitable. So it's one of those things where you should see us continue to work on it to improve it. We've actually changed our team -- our complete digital team, in terms of bringing some high talent from the outside to help us accelerate our growth. We feel very good about where we are headed. And as you know, from a digital standpoint, it's broader than just what you sell online. We also are very aggressive on making sure we use our strength and insights we already have on our digital strategy, based on customer needs. We're having huge growth in terms of the use of our website, the use and download of our apps, and we're also partnering with dunnhumby to improve those from a relevancy standpoint. So we actually are looking at digital much broader than just what you sell online, and we're making huge progress in terms of connecting with the customer digitally, and partnering with dunnhumby to do that in a way that uses our strengths and insights.

Operator

Your next question comes from the line of Joe Feldman of Telsey Advisory Group.

Joseph I. Feldman - Telsey Advisory Group LLC

Wanted to ask sort of a bigger picture question. Just with the recent launch of like AmazonFresh and there's more talk of delivery and e-commerce shopping for groceries, and I was just wondering if you could provide us with kind of your latest updates and thoughts on, I guess, e-commerce strategies or digital strategies within the grocery business.

W. Rodney McMullen

The -- I'll give a little bit -- just in terms of -- tied in and talked -- some of the comments I just made to Tiffany. As you know, we've had, where we deliver in Denver, for several years and -- a website where we sell through. As I mentioned a couple of minutes ago, we continue to work on how to get that to scale and profitability. But we think it's important to look at it more than just what you sell on the web and how do you connect with a customer on an overall digital basis, and making sure we use some of the strengths and insights we have. We're having huge growth with people downloading our apps, using our apps on almost a daily type basis. And we partnered with dunnhumby in terms of making that relevant for each customer, using each customer in terms of setting the prioritization. We feel really good about where we're headed, and it's something we continue to work on and we continue to get better and better at. And selling is just one piece of that connection with the customer digitally.

Joseph I. Feldman - Telsey Advisory Group LLC

Got you. Got you. I mean, do you envision like a store pickup type of program? Or are you testing that anywhere?

W. Rodney McMullen

The -- we would be testing almost everything that you can imagine, but I think, at the end of the day, there will be something that will be a combination of a lot of different pieces together. And we actually think that, that's one of the strengths that will play to us, just because we have so many convenient stores located close to customers' houses that it'll be left up to customer in terms of how they want to engage with us.

Joseph I. Feldman - Telsey Advisory Group LLC

Got it. And then one last one and I apologize for repeating that question, but with -- the Affordable Care Act and how are you guys thinking about that? What kind of impact do you think it might have on you guys and your business, on the labor negotiations that you have? Just any thoughts and more color on that would be helpful.

David B. Dillon

Well, it certainly affects, in one way or another, everything you do that touches health care. So in all of our union negotiations, whether it's at the trust fund level or in the negotiations themselves, you have to make sure that the health care plans work their way to complying with and, actually, working together with what the Affordable Health Care Act requires. So we've been going through that process in negotiations, and it certainly adds some degree of tension in the negotiations. But we have a good, really solid working relationship with the locals that we work with, and as you've seen, the contracts get settled over the last, really couple of years. All of those have had some implications from the Affordable Health Care Act. As to the company plan, we have done the same thing within our own organization of making sure that we've worked through understanding those requirements and including them in our own plans. In terms of costs, sure, we think they will go up a little. We're not -- I don't think we've publicly quantified that and nor do we intend to today. But I think it's all been -- so far, been workable, and we've been happy with the way things have worked out so far. Rodney, you want to add anything?

W. Rodney McMullen

No, no.

Joseph I. Feldman - Telsey Advisory Group LLC

Okay. So you -- I mean, I guess maybe deeper into the year, we'll get a better sense of what you're thinking as far as -- I mean, I guess, I'm trying to understand like will there be any kind of an EPS impact. Really, it's more a 2014 thing. And I know you don't want to quantify it today, but just should we expect that maybe at the October meeting or...

David B. Dillon

Well, what you should expect is that we took into account what we know about health care costs when we gave you the guidance in March and when we updated the guidance today for this year. And we also have in mind and have a sense of what we see in health care trends when we gave you the long-term guidance of our earnings growth of the 8% to 11%, plus a growing dividend. So we're knowledgeable of that when we made those decisions. So to that extent, it's been included in what we've told you.

Operator

Your next question is a follow-up from the line of Jason DeRise.

Jason DeRise - UBS Investment Bank, Research Division

I just thought that -- again, sorry, for the background noise, but I thought the comment about the convenience stores, as they fit into this omni-channel Kroger, was really interesting. And I wanted to get a sense of how far into the future do you think that would be a reality, of the omni-channel Kroger using all the points in online and pickups. I know in the past, it's been said that Kroger is a slow Midwest-moving company, but some of these other retailers are thinking about this more aggressively. So if you can comment on that, that would be great.

W. Rodney McMullen

Well, it's really -- I mean, our strategy is really built around letting the customers decide digitally how they want to connect with us. And we spent a ton of effort and energy making sure that we do an awful lot of research and testing things enough to understand the economics of what we're doing. So it's really taking all the pieces and tying them together. And when -- you should expect to see us, when we find something that makes money, we'll move very aggressively. And until then, you'll see us continuing to test to make sure we're involved and aware, but we don't see a benefit of rolling something out that doesn't create value for our customers and our investors as well.

Jason DeRise - UBS Investment Bank, Research Division

Hopefully, we hear more about this during the Investor Day.

David B. Dillon

And I think that's our last question. Given that we had disruption a couple of times on the call, I thought it would be best to run a little longer and make sure we got all the questions in, and we appreciate all of those. We apologize for the 2 interruptions that we had. And as I usually do, before we end the call today, I'd like to share some additional thoughts with our associates who are listening in today. We encourage them to do that.

First, I want to thank each of the 400 -- or 4,800 leaders around the country who joined us for the first-ever Kroger Leadership Summit in Louisville recently. Because of you, this event was a big success. Taking the next steps in our Customer 1st journey together is important, and we're inspired by the enthusiasm and the passion that you show for leading our associates and serving our customers. We know you will continue to make a difference everyday for our customers and our communities.

Also this month, we celebrate community service in a special way at Kroger. Through widespread volunteer activities, our associates help strengthen the communities where we live and work. We're pleased to recognize, in our Annual Report, 29 associates across the company for their outstanding service as recipients of Kroger's 2012 Community Service Award. These women and men give their time and talent to feed the homeless, raise money to fight cancer and coach at-risk teens, among many other causes, and we are grateful for their commitment.

I want to personally thank all our associates from coast to coast, who volunteer in so many ways. Rodney and I are touched by the work you do. You make a big difference for so many others in all the places around America that we call home. That completes our call today. We thank you all for joining us.

Operator

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