The Kroger Co. (NYSE:KR) Q3 2015 Earnings Conference Call December 3, 2015 10:00 AM ET

Executives

Cindy Holmes - Director of IR

W. Rodney McMullen - Chairman and CEO

J. Michael Schlotman - EVP and CFO

Analysts

Judah Frommer - Credit Suisse

William Kirk - RBC

Alvin Concepcion - Citibank

Erica Eiler - Oppenheimer

Karen Short - Deutsche Bank

Ken Goldman - JP Morgan

Vincent Sinisi - Morgan Stanley

Robby Ohmes - Bank of America Merrill Lynch

Scott Mushkin - Wolfe Research

Steven Forbes - Guggenheim Securities

Andy Wolf - BB&T Capital Markets

Kelly Bania - BMO Capital Markets

Operator

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

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

Cindy Holmes

Thank you, Laura. 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 third quarter press release and our prepared remarks from this conference call will be available on our Web-site 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.

I would like to thank you for attending our 2015 Investor Conference in October. We appreciated the opportunity to share with you our strategy and to give you a chance to hear from other members of our senior management team.

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

W. Rodney McMullen

Thank you, Cindy, and good morning everyone and thank you for joining us today. With me to review Kroger's third quarter 2015 results is Mike Schlotman, Executive Vice President and Chief Financial Officer.

Hopefully you saw our announcement earlier this week that Cindy Holmes has been promoted to Senior Director of Pension Investments. I wanted to take a moment to thank Cindy for her service in Investor Relations. Both Mike and I appreciate Cindy's efforts these past several years, which you know have been exciting and transformative years for Kroger. We know she'll continue to contribute to Kroger's success in her new role.

I'd also like to introduce Kate Ward, who has been promoted to Director of Investor Relations. Kate joined Kroger in 2001, and has held a number of leadership roles in our audit and finance departments. We hope you'll join us in welcoming Kate to her new role.

We often say that Kroger's success starts and ends with our more than 400,000 associates connecting with our customers every day. Our third quarter results are a terrific example of our team's ever-deepening connection with customers. We achieved our 48th consecutive quarter, i.e., 12 consecutive years, of positive identical supermarket sales growth with very strong ID sales of 5.4%.

We exceeded our goal to slightly expand FIFO operating margin, without fuel, on a rolling four-quarter basis, and we continued to manage costs so that we can continue investing to grow our business for the future while delivering today. Based on Kroger's strong third quarter performance, we are raising our identical supermarket sales guidance and our net earnings per diluted share guidance for the year.

During the third quarter, we contributed $80 million to the UFCW Consolidated Pension Plan. This is the latest in a series of steps we've taken during the last four years to help stabilize pension benefits for our associates, while continuing to deliver strong shareholder value.

In January 2012, we agreed to establish the UFCW Consolidated Pension Plan by working with the union to consolidate four multi-employer pension funds into one. This agreement protected pensions already earned and provided greater stability for future benefits of more than 65,000 Kroger associates. In June 2014, we announced similar agreements with two additional multi-employer pension funds.

All of these steps reflect our strategic decision to increase certainty of pension benefits for our associates. These are examples of how we identify opportunities to use our financial flexibility.

We are very excited about our pending merger with Roundy's. We have filed our tender offer documents, and while we wait for the conclusion of that process and regulatory approval, I simply want to reiterate how much we are looking forward to welcoming Roundy's team to the Kroger family of stores.

The economy overall continues to slowly improve, and customers continue to feel more optimistic, but the bifurcation in the economy remains. Some customers are willing to spend more while others are worried about their job or next paychecks are more focused on saving. We find that all customers want quality products and a great shopping experience.

For the customer who's more focused on natural and organic products, we have our own Simple Truth brand. We also have many entry-level price point items of excellent quality. For customers looking for incredibly high quality products like Boar's Head or Murray's Cheese, just to name a couple, we have that too. Our job is to understand and deliver for our diverse set of customers so that they can save where they want to save and splurge where they want to splurge.

Finally, before I turn it over to Mike, I would like to note that there is an important global dialog taking place that underscores the positive role businesses can play in sustainability. Kroger's team has been making progress to integrate sustainable practices into our everyday business operations.

For example, our stores and manufacturing facilities have made significant progress by reducing the amount of waste sent to landfills. In five years, the number of stores recycling food waste has increased 73%, from 290 to more than 1,000 this year. 30 of our 37 manufacturing plants are sending zero waste to landfills, an increase of nine facilities since 2013. Taken together, along with a lot of other efforts, Kroger is sending 69% less waste to landfills than we used to, and we will continue to work toward zero waste.

This is only possible due to the thousands of individual activities our associates are doing on a daily basis. Their efforts are helping make each community we serve a better place to live, and they have helped Kroger earn a spot on the Dow Jones Sustainability Index for the third consecutive year. More than 600 companies in North America are evaluated each year and only the top 20% are listed on the index. This is obviously something we are very proud of.

We look forward to sharing our new five-year sustainability goals, with an eye toward pushing even faster and having more accelerated progress in the near future. As you can see, we have a lot going on at Kroger. I am thrilled with our financial results and what we are doing for our associates, our customers, our communities and shareholders.

Now Mike will offer more detail on Kroger's third quarter results, provide an update on labor relations and an update on our guidance for 2015. Mike?

J. Michael Schlotman

Thanks, Rodney, and good morning everyone. I'd like to echo with Rodney's comments relative to Cindy and also welcome Kate to the team. First, I'd like to spend a few minutes discussing our results for the quarter in each of the key performance target areas for our long-term growth plan.

Our first metric is identical supermarket sales without fuel. As Rodney noted earlier, we are very pleased with our 5.4% identical supermarket sales growth in the third quarter. It reflects the underlying strength of our core business and our associates' growing connection with customers.

Identical supermarket sales growth was driven by a combination of very strong tonnage growth, plus an increase in both the number of households shopping with us and the number of visits per household in the third quarter. As you know, our goal is to grow the number of loyal households at a faster rate than the number of total households who shop with us. I'm happy to report that we continue to meet this goal, quarter after quarter.

All geographies and supermarket departments had positive identical supermarket sales, excluding fuel, during the quarter, with our deli and produce departments leading the way. We continue to see outstanding, double-digit identical sales growth in our natural foods department.

Our second metric is FIFO operating margin without fuel. Several items are excluded from our third quarter rolling four quarters calculation, specifically the 2014 and 2013 adjustment items, the contribution to The Kroger Co. Foundation in the third and fourth quarters of 2014, and the contribution to the UFCW Consolidated Pension Plan in the fourth quarter of 2014 and third quarter of 2015.

While items like this occur over time, we feel it is important to report how our operations are performing. On this basis and without fuel, FIFO operating margin increased 18 basis points in the third quarter.

Our operating margin has expanded more than our goal, largely due to a combination of two factors; first, continued stronger than expected ID sales; second, the continued incremental investments we are making in our Customer 1st strategy are being made in a sustainable way based on insights from 84.51. This is not a new normal for operating margin expansion, but rather a demonstration of our diligence in how and when we invest.

Return on invested capital, on a rolling four quarters basis, was 14.16%. We are not presenting a comparative number this quarter because of last year's third quarter calculation does not include a full year of Harris Teeter assets and results. We continue to expect return on invested capital for fiscal 2015 to increase from fiscal 2014. This is an important metric as we continue to increase our capital investment to drive our future growth.

Before I share our third quarter results in more detail, I'd like to discuss how we are successfully managing through the current inflationary environment. While inflation continued at a lower rate during the third quarter, which we estimate was approximately 1.1% without fuel, some commodities had high inflation and others had deflation. We saw inflation in produce, while meat, seafood, deli and milk were all deflationary. We continue to see inflation in pharmaceuticals.

Now, I'll share our third quarter results in more detail. As you know, we don't provide guidance for total sales because of the unpredictable influence that fuel has on our overall results. Total sales in the third quarter were affected by the low retail price of fuel, much like in the first and second quarters. The average price of fuel during the third quarter was $2.30 compared to $3.22 last year.

Total sales in the third quarter increased 0.4% to $25.1 billion, compared to $25 billion in the same period last year. Excluding fuel, total sales increased 5.5% in the third quarter compared to the same period last year.

In the third quarter, our net earnings totaled $428 million, or $0.43 per diluted share. Net earnings in the same period last year were $362 million, or $0.36 per diluted share, including a $0.02 benefit due to certain tax items. Excluding this, Kroger's net adjusted earnings were $345 million, or $0.35 per diluted share, for the third quarter of fiscal 2014. These numbers don't sum due to rounding.

Kroger recorded a $9 million LIFO charge during the third quarter, compared to an $85 million LIFO charge in the same quarter last year. We have lowered our full-year LIFO expectation to $75 million, from $90 million previously.

The FIFO gross margin, excluding retail fuel operations, decreased 4 basis points from the same period last year.

Strong identical supermarket sales growth and cost controls allowed Kroger to leverage core operating expenses as a rate of sales in the third quarter. Total operating expenses, excluding retail fuel operations, a $25 million contribution to The Kroger Co. Foundation in the third quarter of 2014, and an $80 million contribution to the UFCW Pension Plan in the third quarter of 2015, decreased 23 basis points as a percent of sales compared to the last year.

Third quarter FIFO profit, excluding fuel and the adjustments I mentioned just a moment ago, increased approximately $66 million over the prior year.

Now for retail fuel operations. In the third quarter, our cents per gallon fuel margin was approximately $0.238 compared to $0.232 in the same quarter last year. Fuel results have been more difficult to predict than normal. We did not expect fuel margins to remain this high this late in the year. Our expectation for the fourth quarter is a moderation in margins. Volatility in weekly fuel costs remains high and where those costs end up will influence our fourth quarter results.

Corporate brands' performance during the third quarter was strong, representing approximately 27.7% of total units sold and 25.9% of sales dollars, excluding fuel and pharmacy. Simple Truth continues to grow at an astonishing rate, setting a record high for total sales in the third quarter, while continuing to establish all-time weekly sales records throughout the quarter. Our newest brand, HemisFares, has been embraced by foodie customers, so much so that we are currently working with our Sicilian Gelato supplier to expand capacity while maintaining the best-in-the-world quality of the product.

I will provide a brief update on labor relations. We ratified contracts with the UFCW for store associates in Denver and with the Teamsters covering our Southern California distribution centers. We are currently negotiating a contract with the UFCW for store associates in Portland. 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 and the local unions, which represent many of our associates, should have a shared objective, growing Kroger's business and profitability, which will help us create more jobs and career opportunities and enhance job security for our associates.

Kroger's long-term financial strategy is to use its financial flexibility to drive growth while also returning capital to shareholders. Maintaining its current investment grade debt rating is the cornerstone of this and it allows the Company to use cash flow to take advantage of strategically and financially compelling opportunities and to continue its fill-in strategy, repurchase shares and fund the dividend, which is expected to increase over time.

Our strong financial position has allowed us to return $1.1 billion to shareholders through share buybacks and dividends over the last four quarters. During the third quarter, Kroger repurchased approximately 853,000 common shares for a total investment of $31 million.

Capital investments, excluding mergers, acquisitions and the purchases of leased facilities, totaled $832 million for the third quarter, compared to $681 million for the same period last year. We expect capital investments, excluding mergers, acquisitions and the purchases of leased facilities, to slightly exceed $3.3 billion for the year.

We continue to see a strong pipeline of high quality projects and are encouraged by the results from our new stores. In order to have a steady flow of projects and increase the total number of store projects, we are spending on stores scheduled to open in 2016 to make sure they are ready to meet our target dates. Additionally, we continue to reduce the amount of time it takes to complete projects.

The Company's net total debt to adjusted EBITDA ratio decreased to 1.99, compared to 2.27 during the same period last year. We expect our net total debt to adjusted EBITDA ratio to remain under 2.2 upon the close of our Roundy's merger transaction. Kroger's net total debt is $11.3 billion, compared to $11.5 billion during the same period last year.

As I mentioned last quarter, we have essentially maintained our absolute debt level while returning $1.1 billion to shareholders through share buybacks and dividends over the last four quarters, investing $3.2 billion in capital on a rolling four quarters basis, plus an additional $160 million on mergers, acquisitions and purchases of leased facilities. In other words, we are keeping our commitments to bondholders and shareholders while creating opportunities for our associates.

Now I'd like to update our growth objectives for the remainder of 2015. Based on our strong year-to-date performance, we raised our net earnings per diluted share guidance to a range of $2.02 to $2.04 for fiscal 2015. The previous guidance was $1.92 to $1.98 per share. This range exceeds the Company's long-term net earnings per diluted share growth rate of 8% to 11%. Shareholder return will be further enhanced by a dividend that's expected to increase over time.

As with our third quarter results, the performance of fuel in the fourth quarter will determine where we end up in the range. For the fourth quarter of fiscal 2015, we expect identical supermarket sales growth, excluding fuel, of 4% to 4.5%. As we said in our press release this morning, that implies an annual guidance range of approximately 5% to 5.25%.

Now, I will turn it back to Rodney.

W. Rodney McMullen

Thanks Mike. As you can see, Kroger delivered another spectacular quarter and marked our 12th consecutive year of positive quarterly identical supermarket sales growth. When you achieve such consistently remarkable results quarter after quarter, it's easy to take them for granted. In fact, we have spent the past few years investing in our unique and multifaceted business model, which we believe has been a key driver of our success.

We continually strive to innovate for our customers while delivering on our commitments to you, our shareholders. At a time when so many other retailers are facing very difficult circumstances, Kroger continues to stand out from the pack, thanks to our incredible associates.

Now, we look forward to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question will come from John Heinbockel of Guggenheim Securities. I apologize. Mr. Heinbockel's line has dropped from the queue. Our next question comes from Ed Kelly of Credit Suisse.

Judah Frommer

This is Judah on for Ed. Congrats on the quarter and congrats to Cindy and Kate on the new roles. First just wanted to ask about the Q4 comp guidance, is that an indication of where you're running Q4 to date or is there just some conservatism built into that given that you're early on in a big quarter?

W. Rodney McMullen

If you look at so far, and obviously it's still very early in the quarter and we're cycling very strong numbers a year ago, we would be at the top end of the range that we provided. So it really isn't trying to be conservative, it's just reflecting the fact that we're cycling some incredibly strong numbers, and inflation continues to get a little lower.

The other thing that you never know is how is the weather going to flow. Obviously snow is helpful for the business and that you really can't predict at all. And then as Mike just mentioned to me, this year we will not have a Super Bowl in the fourth quarter. A year ago we had Super Bowl in the fourth quarter.

Judah Frommer

Okay, that makes sense. And then touching on the gross margin performance, I mean you have lapped Harris Teeter fully now and we still don't see a lot of investment in margin. And maybe Mike referenced it in that you're doing good work with 84.51, but is this kind of a new normal, like a less than 10 basis point investment in ex-fuel gross margin?

J. Michael Schlotman

I'll hesitate to give what a normal is for an investment because we do continue to make investments in price in a variety of areas of our store. I'd say it's a reflection of prudence on how and when we make investments. Additionally, the mix, when you look at the strength of brands like Simple Truth, when you look at the strength of natural and organics, all of which have a little bit higher gross margin, that certainly plays into the overall mix of business. But if you were to look at gross margins by department, I have a little bit different view of exactly how and when we invest. But we will continue to invest not only in price but all four keys of our Customer 1st strategy.

W. Rodney McMullen

And we continue to have strong growth in our fresh departments and most of the fresh departments have higher gross as well.

Judah Frommer

That makes sense. Okay thanks.

Operator

The next question will come from William Kirk of RBC.

William Kirk

So you have a very good data analytics and targeted marketing, so I was wondering what are you seeing in terms of available promotional dollars and how they are being allocated in-store versus out of store, and I guess the question is kind of for the industry and more specifically if it's any different for you at Kroger?

J. Michael Schlotman

Obviously we really don't know what's going on across the industry because we only know what's happening for us. What we are trying to do is work with our CPG partners, and we really do view them as partners, and what we're trying to focus on is how to grow their business and grow our business, both. And it's really trying to make sure that we effectively spend that money that they provide to us that we then in turn provide to our customers. So it's really taking that data and helping our CPG partners to most effectively spend their money. So all I can do is talk for what we are doing. I really don't know what's going on in the industry.

William Kirk

Okay, thank you. That's all for me.

Operator

Next we have a question from Alvin Concepcion of Citi.

Alvin Concepcion

Congrats all on another great quarter and also congratulations to Cindy and Kate on the new roles. I think most folks were pleased with the results and the outlook and it seems like you might be taking somewhat conservative approach because of things like fuel gross margin, inflation and weather, so wondering if you could run us through some of the puts and takes in the fourth quarter, and more specifically what type of fuel gross margins are you baking in?

J. Michael Schlotman

When you look at the puts and takes, as Rodney said, weather is often difficult to predict. Last year actually was a pretty favorable weather event for us. Not only did we have the Super Bowl right at the end of the fourth quarter, we also had a fairly large snow event in the Midwest at the end of the fourth quarter, and both of those served to have some pretty strong sales that very last week of the quarter.

As I said in my prepared commands, the ability to predict fuel margins this year has been more difficult than I can remember since we've been in the fuel business, which is really since 1983 when we merged with Dillons Company. It's not just where weekly retails and supply and things like that wind up, it's really the day to day volatility of fuel in the open market because we don't have fuel contracts, we buy everything in the open market.

And frankly, we feel very good about where our core business is going, the day to day runnings inside of our store and the ability to predict that and the strength of our ID sales as we noted with the guidance for the fourth quarter. Where we wind up in the $2.02 to $2.04 will be wholly predicated on where fuel margins wind up for the quarter.

Alvin Concepcion

Great. And then as a follow-up, what are you sort of expecting in pharmacy margins, and also, I don't know might be too early, but any color on 2016 puts and takes as well?

W. Rodney McMullen

On pharmacy, it continues to be tough, as it's been all year. And there's obviously a ton of change going on. And what we really remain focused on is making sure we're helping our customers. We have a great team of friendly and knowledgeable professionals that will help our customers get healthy quicker and it eliminates one stop somewhere else.

When you look at overall, we feel like we have very strong business model, and it's also the nice thing about having such a diverse business when you look at across all our lines, that we can make investments in pharmacy, but when you look at the total business, it continues to perform well.

Relative to 2016 guidance, I'll say a couple of comments, Mike, and if you want to add anything, but we'll give the details in March. We have a meeting where we review our objectives with our Board, and that obviously we're not going to share things publicly until the Board is in concert with what we're doing.

Couple of comments just to remind everyone, and it really ties back to some of the things that Mike and I have already said, fuel margins, we would expect to more normalize. And if you look at inflation, we would expect it to continue to be less. But when you look at overall, and this isn't just for 2016, but our long-term objective remains to grow earnings per share by 8% to 11%, plus an increasing dividend, and that's the long-term objective. And then we'll give more detail in 2016.

Alvin Concepcion

Okay, thank you very much.

Operator

The next question comes from Rupesh Parikh of Oppenheimer.

Erica Eiler

This is actually Erica Eiler on for Rupesh. Just following up on your inflation comment just now, just curious if you have any specific expectations for Q4? And then specifically next year, I mean you mentioned you expected to go lower, I mean any thoughts with regards to how we should think about generic drug inflation for the upcoming year?

J. Michael Schlotman

Generics continue to have a good amount of inflation in them. Really don't see anything as we look into 2016 that would necessarily cause a moderation. Part of that was driven by prices have gotten so low, some folks got out of the manufacture of those products. With good old supply and demand and just basic economic forces, if underlying costs for those continue to be high, at some point other folks will get back into the manufacture of that business and perhaps put pressure on that economic cycle.

Relative to inflation for the fourth quarter, our view would be it would be in the range of where the third quarter was, in the low 1s, and as we look into next year we would certainly expect full year inflation for next year probably to be comparable to where inflation is for this year. We don't see a lot out there in the overall supply chain that would cause us to be different.

Erica Eiler

Okay, that's very helpful. And then just switching gears to your loyalty program offering, I mean we've seen a number of the specialty grocers recently discuss plans for new loyalty programs with different propositions for consumers across each. Clearly Kroger has had success with fuel points in recent years. I guess I'd just be curious, how often do you tweak the value proposition with your loyalty card offering, how important is the points part of the offering versus maybe some of the other components that your program offers, any thoughts that you could share there would be really helpful?

J. Michael Schlotman

We would look at our loyalty program as not tweaking. What we do is we continually use the insights to improve what our customers get, and it's based on how customers react. So it's constantly using what customers actually do to try to do a better offer for our customers on a personalized basis. And the examples you gave would just be small parts of what the overall loyalty offering is for a customer. And the key for anybody doing it is how do you make it worth something the customer finds of value.

Erica Eiler

Okay, great. Thanks and best of luck for the rest of the year.

Operator

The next question comes from Karen Short of Deutsche Bank.

Karen Short

Cindy, we'll miss you. And Kate, look forward to working with you. I just wanted to follow-up, go back to 2016 on a higher level. I guess can you maybe elaborate a little bit more on the Medicare Part D component, because I guess the color would be the reimbursement rates could come down fairly meaningfully, and so I realize that could be maybe a bigger headwind for you in 2016. Obviously gas margins are a wildcard, but then as I think about maybe tailwind for 2016, Roundy's accretion could be a bit more of a tailwind than you've guided to. Inflation is kind of neutral. Any more color you could give on any of those?

J. Michael Schlotman

As Rodney said, we're not going to go too far down the path of talking about 2016. Clearly the litany of things you laid out, it's almost as if you have the draft of our business plan Board book that we're getting ready to take up at the end of the month and send to our Board about the topics we will discuss with them in January. All of those are on our radar screen. We are putting all of those into the mix as we decide what 2016 is going to look like with our Board. As Rodney said, we're committed to the 8% to 11% as the long-term earnings per share growth target, and it just wouldn't be, whoever either he or I, if we want to be on the March call, to get out in front of our Board with talking about 2016 much more.

Karen Short

Okay, that's fair. And I guess just looking at the O&A growth rate this quarter excluding rents and depreciation, I guess when I look at the last three quarters, it's been pretty consistent kind of in the 5.5% range, and I realize for next year Roundy's is going to impact that number, but is that kind of – do you think that's a fair run rate to look at on a more sustainable basis?

J. Michael Schlotman

5.5%? I missed the first part of your comment.

Karen Short

It seemed to be that you've been kind of consistently in that 5.5%-ish range for the first three quarters of the year. So excluding what Roundy's might do to that number, is that kind of the right run rate to think about on a more sustainable basis, because I know we had talked about there were some investments in services and things like that, that you were making because you knew it would drive sales, so I just kind of wanted an update on that?

J. Michael Schlotman

I actually haven't calculated exactly what our OG&A growth has been and I don't know if you've taken out the one-time items from those if you look at our core business. Our rate of sales is – and whether you're doing it with or without fuel. Our ongoing – if I look at it without fuel, it's actually under – year to date it's actually under a 5% increase, and that's including the pension contribution in there.

We look at those service investments the same way we look at price investments, and we step back and we have a very defined plan and a very diligent plan of what we expect to do in departments and how we expect to make incremental investments in all four keys of the Customer 1st strategy. And some of those are price, which become more obvious because of the gross margin calculation.

Other of those are a little less obvious because when you look at things like service that can get drastically covered up, the whole idea of adding service in some of these departments would be to grow sales, and that's how they wind up getting paid for. So overall, we would expect to continue to drive operating costs down and use that as part of the fuel for the engine to continue to invest.

Karen Short

Okay, that's helpful. Thanks.

Operator

The next question comes from Ken Goldman of JP Morgan.

Ken Goldman

Cindy and Kate, congratulations on your new roles. Two questions from me. One, a little bit of a follow-up on a question that was asked earlier, but a lot of the CPG companies, especially on the packaged food side, companies like Kraft, they are running that 3G playbook, they are talking, they are very vociferous actually about how they're trying to get off that promo needle get much more about baseline sales. I'm not talking about any particular vendor, but are you seeing any evidence that that's actually taking place where a lot of your larger food vendors are perhaps getting a little bit less aggressive with [peel-backs] [ph] or is it really not affecting anything yet from your view?

W. Rodney McMullen

I will answer the question that will partially answer your question. What we find is CPG companies, we deal with a lot of different CPG companies, and any point in time you will have different companies with different strategies.

And we have a team that will work with CPGs based on the strategy that they're playing. What we find is when CPGs raise prices when it's not economically driven, our corporate brands always picks up market share, and it's one of the values of having an incredibly strong corporate brand program is that when there's something that doesn't make economic sense, the customer understands that. So at any point in time, probably almost any comment you would make on a CPG, there's somebody out there running that playbook, and each one would have their own playbook.

Ken Goldman

Okay. That's actually helpful, and you know what, I'm going to leave it there and thanks very much.

Operator

The next question is from Vincent Sinisi of Morgan Stanley.

Vincent Sinisi

Wanted to ask about your – you gave some helpful commentary around the macro environment and kind of the puts and takes of the consumer spending behaviors, and if we try to in the sense kind of reconcile that with your natural organic, your corporate brands specifically of course continue to tick up, what are you seeing as you're looking at your loyalty data? Have there been any notable changes in terms of kind of categories or products that are going into the basket more or less, and I guess in turn are you changing the way you're maybe space allocating in any way that might be helpful to share with us?

W. Rodney McMullen

If you look at – there's constantly changes going on in the basket and it's not so much new, but if you look at the fresh departments, that's been a trend that's been ongoing for a long period of time and isn't slowing down at all. The things that you took up, mentioned on natural and organic, that as well. We look at space allocation, it's something that is really important to do on an ongoing basis. And one of the examples I always like to give is coffee. If you asked me three years ago or four years ago what I thought was going to be the future of the coffee category, I wouldn't have been very positive. Today because of innovation by Starbucks and Keurig Green Mountain, it's completely created a different type of growth in that category and we are continually adding spaces on what's inside the store because the customers want it, and it's something that is driven by innovation. So the change in allocation is more driven by innovation than probably anything else, and how the customers react to that innovation.

Vincent Sinisi

Okay, all right, that's helpful. And maybe just a quick follow up, just on Roundy's, just checking, does it still look like the deal should be closing before the end of this calendar year?

J. Michael Schlotman

As Rodney said in our prepared comments, we filed our tender offer and we filed with the regulators and it's pending both of those coming to a closure.

Vincent Sinisi

Okay, great. Thanks very much.

Operator

Next we have a question from Robert Ohmes of Bank of America Merrill Lynch.

Robby Ohmes

Two questions, one just on the inflation. I thought the commentary about produce is inflationary and meat, seafood, deli, et cetera, deflationary, Mike, I think you've made comments in the past about there's good deflation and bad deflation, and so as you're looking into fourth quarter and then into the

2016 overall inflation being similar, can you maybe speak to the components, sort of how inflation is playing out right now if you guys think that produce is still inflationary, sort of the same dynamics? And then remind us if these are better dynamics than other ways to get to this sort of lower level of inflation? And then, if you can, maybe just weave in what you're seeing in the competitive environment right now, is it same, worse, better?

J. Michael Schlotman

Relative to inflation, overall it continues to be a mixed bag, and particularly when you look at the fresh departments like produce, like meat, like seafood, produce in particular, it generally bounces around a lot during the year. When you see dramatic inflation in produce, it's not a good selling season because it's been bad growing for whatever region it is that's there.

Earlier in the year when we saw a lot of dramatic deflation in produce, it was driven by two things, one, last year's first quarter was relatively strong inflation, and then this year you had a good growing crop. So you're really back to a more normal kind of a crop for produce. And actually if you look it on a two-year basis, the first quarter last year and the first quarter this year, combined they were slightly inflationary. So it's more of a normal. While the fourth quarter was inflationary, it was just slightly inflationary.

Meat obviously has gotten a lot of headlines as having been so high for so long. High prices clearly did what supply and demand do. High prices, over time people stopped eating as much meat and whether it's beef or chicken or pork. That means supply picks up a little bit, and guess what, prices start to come down. And if you look at on a – if a two-year stack on something like inflation makes any sense at all, we are still net higher than we were a couple of years ago, but still well down from the peaks of last year.

So it's a mixed bag. We think things like that are going to persist into 2016. The wildcard is always exactly where this pharmaceutical inflation is going to be and it has been very, very high for really the last couple of years.

Relative to the competitive environment, I don't think there's a time that Rodney and I have been doing these calls together that we haven't talked about this being a highly competitive industry. Barriers to entry are low. Our job is to go out every day with our more than 400,000 associates and deliver a better value proposition to our customers today than we did yesterday, and that's solely what we're focused on.

Sure we keep an eye on the competitive environment. There are a lot of people out there trying to sell what we sell and our job is just to do it a little bit better every day and win that customer every day when they wake up and make sure they want to come to Kroger.

Robby Ohmes

Great. And just a quick follow up, could you guys give us a quick list update on those, I think it was 19 non-Harris Teeter stores, and how that's progressing?

W. Rodney McMullen

It's still something that we are still early in the test. We continue to roll it out for customers. Some customers like it a lot and it's just one more reason to shop at Kroger.

Robby Ohmes

Got it. Thanks a lot, guys.

Operator

Our next question comes from Scott Mushkin of Wolfe Research.

Scott Mushkin

So I just wanted to get back to something you mentioned on the gross margin, which was the mix shifting. I wanted to get your perspective on kind of what inning we're in on that mix shift? I mean obviously you've got fast growing categories like private-label, Better-for-You private-label, you have the fresh categories. I do believe you guys are in the process of updating your prepared food area as well, which tends to have a lot better gross margins. So as we look out, and this is really not next year or it's really more of a three-year outlook, it seems to me that this mix shift should remain and maybe even accelerate, and it'd be helpful. Am I off base on that?

J. Michael Schlotman

Scott, it's a phenomena that continues, and to say what inning we would be in on the changing needs and desires of the consumer would be, it will probably be short-sighted on my part and I would be absolutely wrong. We certainly do a lot of predictive analytics with data we see not just inside our stores but overall in the economy, trying to figure out where the consumer is going.

It clearly does seem as though there's going to be persistence and shift to a more healthy lifestyle and maybe out of some of the traditional center-of-the-store categories into more fresh categories. But I would tell you there are plenty of center-of-the-store categories that now have natural and organic offerings in a can, whether it's our own Simple Truth brand with spaghetti sauces and salsas and things like that.

If you go down the dog food aisle, the growth in the dog food aisle is in grain-free and natural kind of dog food, so even our pets are jumping onto the bandwagon of leading a healthier lifestyle. Everybody is laughing at me in the room by the way.

But it's something that our job is to make sure we're there to deliver what the customer wants when they want it, and we will certainly stay on track with it in trying to predict where the customer is going. I don't think I'll get into that, but we're happy with our overall offering, we're happy with our continued growth and thrilled with the team we have working on not just the center-of-the-store and keeping it to healthy and [vibrant] [ph] category, but all the fresh departments around the perimeter of the store as well.

W. Rodney McMullen

Scott, you have followed Kroger for a long time, and you know one of the things that we try to do is make sure we design our business model so it's successful regardless the environment and try to really play to what's going on in the environment. And some of those examples, that's what's going on now, but customers change and we try to make sure that we stay nimble enough to be able to react to those changes.

Scott Mushkin

Okay, perfect. And then I actually had a question. At the Analyst Day, you guys laid out a very compelling case about market share and how that drives returns over time, and that one of the big growth drivers you've seen for Kroger is taking some markets that maybe are a little bit below where the ideal share is and driving them up. As I survey your business, one of those areas seems to be the mid-Atlantic and Southeast that happen to be with Harris Teeter. How do we think about those areas geographically and what you can do to maybe get the market shares up over 20% to really drive some handsome returns?

W. Rodney McMullen

Other than at the Analyst Day, we did give specifics on one market. We won't make it a habit of giving specifics. So we really do look at across all of the opportunities. When we merged with Harris Teeter, one of the things we talked about was one of the reasons we were excited about merging with Harris Teeter was the opportunities that they had in several of the markets that you mentioned. We're equally or more excited today about that opportunity going forward as when we merged with Harris Teeter. So beyond that, I won't get into any more specifics on a market other than as we outlined, we see this as a long-term opportunity across a lot of markets.

Scott Mushkin

So densing up would definitely help you guys in those markets?

W. Rodney McMullen

It would help us in most of our markets.

J. Michael Schlotman

Yes, as we have long said, the higher our market share, the higher our ROA in a particular market, and that's really the cornerstone of our fill-in strategy is increasing the number of markets with that high correlation.

Scott Mushkin

Perfect. Thanks guys.

Operator

The next question will come from John Heinbockel of Guggenheim Securities.

Steven Forbes

It's actually Steve on for John today. As it relates to the capital development program, is there a focus on speeding up the pace of investment here I guess to capitalize on some opportunities, or should we still assume the $200 million of incremental spend annually looking out?

J. Michael Schlotman

Again, I won't get into what our guidance is for 2016, but we do continue to have a great pipeline of projects and are very encouraged by our early projects. We will continue to grow capital as we go into 2016 compared to 2015. The $200 million is a number that I would say for the next several years we would increase capital by at least that amount. Keep in mind, as I increase capital or I increase my base, my store base and the number of stores, I also have to increase maintenance capital a little bit to keep those stores fresh over time. So it's not just an allocation, a new allocation to new stores, I'm going to have to make sure I continue to take care of the base operations as well.

W. Rodney McMullen

And part of the thing that Mike talked about on speeding up, it's really our real estate teams, our facility engineering teams, our division teams and our attorneys are working together to take time out of the process on how long it takes to get a store open. So it's really everybody working together actually taking weeks out of construction time which is causing some of the acceleration of capital investment.

J. Michael Schlotman

Right.

Steven Forbes

And just a follow up, as we try to figure out the impact here of the development program, can you try to remind us of I guess the normal comp maturation of a marketplace or the maturation of the store level EBITDA margin?

J. Michael Schlotman

When you say the normal comp maturation, what do you mean?

Steven Forbes

I guess the store opens at an initial productivity of 70% or so. I mean what is – year one and year two, there's going to be a benefit on the comp side. Do you see a pretty significant ramp both in comp and profitability at the store level?

J. Michael Schlotman

Clearly when you open a store, the first 6 to 12 months of that store opening with all the preopening costs get expensed on the day you open. It takes a while for that store to turn block on an EBITDA standpoint. It doesn't become a comp store until the fifth full quarter that it's opened, the way we do IDs. So it's a while before they contribute to IDs.

In some markets as we dense up, you have the potential to have a little bit of sister store impact. So from a total sales standpoint, you are getting exactly what you wanted from an ID standpoint in a particular geography. You may have a little degradation in a particular geography from their ID sales as you dense up in a particular market. Now some of these markets, our market share is low enough where that won't be as big of a deal, but we continue to monitor that as well.

Operator

The next question is from Andrew Wolf of BB&T Capital Markets.

Andy Wolf

On the ID sales, I want to compare them to Q2 because it was kind of the same number, both for the [print] [ph] and for the inflation. So I think I recall in Q2 you said it was very much volume driven, and I'm not sure you said that here, I think I hear you talking a little more about mix. Should we take away from that that number has a better mix element this quarter than last quarter?

J. Michael Schlotman

It was heavily driven by volume again, very strong. In my prepared comments, I said it was a combination of very strong tonnage plus an increase in the number of households shopping with us and the number of visits per household during the timeframe. So it's a combination of all of those.

W. Rodney McMullen

But tonnage was very strong.

Andy Wolf

Okay, good to hear. So there is no real update on mix, if sort of the bifurcated message continues?

W. Rodney McMullen

It really is the same thing that continues to play out, but now it's playing out on top of years where it played out. So it's growth on top of growth.

Andy Wolf

Few more follow-ups. On 84.51, you've been asked about it and you pointed to it, can you maybe call out some areas of the marketing where it really is helping, where you used to sort of you need promotions but is it also in pricing, and I know you've been asked about allocation, but could you give us a high level there as to where it's currently, is it helping the business more than has maybe as we're used to hearing about? And also, when you announced the split from Dunnhumby, you said you could probably work with some or are excited to work with similar companies. Any update there would be helpful as well.

J. Michael Schlotman

On working with other companies, that we wouldn't share at this point, other than saying that that's something that is part of what we are allowed to do now and we work against that. On helping more than the past, one of the things, even some of the examples that you gave, just by continuing to learn and continuing to be more integrated, we're making progress on top of where we were.

So to me the biggest improvement and change has been in the meetings now, the 84.51 team is part of the same meeting. So you're not having a discussion and deciding what to do and then going back and sitting down with 84.51 to say, okay, here's what we want you to do. It's actually everybody in the same meeting and their insights to say, you're thinking about this but it's probably better if you think about it this way. And it's really the professional insights and experiences that's helping us accelerate where we are versus necessarily just doing something new.

And in the past, while we owned half of them, they would have not been always around the table initially because we did only own half of them and they had obligations outside the Kroger world as well. So you had another follow-up?

Andy Wolf

Yes, just real quick, on the $80 million pension contribution, I assume that was contemplated in your guidance either for the quarter or for the year. I just wanted to double-check that.

J. Michael Schlotman

It is contemplated in the guidance in the $2.02 to $2.04 for the year. Those are things that with some of the strong fuel margins rather than that happening a little bit every so often, we've taken opportunity to put the money in when we have that tailwind. It gets the money into the fund and they can start putting it to work faster than if we did it over time.

Andy Wolf

Thanks. And I also wanted to just congratulate Cindy on a great job these past few years.

J. Michael Schlotman

With all these accolades for Kate and Cindy, I'm going to have to warn Kate that the glow goes away pretty fast. We have time for one more question.

Operator

And that last question will come from Kelly Bania of BMO Capital Markets.

Kelly Bania

I'll just reiterate, good luck to Cindy in the Pensions, and just wanted to ask a question about relative price gaps. I feel like everywhere I turn in the industry, someone's telling me just how aggressive you're being with price. Our studies show something similar. And your gross margin is just holding up remarkably well. You talked about the mix. But I guess I'm just wondering if you could talk about how you feel about your relative price gaps, do you think you have maintained them, widened them, what do you think the plan for next year is?

J. Michael Schlotman

If you look at longer-term, we've always assumed that markets will get more competitive, and that's been part of our business model really starting, they've caused us to start that years ago and it's something that we just [indiscernible] changing at all.

The gap, I guess I would word it a different way, you're always trying to get better but you are proud of where the progress you have made, and it's something that's very important for us to be able to make sure that we're giving our customers a better deal. Price is one element of that but service is just as important, and we're focused as much on that in terms of fresher product and better service as well. And all of those things together is what we think creates a unique model for Kroger and is driving a lot of our success.

Kelly Bania

Great, that's helpful. And then just a question on the pension contribution. It seems like, and I don't know if I'm thinking about this the right way, but when you have this very strong gas margin environment that generates a little extra cash and earnings, you kind of offset that with these kind of one-time contributions, is that the right way to think about that in terms of how you plan for these? And then just what is the status of the consolidated UFCW plan at this point?

J. Michael Schlotman

The status of it is it's in great shape. Cindy will make sure it stays that way. We did joke internally that it was her going away present from IR to the Pension Group, but that wasn't. These funds will need money over time. Our enrolment in these plans continues to grow. Folks continue to earn benefits. We have a great investment strategy, but they do require funds over time, and while we would budget them in to be made at different points in time, as I said earlier, when we have the opportunity and a little bit of tailwind and a few extra dollars in the coffers, we feel it's prudent to go ahead and put that money into the fund, let the fund put that money to work as quickly as possible to generate the return and continue to have strong benefits for our associates.

Kelly Bania

Great. Thank you.

W. Rodney McMullen

Before we end today's call, I'd like to share some additional thoughts with our associates listening in today. As I said a few minutes ago, Kroger's consistent, outstanding results are easy to take for granted. The fact is, your hard work in our stores and facilities every day makes it all possible. Your commitment to our customers brings our Customer 1st strategy to life. In large and small ways, each and every day, what you do makes these terrific results possible.

The holiday season is such a special time of the year in our stores all over the country. You help millions of customers every day prepare for celebrations at their schools, offices, churches, homes and more. Thank you for your hard work to make the holidays brighter for each of them.

You also make it a season for giving by working with Feeding America, the Salvation Army and other local community partners who help work with us to donate food and other items where they are needed most. Thank you. And thank you for being part of our big Kroger family. Merry Christmas and Happy Holidays to you and your family.

That completes our call today. Thanks for joining.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.