The Kroger Co. (NYSE:KR) Q1 2016 Results Earnings Conference Call June 16, 2016 10:00 AM ET

Executives

Kate Ward - Director, IR

Rodney McMullen - Chairman and CEO

Mike Schlotman - EVP and CFO

Analysts

Ed Kelly - Credit Suisse

John Heinbockel - Guggenheim Securities

Shane Higgins - Deutsche Bank

Scott Mushkin - Wolfe Research

Rupesh Parikh - Oppenheimer

Andrew Wolf - BB&T Capital Markets

Ken Goldman - JP Morgan

Zack Fadem - Wells Fargo

Mark Wiltamuth - Jefferies

Robby Ohmes - Bank of America Merrill Lynch

Chuck Cerankosky - Northcoast Research

Alvin Concepcion - Citi

Kelly Bania - BMO Capital Markets

Priya Ohri-Gupta - Barclays

Ajay Jain - Pivotal Research

Operator

Good morning and welcome to The Kroger Company First Quarter Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] Please note this event is being recorded.

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

Kate Ward

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

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

Rodney McMullen

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

Our associates delivered another solid quarter. We continue to execute our growth plan and to deliver on our financial performance commitments. Most importantly, we continue to strengthen our connection with our customers, growing loyalty and market share, and achieving Kroger's 50th consecutive quarter of positive identical supermarket sales growth, excluding fuel. Most companies can only aspire to achieve these results. It says a lot about our consistently remarkable performance, and our ability to grow in a balanced way with a long-term focus.

We've managed through nearly every conceivable operating environment, and demonstrated through different cycles that by providing value to our customers and partnering with our associates, we'll continue to make a difference for our customers, associates and communities. And when we do that we create value for shareholders, as evidenced by our growing dividend and our consistent net earnings per diluted share growth above our long-term guidance of 8% to 11%. In fact, our net earnings per diluted share growth rate, on a compounded annual basis, was 14.1% for three years, and 18.8% for five years.

We demonstrate our long-term focus by continuing to invest for the future. We are making investments in our people, our digital and online capabilities, and our strategic partnerships.

Across the board, Kroger has an incredibly strong management team and a deep bench of leaders who are making us better every day. We continue to make strategic investments in leadership development and training for all of our associates, including high-volume store managers and future senior leaders.

Many people come here for a job and Kroger creates opportunities for all associates to build a career. Despite record-low unemployment figures, when we held a one-day hiring event in every supermarket location in May, we received more than 116,000 applications. From that pool, we hired more than 12,000 new associates. We see our Opportunity Culture as a competitive advantage.

We are expanding our digital presence and marching steadily toward a time when we can provide our customers with anything, anytime, anywhere. As you know, we are taking a disciplined approach to digital growth, testing new offerings in local markets so we can make sure we get it right before we scale offerings more broadly. Our ClickList and ExpressLane offerings are now available in 25 markets, with more to come. Our merger with Harris Teeter gave us a base of learnings that allowed us to ramp up quickly the development of ClickList. Customers now have downloaded nearly 3 billion digital coupons and offers from our mobile app and website. And we continue to experiment with Vitacost.com's ship-to-home technology and platform.

Earlier this week, Kroger's technology business unit was named one of the Top 100 places to work by Computerworld magazine. We are obviously very proud of this honor. We've launched a new website, kroger.com/livekt, to connect with and recruit top talent from around the world to join the Kroger team. Similarly, we are finding out that ClickList also serves as a great tool to both hire and retain great people. Kroger is a fantastic place for tech talent to build careers because the technology they create can improve the lives of millions of customers each and every day.

In April, we announced a strategic investment in Lucky's Market, a specialty grocery store chain focused on natural, organic and locally-grown products currently operating in 22 locations. We invested in Lucky's because of their great people and unique go-to-market strategy, which includes smaller format stores that resemble an indoor farmers market, plus a culinary department that showcases amazingly restaurant-quality prepared foods. Lucky's approach is very much aligned with our efforts to provide affordable, fresh organic and natural foods as part of our Customer 1st Strategy. We expect to learn a lot from each other.

There are a lot of questions about the economy and the customer, inflation or lack thereof, consumer sentiment, or competition. These are all issues that we've managed through, some several times, over the last 50 quarters.

Inflation, for example, I have often said that 2% - 3% inflation would be a great environment to operate in. However, you rarely get the perfect operating environment.

What we know is that by focusing on our associates and our customers will be a winning formula in the future as it has been in the past. At times like this, it is even more important to have 84.51° on the team so we can generate insights into what our customers want, and figure out a way to give them that without having to guess at it.

Kroger's core business is solid. We are providing exceptional customer service and the highest quality, freshest products. Customers are giving us higher marks for better product selection and store layout, as well as friendlier service. We remain focused on customer loyalty that grows tonnage and both our top and bottom lines, which then creates value for shareholders.

Where we are right now, it looks like we will be at the low-end to mid-point of our 2016 net earnings per diluted share range. Where we end up in that range will be driven primarily by fuel margins. I do want to stress that we are never satisfied. And our to-do list remains longer than our done list.

Now, Mike will offer more details on Kroger's first quarter financial results and discuss our guidance for the remainder of the year. Mike?

Mike Schlotman

Thanks Rodney and good morning everyone.

IDs came in at 2.4%. As Rodney said, we have been in environments like this before and we will continue to focus on growing households, growing units, and making sure we are delivering the right value proposition for our customers.

Inflation was non-existent in the first quarter. Lower inflation has persisted and in fact was slightly deflationary without pharmacy. When you add pharmacy back in, we had approximately 30 basis points of inflation. This is the lowest we've seen in the last six years.

During the quarter, trips per household were up and units per basket declined. This, combined with more households, led to positive tonnage growth.

Operating costs excluding fuel and Roundy's were 4 basis points better in the first quarter. Operating, general and administrative expenses were 11 basis points better, and grew by approximately 2.9%. Rent and depreciation were a combined 7 basis points worse.

We continue to work diligently to keep operating costs in check. As you know, this is the fuel we use to run our Customer 1st Strategy. And as Rodney just said, this is an area where our to-do list is longer than our done list.

Now for an update on retail fuel. In the first quarter, the average retail price of a gallon of gas declined by 0.45 compared to last year. Our cents per gallon fuel margin was approximately $0.143 compared to $0.116 in the same quarter last year. On a rolling four quarters basis, we were at $0.182 this year compared to $0.184 last year. We expect this downward trend to accelerate as we cycle some very strong margin quarters for the rest of the year.

Our first quarter net earnings per diluted share increased 12.9% to $0.70, compared to $0.62 during the same period last year. This result was helped primarily by our operating results and higher fuel margins during the first quarter. A lower LIFO expense and share buybacks also contributed to the EPS growth.

Our integration with Roundy's is well underway. Synergies are coming together nicely. We are beginning to focus on the physical assets in Wisconsin while continuing to open new Mariano's stores in Chicago.

Roundy's associates share our deep commitment to putting our customer first, which makes it easy for us to work together as one team.

For our Corporate Brands portfolio, we are off to an exciting start on new innovations in 2016. Last quarter, we told you that we had just introduced Simple Truth household and personal care products, expanding our popular natural and organics line into a true lifestyle brand. Customers have responded enthusiastically as both sales and unit volume have exceeded our expectations in all categories. We continue to launch new Simple Truth offerings in laundry, household, baby and health & beauty care.

We also continue to push the boundaries of culinary trends with new Private Selection spices, marinades, condiments and cooking sauces. Customers are savoring global flavors in our delicious Private Selection products such as Korean Black Garlic Kalbi marinade and Peruvian Aji Amarillo hot sauce.

During the first quarter, Corporate Brands represented approximately 27.9% of total units sold, and 25.9% of sales dollars, excluding fuel and pharmacy.

The Company's net total debt to adjusted EBITDA ratio increased to 2.12 times, compared to 2.09 during the same period last year. This result illustrates our commitment to use free cash flow to both grow our business and return cash to shareholders, while maintaining an appropriate level of leverage for our credit rating.

Over the last year, Kroger has used free cash flow to repurchase $1.1 billion in common shares; pay $397 million in dividends; invest $3.6 billion in capital; and merge with Roundy's, for $866 million.

Kroger's strong EBITDA performance resulted in a return on invested capital for the first quarter of 14.08%, excluding Roundy's, compared to 14.03% for the first quarter of 2015. Our balance sheet is as strong as ever.

I will now provide a brief update on labor relations. We recently agreed to new contracts covering store associates in Houston, Indianapolis, Portland

and Roanoke. We are currently negotiating contracts with the UFCW for store associates in Little Rock, Nashville, and Southern California.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality, affordable health care, and retirement benefits for our associates. Kroger's financial results continue to be pressured by rising health care and pension costs, which some of our competitors do not face. Kroger and the local unions, which represent many of our associates, 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.

Turning now to our 2016 guidance. We continue to expect identical supermarket sales growth, excluding fuel, of approximately 2.5% to 3.5% for 2016. This reflects lower inflation as well as Roundy's results, which are an approximate 30 basis point headwind to identical supermarket sales growth.

For full-year net earnings, we expect 2016 range of $2.19 to $2.28 per diluted share. As Rodney said earlier, based on current fuel margin trends, we expect to be at the low-end to mid-point of our guidance range. We expect fuel margins will be at or slightly below the five-year average. Shareholder return will be further enhanced by a dividend that is expected to increase over time. In thinking about the cadence of our quarterly results compared to our long-term 8% to 11% guidance, we believe that the second quarter will be the toughest quarter, with slight growth over 2015. Keep in mind the second quarter last year grew by 26%. Both the third and fourth quarters will be at the low end to midpoint of the range.

We continue to expect capital investments excluding mergers, acquisitions and purchases of leased facilities, to be in the $4.1 billion to $4.4 billion range for 2016. Finally, we continue to expect Kroger's full-year FIFO operating margin in 2016, excluding fuel, to slightly expand compared to 2015 results.

Now, I will turn it back to Rodney.

Rodney McMullen

Thanks Mike. We are proud of our team's performance during the quarter, especially in light of the challenging operating environment. We've been through business cycles like this before. The best thing we can do is to deliver on our promise while investing for the future. We will continue to execute our Customer 1st Strategy and by doing so, we'll create long-term value for our shareholders. Now, we look forward to your questions.

Question-and-Answer Session

Operator

We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Ed Kelly of Credit Suisse.

Ed Kelly

Can we maybe start off with just color on the cadence of the IDs through Q1? What you're seeing so far in Q2 and then, Rodney or Mike, could you maybe dissect sort of like tonnage trends versus inflation trends; and then lastly, as part of all that the impact that Roundy's had on the Q1 comp?

Rodney McMullen

Ed, I'll start out and let Mike fill in. But, if you look across the quarter, I would say it bounced around a bit. Part of that was driven by weather. Earlier in the quarter, we had basically no weather benefits this year versus a lot in the prior year. As you get towards the end of quarter, Memorial Day moved from the first quarter to the second quarter; and early in the quarter you had Super Bowl. So, there is a lot of things going on. The other thing on inflation; inflation, we had expected that it would start picking up some. And when we look going forward, we just don't see that picking up. If you look at so far this quarter, we're inside the range, just slightly below the midpoint of the range of the 2.5% to 3.5%. But, as you know, it's still very early in the quarter. Overall, the core continues to be strong. And we're cycling incredibly strong numbers from last year, and tonnage continues to be solid.

I don't know Mike, anything else you would want to add, or thoughts?

Mike Schlotman

No. One of the things we have done is if you look at our real growth that's IDs minus the inflation number that we gave. If you look at a two-year stack of that, it is amazingly consistent quarter-to-quarter, less than a 50 basis-point swing when you look at it over the last five or six quarters. So, when you look at things over little bit longer timeframe and you take out the effects of inflation on the reported numbers, our results have actually been amazingly consistent.

Ed Kelly

And Mike, just on the impact of Roundy's on that 2.4% you report this quarter?

Mike Schlotman

It's about 30 basis points.

Operator

And the next question will come from John Heinbockel with Guggenheim Securities.

John Heinbockel

I know it's still early with ClickList in some markets, but what have you seen thus far in terms of how that's changing consumer behavior, and is it yet a new customer acquisition vehicle?

Rodney McMullen

As you started out your question, it's obviously very early. And as I mentioned in the prepared comments that we're in now 25 markets. What we're finding is almost anything you say would be correct. So, there is some new customers. And we find in some situations a customer will spend more with us. But, as you know, we're so focused on what is it that customer wants and needs are and what we have as some of our customers tell us they really appreciate it. And that's really why we're focused on it and continue to roll it out, because some customers find it incredibly helpful. We definitely from everything that we see, we find it an "and" and not a "or". And the ClickList customer continues to come into the store and it really -- it's just one more way of making their life a little bit easier.

John Heinbockel

And then, I guess just as a follow-up, do you see -- do you think there is any difference in how you will run ClickList or customer behavior in the marketplace versus a traditional food retail store, given size differences and so forth?

Rodney McMullen

We have it in -- all in both types of stores and we really find the behavior isn't that much different, but we do not have the marketplace product on the website. So, if somebody wants to buy something from the marketplace site, they have to put in a comment section, "can you get me that". And obviously we will. But we don't see differences in behavior between one type and other. One of the things that's always part of the consideration is do we have space to do it in a store. And that's driven as much the decision on a size of store. There is some marketplace stores, we don't have it in and that we'd like to have it in because we just really don't have the space to do it.

Operator

Next we have a question from Shane Higgins of Deutsche Bank.

Shane Higgins

How much you guys characterize the macro environment in the quarter? And any color you have on just the consumer sentiment overall? I think you guys mentioned that units per transaction were down slightly. Is that any kind of indication that consumer might be a bit softer, or any color there would be great?

Mike Schlotman

When you look at the units per basket, they were down slightly but that was overcome by more trips, making more trips to drive more units during the quarter. So, if you just look at those two metrics, it would have been a slight increase in the tonnage, and then the new households pushed the tonnage to be nicely positive. And I think Rodney touched, there is clearly a lot going on out there, the macro environment, there is the inflation and deflation, there is gas retails were rising during the quarter. It was an interesting quarter because there are so many unusual things out there. Our own comparisons to a lot of like Rodney said, the Super Bowl this year, then the weather, then Memorial Day moving. As Rodney said, the cadence of ID sales was really a little bit all over the board, depending on the week you're looking at. But, our fundamental approach is focused on the customer to make sure we're delivering on the value propositions that they want. And just based on how they're shopping, it's sure seems like we are hitting the mark on that.

Rodney McMullen

On the economy, to me, Mike and I have talked about this, it's really hard to describe, and it's very mixed. And how much of that is driven because of the election and everything else, I'll let somebody that has better insights into that than us to try to speculate on that. The strength certainly doesn't feel as strong as the numbers suggest. But with that said, if you look at the things that would be discretionary items or more upscale items, if you look at why, Boar's Head, Murray's, Starbucks, all of those continue to grow very nicely from an identical standpoint and well outperform the total. So, it’s really pretty hard to describe from what we can see.

Shane Higgins

Yes, I appreciate the color, and just a quick follow-up. So, it sounds like you guys are driving additional trips. Is that a function of consumers utilizing your fuel rewards, is it more of a shift towards fresh and produce, more produce more fresh?

Rodney McMullen

You do see those types of items in a lot of the baskets of the incremental trip. And as people strive to eat healthier and need more fresh products rather than buying it and putting in the refrigerator or freezer, it does appear as though they are making their trips to the grocery store little more regularly and buying for a few days rather than for a week long stock up. That’s certainly what it seems to be.

Operator

And our next question comes from Scott Mushkin, Wolfe Research.

Scott Mushkin

Hey guys, thanks for taking my question. First, I had a quick clarification to your answer to Ed on the quarter to date trends. I think you said you’re slightly below the midpoint of the range, is that correct?

Rodney McMullen

Correct.

Scott Mushkin

And then, does that include or exclude the Memorial Day shift?

Rodney McMullen

That would include the shift of Memorial Day.

Scott Mushkin

Okay, that's perfect. So, you're at kind of a little below with the shift included. Okay, that's perfect. And then my big question, obviously you've got a competitor, a large competitor making a lot of noise around price. So, have you seen anything in the marketplace where they've gotten more competitive? And they have done and delivered what they said they are going to deliver as far as cleanliness and in stock. How seriously do you guys take their comments about several billion dollars of price investments? And they are even willing to take deflation in their own comps or kind of lower their own comps to get that done, and what's the plan at Kroger to kind of combat that if it ends up happening?

Rodney McMullen

Well, if you look, we take all competitors serious. So, to say we only focus on one, we really do look at all competitors. And we think it's incredibly important to make sure we focus on what our customer needs are. And as you know, if you look on annual basis, we are investing $3.6 billion on price today versus when we started on this new journey. So, we would have every intention to continue to maintain our price position. But, when you look at overall, the total customer, the way they look at value is much more than just price. And as you know, we stay focused on the total customer needs. And fresh products are incredibly important; what's the shopping experience; how long is the customer in line; how do they get treated by associates, all of those things are equally important. And we really are focused on continuing to improve all of those and we've made substantial improvements in all of those. And a customer doesn't make a decision to shop where to shop based on only one dimension. And we think some of those other things create a very large competitive advantage for us.

Scott Mushkin

Okay, great. And then, I have one question. Obviously the ten-year bond has been falling quite steadily here for three or four months and then obviously has impacts on pensions. And I just want to get you guys' thoughts on this. We've seen the drop like, 50, 60, 70 basis points something like that. And how should we think about pensions next year, and any framework there, Mike, on that if you think about this or no?

Mike Schlotman

Well, of course, I think about it. The effect of interest rate, it's really -- it's odd how a lot of pensions are calculated from the liability use and the interest rate, the present value of the liability. If you look at state and local and several pensions and multiemployer pensions, their liability is actually calculated using the expected rate of return as the discount rate. So, UFCW plans, the way they calculate their unfunded status is really unaffected by changes in the interest rate, unless they change their expected rate of return. It's the same way -- the way it's mandated to be done. It would affect the Company plan a little bit but remember our Company plans are frozen plans. There continue to be benefits earned by those who are still working and our participants in it, but there is no new participants in it. And we try to maintain the funded status of that enough, so we don't have to do some reporting issues to participants. But, I never want that fund to go overfunded because as the last person winds up getting their check, there is no easy way to get any excess money out of that. So, we purposely manage that to be slightly underfunded -- to be underfunded because someday rates will go up. And I don't want to put a bunch of money in now and then wake up in five years and have the fund be overfunded because I can't do anything with it.

Scott A. Mushkin

Any idea kind of a rule of thumb what the expected rate of returns on these -- on UFCW plans are and then our yield? Thanks.

Mike Schlotman

They're a little bit all over the board, I would say and the sevens [ph] is the most common; not a lot different than state and -- all the state, pension plan, they are all -- they all do it the same way.

Operator

And the next question will come from Rupesh Parikh of Oppenheimer.

Rupesh Parikh

Thank you for taking my question. Just on the topic of food inflation, deflation. This morning, the government data again showed a decline in food prices. So, I just want to get a sense what your latest full year outlook is and how you are thinking about the cadence, going forward?

Mike Schlotman

As I said in prepared remarks, we would have expected to start seeing a little bit more inflation right now than when we were sitting here three or four months ago thinking about it. And it just hasn't happened. And as I sit here today, it certainly doesn't feel like we are going to have the pickup in overall food inflation. Milk would have been projected to start having some cost increases but the federal market order on milk isn't showing any upward trend or not any significant upward trend. So, I think we are going to wind up most of the year in a fairly low inflationary environment.

Rodney McMullen

But, as Mike mentioned before, tonnage continues to improve; we're continuing to improve market share. If you look at year-on-year, we continue to improve the connection with the customer, and our gross profit dollars in departments remain strong as well. So, I think it's important to look at all these things together.

Rupesh Parikh

And then just going back to your comment here on traffic, if you look at traffic this past quarter versus recent quarters, has it improved? And if so, what's been some of the drivers do you believe behind the improvement?

Mike Schlotman

We have continued to see a strong growth in all households including loyal and non-loyals. I would go back to Rodney's prior comments on our never ending focus on the customer and making sure we understand what they want to figure out the way to deliver that with them while still having the right value propositions for them and our shareholders.

Operator

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

Andrew Wolf

On food retail turning slightly deflationary, just to kind of echo Scott's question. Is that being driven at all by competitors taking pricing down even more so than the deflationary, just taking it down, try to get business going or is that all as far as you can tell or mainly as far as you can tell from the lower product cost?

Rodney McMullen

Almost all of it is the fresh department; it's the seafood, deli and all of those areas would be primarily driven by commodities. And then, if you look at in the grocery complex, milk would be a heavy deflation item; and that's as Mike mentioned before, really driven by the federal market. So, it's really -- it looks overall as for commodity based versus competition based. I don't know Mike, anything you'd want to add to that?

Mike Schlotman

No, I absolutely agree.

Andrew Wolf

And on the guidance, keeping the ID sales the same as before but on lower inflation, obviously means you think the -- you are going to see improvement in volume. So, it sounds like volumes picked up a bit but what's sort of driving that outlook? Is it…

Mike Schlotman

It's our expectation for the year. If you look at the first quarter, we delivered the 2.4% in exactly that kind of environment, and that was without the weather from the prior year and Memorial Day moving. So, we continue to focus on driving units, driving tonnage and making sure that the customer is getting the well rounded shopping experience that Rodney just spoke of.

Andrew Wolf

And if I could just get in a follow-up on ClickList, kind of a generic question on profitability. Is the current model -- let's say a volume -- store produces a reasonable amount of volume in ClickList, is that going to be as profitable as having a customer coming to store and pick their own groceries or does the model really have to shift to something that's scaled up or you can have a kind of a dedicated pick facility?

Rodney McMullen

When you're in the start-up period, obviously it's a headwind; there is more expense versus the other way. We certainly see that if you look at a model, we feel very comfortable the model can scale out to where from a profitability standpoint the customer can do either one and we are completely in different. One of the things that our team has done a lot of work on is trying to make sure we design a ClickList model that can scale to whatever the volume it scales to. So, if it is 5% of the business, we will do fine; at 5% if it becomes 20%, we will do fine at 20%. And our team really has done a lot of work to try to make sure we have designed a model that can scale and scale from a profitability standpoint, and the customer will lead us to where -- what percentage they want it to be.

Operator

And our next question will come from Ken Goldman of JP Morgan.

Ken Goldman

Is there any way to even roughly quantify the benefit of the Memorial Day shift on 2Q today, because you haven't really talked about that since 2004, and it's a long time ago? But from that we estimate maybe a shift like that can help roughly about 100 basis points on a quarter-to-date number. So I am just curious, is that roughly in the right range, meaning on a like for like basis you're doing maybe a bit below 2% so far in the quarter excluding the benefit from Memorial Day?

Rodney McMullen

I don't know that we'll give you the exact number, but the 100 basis points isn't remotely correct. And don't forget, you have the week after as well and you really have to look at the two weeks together.

Ken Goldman

Not remotely correct meaning it's lower than 100 or higher, I am hoping lower?

Rodney McMullen

It's not even close to 100.

Mike Schlotman

Yes, you're not even in the right ballpark.

Ken Goldman

I've never been so happy to be wrong, but I appreciate that.

Rodney McMullen

I am as well.

Mike Schlotman

And if that's impression that's out there, I've never been so happy to help you be wrong.

Ken Goldman

Yes. That is the impression. So, we'll be smiling in the wrong house together. And then, I wanted to follow up on EPS, and forgive me if this was asked; I didn't hear it. Coming in closer to the bottom or the midpoint of the range, the reason that was cited was fuel. But you didn't -- unless I missed it, you didn't change your guidance for fuel margins coming in at or slightly below the five-year average. That was the same verb that you used last quarter. So, I just wasn't quite sure what actually changed that caused you to reduce the outlook?

Mike Schlotman

Fuel continues to be very volatile, and it certainly, again, I am sitting here in June trying to predict the rest of the year. And certainly seeing from what we see today that fuel will coming in at or below it, we pumped a couple of billion gallons of fuel in the first quarter and a very small change in that retail cents per gallon adds up to a lot of money very quickly. So, it's not like fuel has to change by $0.04 or defect our numbers in a big way. And it certainly seems that the trend would be closer to the below the five-year average than at the five-year average. But again, overall, it's really tough to predict. The last four days, the oil has gone down; is that going to leave the lower wholesale price of unleaded fuel? We'll know in the next few days.

Rodney McMullen

Plus the first quarter was slightly better than where we expected it to be. But when we look at the year, we really don't see the change.

Operator

The next question is from Zack Fadem of Wells Fargo.

Zack Fadem

Can we walk through some of the moving parts to the gross margin line in the quarter? With gross margin ex-fuel down slightly, can you talk about how things like deflation, price investments and the impact of Roundy's come into play here?

Mike Schlotman

I don't think I'll go down to that level of detail and walk through all the individual numbers. We continue to make the investments we plan to make in price throughout the first quarter. Certainly the dynamics of deflation, when you look at the whole gross profit margin for the entire Company, makes it kind of interesting, because as you have deflation, if you pass on exactly the lower cost of the customer, it drives your gross profit rate up; it's just simple math. Pharmacy continues to be a bit of a headwind to the gross profit numbers as well with some of the inflation in there and where the reimbursement rates are. So, it's just a really big mix bag; I would need several hours probably to point it.

Zack Fadem

Okay, we'll take that one offline then.

Mike Schlotman

Sorry to interrupt, but when you look at it overall, it's pretty close to where we expected it to be.

Rodney McMullen

And we executed our plan as Mike said.

Mike Schlotman

I absolute agree with that.

Zack Fadem

And just secondly, there has been a lot of talk about the online meal prep companies like Blue Apron. Have you considered expanding into this business? And if so, how you're thinking about it in terms of build versus buy?

Rodney McMullen

I want to answer it but I don't want t to sound flip. The short answer is absolutely. And as you can imagine, we would look at any and all approaches. The thing that's important is if we find somebody to make an investment and that they would value the leverage that we bring to the party as well and assign some value to that. So, it's not just something that has pure option value in the way they're getting valued. So, the short answer is yes. We would be very open to doing it on our own or doing it with somebody. And I think if you look at our track record, we've had those approaches.

Operator

The next question comes from Mark Wiltamuth of Jefferies.

Mark Wiltamuth

I wanted to dig in a little more on the Walmart question. We did a May price survey that was showing Walmart actually cutting in produce in two markets, cutting about 9%, and 5% to 6% cutting in another market. Are you seeing that in your view of marketplace? And do you think it really matters relative to your offering in produce since you have a broader offering and a little more robust?

Rodney McMullen

I don't know that I want to go in specifics because if you look at over the last say two years, you're going to find that type of variance among all retailers when you hit that specific market, and it's really which market are you looking at. So, I would hesitate to say there is something that's just fundamentally changing because you'll see those behaviors in specific markets all the time because any of us -- there maybe some market that we're trying to cause something to happen. If you look -- as you know for us, we have invested a ton of resources and labor improving the freshness of our products and especially in the produce department. And our customers are telling us, we're making meaningful improvements in what they see from a freshness standpoint in produce, specifically. We're getting the same thing in other departments but produce would be one to tell. And for us, it's really important the progress we're making to continue to make improvements from that. And as you know from an organic produce standpoint, we find that we have a outstanding variety of organic and customers continue to connect with that in a much deeper way.

Mike Schlotman

Yes. Inflation in produce in the first quarter was almost 400 basis points lower than the fourth quarter, still inflationary, but from fourth quarter to first quarter, it declined almost 400 basis points, less inflation.

Mark Wiltamuth

Okay. And Mike while we've got you on, I wanted to ask about the buyback. You did like $1 billion of buyback here in the quarter. Do you anticipate more throughout the rest of the year; do you have any remaining in your buyback plan; and just give us some an update on where you're there?

Mike Schlotman

I currently have exhausted the authority the Board's given me. And if you look at our history, like to be with that authority for any particular point in time. And we have gotten a cadence over the last couple of years of frontend loading our buyback for the year. But we always want to have dry power, if the stock reacts in a way that we don't think is prudent based on our view of the underlying value of the Company.

Operator

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

Robby Ohmes

I actually wanted to -- two questions, one, I wanted to see if I could dig a little bit more into the inflation or deflation versus your outlook. Mike or Rodney, you guys have been talking about sort of good deflation versus demand driven deflation. Are you -- I just want to clarify, are you starting to see some demand driven deflation in your outlook that we should be concerned about? And maybe also -- it was helpful that you comment on milk and perishables. What's the center of store inflation outlook for you guys now; has that changed since you guys spoke to us last quarter? And then, I have a follow-up.

Mike Schlotman

Yes. I would say, it hasn't really changed very much other than it looks like it's going to come slower which could lead the less inflation for the full year by the time we get to the end of the year. And really as Rodney said earlier, everything we're seeing is really price led deflation, not demand driven. We haven't -- I am not sure -- trying to understand if your demand driven deflation on the fly here because the number we're talking about is what we pay for a product versus what we paid for it last year. So, I am not sure the demand would have to change rather dramatically in the marketplace for to affect grocery category. But everything we're seeing is just a little bit less inflation than we expected, right now, and it looks like that's going to persist.

Robby Ohmes

Thanks. And then, just one Roundy's, have you given us or can you give us a sort of rough, what do you think the rough impact on the FIFO operating margin is from Roundy's for this fiscal year? And just clarify, is that -- does it look like the amount you're going to have to invest in Roundy's including Mariano's, is that -- are you guys saying that's tracking right on plan or is that maybe going to be a little more than you initially thought? Any color on that would be great.

Rodney McMullen

If you look it overall, it's tracking on plan. I would say the thing that's taking a little longer than we would have expected is to get the actual things started. So, if you look at Wisconsin, obviously I mentioned it in the prepared remarks, but on remodeling stores and making some of those changes, it took a little longer to get started than what we would have guessed. Now, why we thought we could have got it started it so quickly, I am not sure. And we'll learn that, so the next time we do something, because we're still doing it faster than what we could do within one of our historical Kroger divisions. The thing that I would say that I am extremely pleased with is our associates at Roundy's and how welcome they are and how excited they are to be part of the Kroger, and making sure that we leverage the size of Kroger. And the synergies continue to actually come in better than what we were expecting a little bit. But, as you know, we'll continue to invest those synergies into driving our business. Mike, you work on it closer than I do.

Mike Schlotman

No, I agree, and I disagree with Rodney's comment, I'm not sure why we were as bullish as we were being able to get remodel started, because with an early termination of HSR filling, the time from announcement to close was very quick, and then you had the holidays, because we closed on December 18. And it just takes a while to get plans drawn, get sign off on how we're going to remodel the stores and things like that. But I can -- you can rest assured that if you found the right part of Wisconsin to go to, you would see a lot of activity going on in and around a lot of stores today.

Robby Ohmes

And for Mariano's, are changes that you plan there, either do assortment or anything else, is that may be running a little bit slower than initially hoped for?

Rodney McMullen

On Mariano's, there really isn't much of a focus on assortment, there may be some products that if the team in Chicago asks for, we'll obviously give them access to it, will start carrying it. But, in Mariano's, the focus is continuing to build more stores. And I think, this year, we'll end up opening four or five stores in Chicago on the base of 30 some stores, so very aggressive capital plan there.

Operator

And next we have a question from Chuck Cerankosky of Northcoast Research.

Chuck Cerankosky

Good morning everyone, nice quarter. I would like to take a -- not a crack at that question about the economy but not so much about how the U.S. economy is growing or slowing or whatever the case might be, but really looking at customer behavior, as they all look at some of these fresh departments and experience lower prices. What are you seeing between say types of protein; are we seeing trading between those categories simply because people are more impressed with a lower price than they were last year?

Rodney McMullen

There is no doubt that you see people like in beef, buying more beef, things like that. So, those things are definitely happening. But some of those prices are the best prices that customers would have seen in, I want to say, almost three years, just reflecting back. So how much of it is driven because of economy and how much of it's just driven because it is a great -- it's a good value, again, given the changes in price. Mike you were looking at some details.

Mike Schlotman

I absolutely agree with what Rodney said. And if you look at the meat category in particular, until we got into late 2015 and in 2014, you had -- in the early part of '14 you had mid to single digits inflation, ended 2014 with double-digit inflation. Last year started off high and then as we got into the third or fourth quarter, the prices really started coming down. And it's people buying, perhaps buying more and people coming back into the categories what's driving it there.

Operator

The next question comes from Alvin Concepcion of Citi.

Alvin Concepcion

Thank you for taking my questions. I'm wondering if you could give us sense of just the overall competitive promotional environment in both conventional as well as natural and organic, how is it today versus what you saw in the quarter versus the prior quarter. And more specifically, have you seen any impact from all these in California?

Mike Schlotman

Again, we won't go into specific competitors or geographies but we always assume the environment around that it's going to get more competitive when we build the business plan. If you happen to have a year where that's not the case, that just makes the year a little bit better. But the industry has always been very competitive. And we see no, nothing out there that would cause it to be less competitive. And we go in every year with that assumption and build a business plan of how we can invest the dollars we have to invest for our customers' benefit to drive more tonnage and more trips to the store and increase loyal households. And as we continue to do that, you see the results as the number of our loyal households continue to grow, their trips to the stores continue to grow, and then the units they buy on a monthly or quarterly basis, continue to grow. And that really winds up being our focus. As Rodney said early on, competition and pricing environment. We don't ignore anybody; we know what they are doing, but we always come back to what's our customer wanting and how can we satisfy that need.

Alvin Concepcion

Got it, thank you and just as my follow-up. Wondering how we should think about the puts and takes to margins over the next few quarters. I know fuel margins are big impact but how much of an impact do you expect from things like the overtime legislation and are you fully EMV compliant at this point?

Mike Schlotman

We're EMV compliant where you have to be EMV compliant. The sea stores and fuel pumps and things like that have a different deadline to be implemented. Some of our merged companies aren't completely there yet because they started later than we had started, and we are working to get them caught up. But, if you at pre -- if you look at, Roundy's has some work to do on EMV compliance, relatively small piece of the total pie. So, those things weren't -- won't affect. What was the first part of your?

Rodney McMullen

On the labor changes, we would not have very many management people that would be below the new minimum wage. We are going through and understand exactly how it will impact us. But a rough guess, on an annualized basis, it's probably right now our guess would be 15 million to 20 million for the whole year. So, in the overall scheme of things, it's not a lot. But, we are still in the process of making sure what's the best approach for all our associates, but we don't have that many people that make less than that.

Operator

The next question comes from Kelly Bania of BMO Capital Markets.

Kelly Bania

I wanted to circle back on Roundy's. It seems like their performance there was better than maybe your expectation. And just curious what drove that. Was that Wisconsin markets or Chicago? And do you think that 30 basis points -- are you looking for that 30 basis points drag for the next couple of quarters or do you think that could continue to improve, any color there?

Mike Schlotman

Yes, I would think the 30 basis points is what it'll wind up affecting the full year by. They continue to have obviously with it being a headwind, their sales trends are below the rest of the Company. It's not like flipping a switch and all of a sudden you put a program and they are done. We are going about this in a very methodical way for lack of a better world of making sure the stores are cleaned up, making sure the reset, making sure stores are remodeled that need to be remodeled, some may wind up being relocated. And then you step back and you figure out how to get the best value proposition to their customers, like we have done pre merger with Roundy's. So, the good news is this is a game plan that we have used before, as we invested in growing -- taking the business who had sluggish sales in Kroger at the turn of the century to a company that has very robust sales, and it's a strategy we would expect and implement in Wisconsin as we go throughout the year. But it won't be flipping to switch where all of sudden they'll turn on a dime.

Rodney McMullen

And if you look at our overall Roundy's strategy, when we announced the merger, we really look at as a three-year approach. And obviously some of the things that we've talked about as part of it but as Mike just mentioned, our real estate would be part of that remodeling stores, expanding stores, all of those things would be part of the total package. One of the reasons why we got excited about Roundy's was obviously Mariano's but in addition to that in Wisconsin, the quality the real estate, most of the real estate to have there is very good location and for the most part good store sites as well.

Kelly Bania

Then, just wanted to ask, when you look at your households, your increasing penetration with new households in particular, I am wondering if you have any color on what kind of customer that you are getting there that new customers, is that higher income customer or lower income customer, is it at diverse group, any analyses that you've done around that would be helpful.

Rodney McMullen

It is very diverse. And if you look, it would certainly be heavily weighted the mainstream and it scales from that. So it is diverse from ethnic diversity, it's diverse from income diversity, and it's diverse from age, which for us we obviously get excited by being in all of those groups.

Kelly Bania

And then one, just last one on the fuel margins for Mike. Is it fair to say $0.01 swing in the gas margin could be around $0.05 to the EPS, is that rough ballpark way to think about it?

Mike Schlotman

I actually don't have that calculation handy.

Rodney McMullen

For the year that would be close.

Mike Schlotman

Yes, for a quarter, -- as Rodney said, for the year, it would be fairly…

Kelly Bania

For the year?

Mike Schlotman

Yes.

Operator

The next question comes from Priya Ohri-Gupta of Barclays.

Priya Ohri-Gupta

Mike, just a quick question on your view of the refinancing market right now; it looks like you had about $1.2 billion in CP and you have $100 million maturing later this year. So, I just wanted to get your view on continuing to use the CP market to roll some of your maturities versus terming them out in terms of a long-term market, given where rates are? Thank you.

Mike Schlotman

Yes. We do have the $800 million later this year and 500, a little over 500 million in January. What the reason -- I would see as that matures, terming that out, as it comes closer, we have been putting interest rate hedges on that debt through our time to take some of the interest rate risk off of the table if rates got to way from us quickly. Relative to commercial paper, you will probably us maintain commercial paper in that range. It's the easiest way, particularly with where commercial paper rates are today; it's the easiest way for us to get exposure to floating rates. If you want to modify your exposure to floating rates quickly, it's easiest to do that with commercial paper because assuming the markets are open, I can always term them out. If I have swaps or hedges or if I've done a three or five-year floating rate note, you really can't change that quickly or eloquently. So that will continue to be part of our strategy.

Priya Ohri-Gupta

Thank you very much.

Mike Schlotman

And we probably have time for one more question.

Operator

And that final question will come from Ajay Jain of Pivotal Research.

Ajay Jain

Actually most of my questions have been asked already. My question is on Roundy's. Obviously, it's early in your experience there, but since last year's fourth quarter was a stub period and now you've got one full quarter under your belt, I am just wondering if you seen any change sequentially in Roundy's operating performance sequentially, are you seeing any change there that's meaningful?

Mike Schlotman

Again, it's in the ballpark of what we expected them to be. We have, as Rodney said, if there is anything on Roundy's of note from us, internally it's just that we had a little bit higher expectations of how quickly we could do some of the things that have taken a little bit longer than we expected. But, we do have some momentum going now.

Ajay Jain

And, I think you mentioned and Rodney you mentioned things took a little longer to get started in Milwaukee. But can you also maybe comment on how you view the challenges for Roundy's in Chicago compared to Milwaukee? Obviously they're very different formats and different customer demographics. But to the extent that there is any real variability in terms of how those markets are performing, can you speak to that at all?

Rodney McMullen

In Chicago, it's completely different. Obviously the condition of the store base is substantially very, very good, most of the stores. The first store was opened in 2010. They had acquired a bunch of stores from Dominick's when Dominick's left the market; they're in the process of remodeling those stores. But the rest of the stores are in very good condition. The biggest thing in Chicago is just cycling a lot of sister store impacts because there were so many incremental new stores because of the Dominick's acquisition. But it's really -- the focus there is to continue to execute the plan, continue to connect deeper with customers and grow our market share. And Chicago is a fantastic market that we really like.

Ajay Jain

Okay, great. Thank you.

Rodney McMullen

Thank you. Before we end today's call, I'd like to share some additional thoughts with our associates listening in today. And as you know, I always like to tell our associates a few comments because we just have so many that listen in. And first, I want to take a moment to extend our deepest sympathies to the family and friends of those who lost their lives in the recent horrific attack in Orlando. What happened is tragic and heartbreaking. I also want to thank the first responders, who put their lives in danger every day to protect us. I know our family of associates those at Axium Healthcare outside of Orlando, across Florida and throughout the rest of the country is deeply saddened by what has happened. We stand in support of the LGBT community. An event like this affects each and every one of us, no matter where we live or work. It serves to remind us of what is most important and that is taking care of each other. I want to thank our associates everywhere who demonstrate our values of diversity, inclusion and respect every day to treat all with dignity; to seek and embrace the differences among people; and to lift each other up.

That completes our call today. Thanks for joining us and have a good summer.

Operator

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