The Kroger (NYSE:KR) Q4 2013 Earnings Call March 6, 2014 10:00 AM ET

Executives

Cindy Holmes - Director of Investor Relations

W. Rodney McMullen - Chief Executive Officer and Director

Michael L. Ellis - President and Chief Operating Officer

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

Analysts

John Heinbockel - Guggenheim Securities, LLC, Research Division

Meredith Adler - Barclays Capital, Research Division

Scott Andrew Mushkin - Wolfe Research, LLC

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Gregory Hessler - BofA Merrill Lynch, Research Division

Karen F. Short - Deutsche Bank AG, Research Division

Charles Edward Cerankosky - Northcoast Research

Stephen W. Grambling - Goldman Sachs Group Inc., Research Division

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Edward J. Kelly - Crédit Suisse AG, Research Division

Operator

Good day, ladies and gentlemen, and welcome to the Q4 2013 The Kroger Co. Earnings Conference Call. My name is Glenn, and I will be your operator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to your host for today, Ms. Cindy Holmes, Director of Investor Relations. Please proceed, Ms. Holmes.

Cindy Holmes

Thank you, Glenn. Good morning, everyone, and thank you for joining us.

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

Both our fourth quarter press release and our prepared remarks from this conference call will be available on our website at ir.kroger.com. After our prepared remarks, we look forward to taking your questions. [Operator Instructions]

I will now turn the call over to Rodney McMullen, Chief Executive Officer of Kroger. Rodney?

W. Rodney McMullen

Thank you, Cindy. Good morning, everyone, and thank you for joining us today. With me to review Kroger's fourth quarter and full year 2013 results are Mike Ellis, Kroger's President and Chief Operating Officer; and Mike Schlotman, Senior Vice President and Chief Financial Officer.

Our associates continue to execute our accelerated growth plan, resulting in a great quarter and a full year we are proud of. Kroger is delivering on the key performance targets we committed to when we outlined our long-term growth strategy at our October 2012 investor meeting. Mike Schlotman will give more details about each of the 4 metrics, but I'd like to share the highlights.

We achieved our 41st consecutive quarter of identical supermarket sales growth. We expanded our rolling 4-quarter FIFO operating margin excluding fuel. We improved our return on invested capital even as we increased capital investments, and we increased our market share in 2013.

For the full year, we continue to perform for shareholders by delivering adjusted earnings per share growth of 13%. We achieved our ninth consecutive year of reducing operating expense as a rate of sales, and we returned 600 -- or $928 million to shareholders through share buybacks and dividends. That we accomplished all of this while also successfully completing our merger with Harris Teeter is a great testament to our associates' determined focus on serving our customers. We are confident that 2014 will be a great year and that we will continue to deliver growth that investors can count on.

Consistent with what we've been saying for the last several years, we expect the economic recovery in 2014 to remain fragile and uneven. Things will continue to get better for some customers, while others remain under economic stress, and we are doing all we can to help. For customers focused on their budget, we continue to offer low entry price points on key items, especially in our corporate brands portfolio.

If you look at our SNAP households during the fourth quarter, they increased their total monthly spending in our stores for each of the 3 months since the benefit reductions took effect compared to the prior year. What we saw play out in the fourth quarter was what we anticipated, that SNAP customers spent more of their own cash on food.

All of our customers are benefiting from our relentless focus on friendly service and fresh products, including our organic and natural foods and our own unique brands like Simple Truth. We have a lot of room to grow because the overall industry in which we operate in is expanding. We continue to improve our connection with customers across the entire spectrum. Whether value, mainstream or upscale customers, we are competitively positioned to deliver the right value proposition, and our customer insights help us to focus on the right opportunities for growth in each segment, so that we will capture more of the share of the massive food market.

Now I'll turn it over to Mike Ellis to outline our operational performance. Mike?

Michael L. Ellis

Thanks, Rodney. Good morning, everyone. We continue to have opportunity with our low customers because on average, we capture $0.50 of every $1 they spend on the products that we sell. This figure has remained steady due to the effect that new households have on this calculation. As we told you in December, our loyal household count has increased by an outstanding 83% over the past decade. We do, however, see incrementally more spending from our mature loyal households.

During the fourth quarter, we continue to grow the number of loyal households and at a much faster rate than total household growth, which was also up for the quarter. We continue to improve our friendliness, product freshness, shopping experience and price perception in our customers' eyes. As you know, we closely tracked these 4 keys against our competitors. What we have been tracking internally is consistent with the independent American Customer Satisfaction Index released last month, which reported steady improvement in Kroger customer satisfaction.

Inflation was low in the fourth quarter. We expect inflation to be low in 2014 as well, which is reflected in our identical store sales guidance for the year, which Mike Schlotman will talk about shortly. A key driver of growth is our commitment to Customer 1st innovation. As you know, we have done a lot of innovative things over the past couple of years to create unique competitive advantages for Kroger, like our faster checkout initiative. Each quarter, we will highlight one or more innovations that improve our connection with customers and improve our market share. This quarter, I will highlight corporate brands and digital.

Corporate brands continue to be leading differentiator for Kroger. We introduced 937 new products in fiscal 2013, including 100 new Simple Truth items. Simple Truth continues to grow at an astonishing pace, and we now expect it to reach $1 billion brand status by the end of fiscal 2014.

Corporate brands continue to gain market share during the fourth quarter, with corporate brands representing approximately 27.2% of total units sold and 24.4% of our sales dollars, including pharmacy and fuel.

We recently announced the exciting new acquisition of our digital coupon marketing provider, YOU Technology. We believe that YOU Tech has strong growth potential and will, over time, become the leading digital coupon provider for U.S. retailers, not just Kroger. YOU Tech has helped us reach another digital milestone recently. We began offering digital coupons in early 2010 and within 3 years, our customers had downloaded 500 million digital coupons. Customers download the next 500 million in only 14 months. In fact, at approximately 5:57 p.m. Eastern Time on February 6, a customer downloaded Kroger's 1 billionth digital coupon. It was an exciting moment for us and one that demonstrates the growth and customer acceptance of our digital efforts.

Now I will provide a brief update on labor relations. We're currently negotiating contracts in Cincinnati, Atlanta 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, 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 all of our associates. In fact, we added more than 7,000 jobs last year and more than 40,000 jobs over the last 6 years. Those numbers are even larger when you include Harris Teeter's more than 25,000 associates.

Now Mike Schlotman will offer more detail on Kroger's growth metrics and financial results, as well as our guidance for 2014. Mike?

J. Michael Schlotman

Thanks, Mike, and good morning, everyone. We exceeded our expectations for the quarter and the year, thanks to our associates performing to deliver growth. We continue to implement our long-term growth strategy, which includes targeting capital to grow our business in new and existing markets, leveraging customer insights to solve varied customer needs through both traditional and digital channels and continuing our share buyback program. As Rodney mentioned earlier, when we outlined our accelerated growth strategy at our October 2012 investor conference, we also identified 4 key performance targets for shareholders to measure our progress. I'd like to spend a few minutes discussing the results in each metric.

Our first metric is identical supermarket sales without fuel. We are very pleased with our fourth quarter ID sales growth of 4.3%. This strong performance was supported by ID sales growth in every department and every supermarket division. We continue to see outstanding double-digit identical sales growth in our natural foods department. Our produce and deli bakery departments also posted strong ID sales growth, highlighting our customers' continued demand for fresh products. Kroger's pharmacy department continues to outperform as well. Our ID sales results, in light of the slow economic recovery and low inflation throughout the year, are quite remarkable. Weather conditions across much of the country were a net positive as well. Our team's Customer 1st response to weather events kept our stores open and shelf stock, which coupled with our convenient locations, made Kroger more accessible for customers who flock to stores to stock up before winter storms.

For only 4 quarters adjusted FIFO operating margin, excluding fuel and the extra week, increased by 11 basis points compared to the adjusted fiscal 2012 result. This is a result above our commitment to grow the rates slightly over time on a rolling 4 quarters' basis.

The third target metric is return on invested capital. We reported a return on invested capital, excluding Harris Teeter, on a 52-week rolling 4 quarters' basis of 13.43% compared to 13.42% during the same period last year. As we told you, as we increase capital investments, it will be more difficult to grow ROIC in the near term. However, as these investments mature, we expect them to be accretive to ROIC.

Our fourth target metric is market share growth, which we report on annually. We look at market share the way customers would look at it, where they spend their money. In the past, we use Nielsen Homescan data as our source for market share. We're now using a different Nielsen product, Nielsen POS plus, which includes all point-of-sale data from several competitors and includes all departments inside our stores, except for pharmacy. We believe Nielsen POS plus is a good data -- is a good and consistent source. While POS plus does not include all of our competitors today, it covers -- captures roughly 85% of the items we sell, including most perishable items, which Nielsen Homescan did not include.

According to Nielsen POS data, Kroger's overall market share of the products we sell in the markets where we operate grew approximately 50 basis points during 2013. This data also indicates that our share increased in 16 of the 18 markets outlined by the Nielsen Report and was down slightly in 2 markets.

Walmart supercenters are 1 of our top 2 competitors in 13 of the 18 markets outlined in the Nielsen report. Kroger increased share in 12 of those markets and declined slightly in 1. The Nielsen POS data is generated by real retailers who report their sales to Nielsen. This includes food, drug, mass and dollar channels. This does not include C-store and club.

Now I'll share our fourth quarter results and fiscal 2013 results. Please note that Harris Teeter is included in the company's ending balance sheet, but because of the timing late in the year, it had no effect on our adjusted fourth quarter or fiscal 2013 earnings. If you remember last year, we gave you details to better understand how our core business performed. This year, we have similarly outlined our adjustments for fiscal 2013 and 2012 in Table 6 of our earnings release. The following results are all adjusted as outlined in Table 6 and exclude the effect of the 53rd week last year.

In the fourth quarter, our net earnings totaled $421.9 million or $0.81 per diluted share. Excluding the items outlined in Table 6, Kroger's adjusted net earnings per diluted share grew 10% to $0.78 in the fourth quarter. We recorded a $9.7 million LIFO charge during the quarter compared to $41.2 million credit in the same quarter last year. FIFO gross margin increased 11 basis points from the same period last year excluding retail fuel operations.

Operating, general and administrative costs plus rent and depreciation, excluding retail fuel operations, declined 16 basis points as a percent of sales compared to the prior year's adjusted fourth quarter.

Before I move on to discuss Kroger's full year 2013 results, I'll share some data on our retail fuel operations. About half of our supermarkets have fuel centers today. In the fourth quarter, our cents per gallon fuel margin was approximately $0.113 compared to $0.13 in the same quarter last year, after adjusting for the additional week. For the full year, the cents per gallon fuel margin was roughly $0.141 compared with $0.14 last year, again, after adjusting for the additional week.

Turning now to full year 2013 results, Kroger reported total sales of $98.4 billion in fiscal 2013, an increase of 3.9% after adjusting for the extra week last year. On this basis, and excluding fuel, total sales increased 4.2% over the prior year. Identical supermarket sales without fuel increased 3.6% in fiscal 2013 compared with the prior year. Net earnings for fiscal 2013 totaled $1.52 billion or $2.90 per diluted share, adjusted net earnings of $1.5 billion or $2.85 per share, a growth of 13%.

Kroger's LIFO charge for fiscal 2013 was comparable to fiscal 2012. Strong identical sales and cost controls allowed Kroger to leverage operating expenses as a rate of sales for the ninth consecutive year. In fiscal 2013, OG&A costs plus rent and depreciation without fuel and the extra week were down 24 basis points.

For 2014, our planned uses of cash remain unchanged, maintain our current investment-grade debt rating, repurchase shares, have an increasing dividend and fund increasing capital investments. Net total debt was $10.9 billion, an increase of $2.3 billion from a year ago as a result of the Harris Teeter transaction and due to the timing late in our fiscal year, we realized no incremental EBITDA in 2013 from this transaction. Therefore, Kroger's net total debt to adjusted EBITDA ratio was 2.43 compared to 2.04 during the same period last year.

Kroger remains committed to managing its free cash flow to achieve a 2 to 2.2x net total debt to EBITDA ratio over the next 18 to 24 months.

Capital investments, excluding mergers, acquisitions and purchases of lease facilities, totaled $2.3 billion for the year compared to $2 billion for 2012. For 2014, we expect capital investments to be in the $2.8 billion to $3 billion range, including Harris Teeter. As you know, part of our long-term growth strategy is to increase capital investments over time. This will take the form of adding square footage in markets where we believe our business model is already resonating with customers. With a better presence, we can grow our market share and return on invested capital. We continue to make good progress adding square footage in our fill-in markets, and we have identified others based on various metrics. Additionally, we continue to narrow our focus on markets where we do not currently operate, with the intention of selecting one to enter organically. In 2013, we opened the first stores under our new capital allocation strategy. It is still early, but we are pleased with their performance to budget and expect these and future stores will greatly support our growth plan.

During 2013, Kroger purchased 16.1 million common shares for a total investment of $609 million. Since the end of the fourth quarter and through the close of the market yesterday, Kroger has approximately $18.7 remaining -- $18.7 million remaining under the $500 million stock repurchase program announced in October of 2012.

Now I'd like to outline our specific growth objectives for fiscal 2014. Kroger anticipates identical supermarket sales growth, excluding fuel, of approximately 2.5% to 3.5% for fiscal 2014. This range takes into account the expectation of low inflation during the year and includes Harris Teeter.

Full year net earnings for fiscal 2014 are expected to range from $3.14 to $3.25 per diluted share. This guidance includes Harris Teeter. Growing fiscal 2013 adjusted earnings per diluted share of $2.85 by our long-term growth rate of $0.08 to $0.11 equates to a range of $3.08 to $3.16 per diluted share. We then added the net accretion to earnings from the Harris Teeter merger of $0.06 to $0.09 per diluted share, excluding transition in -- transaction costs, resulting in the 10% to 14% growth rate for fiscal 2014. As you think about early estimates for 2015, we would expect to return to our 8% to 11% long-term growth rate.

As we report earnings during 2014, we will not break out Harris Teeter results separately, which is consistent with our treatment of all supermarket divisions today. Shareholder return will be further enhanced by a growing dividend, and we expect Kroger's full year FIFO operating margin rate in 2014, excluding fuel, to expand slightly compared to adjusted fiscal 2013 results.

When looking at our cadence by quarter, we expect the first, second and fourth quarters to be within the 10% to 14% range and the third quarter to be above it.

Now I will turn it back to Rodney.

W. Rodney McMullen

Thanks, Mike. Being part of a growing retailer is exciting for our associates. 7,000 new jobs last year means not just new team members, but opportunities for our current associates to grow and advance as well.

Our business is strong. Our merger with Harris Teeter is going well, and our associates continue to execute our growth strategy. The remarkable consistency of Kroger's performance has shown time and again that serving our customers is serving our shareholders. I can think of no better example than our associates' dynamic response to the severe weather in many of our markets during the fourth quarter. Often, our logistics and distribution teams sped up deliveries to keep stores stocked several days before major storms. Most of our stores remained open even in the worst of the winter weather. In some cases, our associates even welcome stranded travelers in extreme freezing conditions to spend the night in one of our stores. Our customers trust that our -- their neighborhood Kroger will be open and stocked when it matters most, and we couldn't be more proud of the way our associates rose to the occasion.

Now we look forward to your questions. Glenn, you can go ahead and get questions started. Thank you.

Question-and-Answer Session

Operator

[Operator Instructions] And your first question comes from the line of John Heinbockel with Guggenheim Securities.

John Heinbockel - Guggenheim Securities, LLC, Research Division

I just wanted to start with a strategic question. You provided the market share performance and how you do against supercenters. I'm curious, how many neighborhood markets are you against today and what has the experience there been? And how do you think about competitively addressing that format, right, which is basically a supermarket format versus a supercenter?

W. Rodney McMullen

In terms of the specific numbers, I wouldn't have those. I don't know, Mike or Mike, if you have the specific numbers? Obviously, we have a lot of respect for everybody that we compete against. We would not look at a neighborhood store much different than a supercenter. And what we're really focused on is, obviously, our customer and serving our customers and making sure that we continue to improve the value, but we really don't see the effect much different. Part of it will depend on how close that neighborhood store is to a Walmart -- prior Walmart store as well, affected as well. And then, Mike, anything you want to add?

Michael L. Ellis

Well, we know that there's significant capital being allocated to the neighborhood markets, but as Rodney mentioned, one of our advantages really is our location. We're located within 2 miles of so many of our customers that and convenience and the variety that we offer, we feel comfortable where we're at today.

John Heinbockel - Guggenheim Securities, LLC, Research Division

And we don't know -- I mean, in the markets we -- over last week with supercenter and your gain in share, you don't know where that's coming from. So that could be coming from -- even a lot of that could be coming from fallout among traditional food retailers?

W. Rodney McMullen

That's correct, John. And we -- also, if you look at some of the additions that we're doing with natural foods, organic, things like that, so some of the gain in share would be that as well. So it's not just only other traditional supermarkets.

John Heinbockel - Guggenheim Securities, LLC, Research Division

Okay. And then, well, lastly, what do you think the impact is, in totality, right, the good and bad impact from ACA this year?

W. Rodney McMullen

I was -- we were looking at each other. When you look at '14, we really don't think at the end of the day it'll have a huge amount of effect in '14. Obviously, over time, it will have an increasing -- increasingly amount of effect. Whether that's a net positive or a negative, I think it's way too early, because obviously, on some pieces of it, it's a positive because it expands people's access to health care, which in our pharmacy business and our health care business is a positive. So I think it's way too early to tell you one thing or the other. We're working really hard to make sure that we try to minimize the effect on our associates as we transition to the new plans.

Operator

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

Meredith Adler - Barclays Capital, Research Division

I actually quickly like to follow up just on what you were talking about now, just to confirm that when you talk about the impact on your associates, it's only the nonunionized associates you're talking about, right?

W. Rodney McMullen

No. I mean, obviously, with the union plans, we will partner with the union and try to make sure that we minimize that effect, but it's much broader than just only our own health care plans.

Meredith Adler - Barclays Capital, Research Division

Okay. And then I just want to switch gears and talk about -- I know that you're investing a fair amount of money in North Texas, and that it does include not just building facility stores, but also lowering prices. And I was just wondering if you could talk more broadly about your strategy. I think this is an indication of the -- things you were talking about more broadly, but I wanted -- I just want to talk about why that market and how it's going and what is the new response to lower prices?

W. Rodney McMullen

If you look at the strategy itself, there would be lots of markets that we would have similar strategies in. It just happens that this one has a little -- it's a little higher profile than some of the others, and why that happens is always hard to say. As you know, overall, we remain committed to slightly improving our operating margins. And as we take costs out of the business, we partner with dunnhumby and figure out a way to give that lower cost back to the customers in ways that matter. And as you know, that's been our strategy for many years, and we continue to do that. And if you look at the things that we're doing in fourth -- that we did in '13, the things we're doing in '14, we're very pleased with the results we're getting, just like we have been for the last several years. I don't know, Mike or Mike, do you want to add anything?

Michael L. Ellis

No.

J. Michael Schlotman

No.

Meredith Adler - Barclays Capital, Research Division

Okay, that actually clarifies things somewhat. And then I'm going to ask a tough question, and I'm not even sure I should ask it. But would you do anything in the world of M&A that would substantially change your balance sheet or the tasks that you have to accomplish in the next couple of years?

J. Michael Schlotman

It's an interesting way to ask the elephant-in-the-room question, Meredith.

Meredith Adler - Barclays Capital, Research Division

I try to be interesting all the time.

J. Michael Schlotman

It just doesn't do us any good to comment on potential activity that's out there, so we'll just take the stance of no comment on M&A activity.

W. Rodney McMullen

That's one of the things. Meredith, the only thing I would add is just remember the model that we've outlined in terms of growing our business for our shareholders doesn't require any type of mergers to achieve. And if you think about the merger with Harris Teeter, the benefit that, that brought to our company, we actually increased the growth rate from the first year. In terms of specifics, I'm not going to get into any specifics.

Operator

And your next question comes from the line of Scott Mushkin, Wolfe Research.

Scott Andrew Mushkin - Wolfe Research, LLC

Meredith, you took my question. So I actually wanted to go to gross margins and a lot of our work is showing you guys priced very aggressively on some of these fast-turning items, probably more aggressively than we've ever seen you. Yet your FIFO gross margins are probably better than we would've expected and continue to push in the right direction. How are you doing this? I mean, one side of it, you're taking huge share, pricing is very aggressive. But on the other side, it seems like you've got some secret sauce here. And I just wanted to have any comments on how you're able to do this.

J. Michael Schlotman

The fourth quarter was a little different than everybody had seen and has expected from us. Clearly, pharmacy that we talked about in the prepared comments had a very strong year and was a good contributor to gross margin. It had a nice gross margin increase. Our mix in the fourth quarter was very strong. When you look at just gross margin, obviously, a lot of those fresh categories have a little bit higher overall margin than some of the center-of-the-store categories, so that mix can help. And certainly, the snow helped, as we made the comments on people coming in to stock up before weather events. Typically, when people go on a normal shopping trip, they shop off of their lists. When they come in to stock up before an event like that, they come in to stock up before an event like that, and they aren't really beholden to a list at that point in time. So I would say those 3 were the main drivers of what we saw in the fourth quarter, not necessarily something that's going to continue out into the future.

Scott Andrew Mushkin - Wolfe Research, LLC

Okay. Then I -- one other question about the guidance. I noticed -- I think you're down pretty low on your repurchase authorization. I think, Mike, you said about $18 million or something or $18 million, $19 million left. How much of the guidance of repurchase activity is contemplated in that guidance? I mean, should we expect a change, I mean, you're -- like you're almost done?

J. Michael Schlotman

Yes, a couple things on repurchase activity. We've been a regular buyer of our shares since January of 2000. There have been a few times when we've been out in the market, and most notably, around the White House work stoppage and then when we were blacked out as a result of the Harris Teeter negotiations. But other than that, we've generally been in the market almost all of the time and I would expect going into the future, we would continue to be in the market. Obviously, I don't have a lot of money left to do that with and our guidance, as we just talked about back in October of '12, in the early years of that growth model, it is an important contributor to our earnings per share growth, until those stores, as we talked about coming out of the ground beginning in 2013 start to mature, we will rely on some share buyback activity. To get any more specific than that -- I'm not going to go any more specific.

Scott Andrew Mushkin - Wolfe Research, LLC

So there is some of that contemplated in the guidance you put out?

J. Michael Schlotman

Yes.

Operator

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

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Great. I have 2 questions, let me try and attack the elephant a bit differently. Can you remind us in general what your requirements are or what attributes you look for when you do M&A? And my impression has been that you're not necessarily interested in what I would call turnaround stories that needs some price investment, but you'd rather buy a ready-to-wear asset like Harris Teeter. Is that a fair judgment still? Would you theoretically look at stores that need a little TLC if the price is attractive enough? Just on a general basis.

J. Michael Schlotman

Well, even when you look at -- let's just talk about the Harris Teeter transaction. The thing that was attractive about Harris Teeter as a transaction is that it's a well-run company that overall we admired a whole lot. That's not to say -- you only picked off price as an attribute that might need some TLC. What we have not liked over time is poorly run companies, not just one attribute of the company that might have an issue.

Kenneth Goldman - JP Morgan Chase & Co, Research Division

That's helpful. Can you maybe just add a little color on what poorly run means to you?

J. Michael Schlotman

We're getting close to just -- to asking the question. Poorly run just -- results aren't strong, cash flow is not strong, pick the attributes.

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Okay, I hear you. And then other question, can you talk a little bit about how happy you are with center store performance in general? And the reason I'm asking is the shelf's stable numbers that we're seeing from the manufacturing side, just very sluggish across the board except natural and organic and yet we're seeing specialty groceries, right, that focus on fresh, prepared, et cetera, do pretty well across the board. I walked down the aisles of Kroger and Safeway and SUPERVALU banners and I see a lot of meaningful space still being given to cereal, soup and categories in decline. I'm just wondering how long can that last, right? What would it take for you to take a more dramatic change to your in-store footprint, right, so you can replace some of that dry grocery shelving with some room for fresh, prepared, et cetera?

J. Michael Schlotman

Well, the core of our business is still a big part of our business. And when we look at space allocation, especially in some of our new stores, you'll find that we are allocating more and more space to perishable, refrigerated and the categories that the customer really cares about. The customer is telling us that's what they're interested in, but we can't ignore the center store and health and beauty care products and grocery that are still a big, big part of our business. But we constantly look at space allocation and make adjustments based on what the customer is telling us they want.

Kenneth Goldman - JP Morgan Chase & Co, Research Division

Okay, so no plans to sort of accelerate that shift in space?

J. Michael Schlotman

No, I think we're constantly looking at this, the allocation and making changes. If you get into our new stores, I believe you'll see some changes in mix.

Operator

And your next question comes from the line of Robbie Ohmes with Bank of America.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

I just had a few quick follow-ups. First, I just want to clarify, and you guys have probably explained it more than once, but so the SNAP reductions are actually supporting market share gains for you? Is that fair to say?

W. Rodney McMullen

Well, I wouldn't say it that way. What we're seeing is our SNAP customers continue to spend more money with us, and what they're doing is substituting SNAP dollars with their own cash or on debit or credit card. We believe -- if you look, overall, fuel prices are down to even, depending on what part of the period you're looking at. So we believe some of that has been funded by our SNAP customers spending less in other places and reallocating dollars. So I wouldn't make the direct connection the way you did. We're really focused on how do we make sure that we're giving the best value we can to that customer, along with all our other customers, and they're rewarding us by spending more money with us.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Got you. That's great. Second follow-up question, which is the weather and stock-up, any -- did you guys take a guess at quantifying how much that might have helped comps in the fourth quarter in gross margin?

J. Michael Schlotman

It's really difficult to say. When you look at weeks like that, clearly, it's a net positive when it winds up happening. But you have days that are up double the prior year and then you have a couple days after that, that are down significantly from the prior year. So it gets very, very choppy. Clearly, with the help, and as I said in the prepared comments or I said earlier in the -- to the gross profit question, the mix during those shops helps the gross profit rate because people come in, really, not with the list like they'd normally do, but they come in to have things deep for the next couple of days.

W. Rodney McMullen

Robbie, overall, was -- it was helpful, but we did -- when you look at the 2004 expectations, we grew that off of the actual '13, excluding any unusual items. So we did not adjust out that -- any weather benefit. But overall, we do think it was a net positive.

Robert F. Ohmes - BofA Merrill Lynch, Research Division

Got you. And then last question, I'll let you guys move to the next. Harris Teeter, I'm a personal fan of. I shop there when I'm down south. And is there any other -- you guys have talked about some of the things they do well that you might be able to bring into The Kroger store base. Anything since we last did a conference call that you can update us on?

J. Michael Schlotman

Robbie, it's -- the merger ultimately closed January 28. So it's only been a handful of weeks since we've actually been able to roll up our sleeves and have the kind of conversations you want to have when you start integrating a company. That said, we've made a lot of progress in those 6 or so weeks since the merger's been closed. Clearly, one of the things we like is that about -- a little over 160 of their stores, they have what -- it's called Express Lane, we call it click and collect. That's something that intrigues us as -- it's an internet but pick-it-up yourself kind of a process at the store that appears to appeal very strongly to their customer. That's something we'll try to learn from. But it's been a very positive and we're very happy with the start we've had to the integration progress with Harris Teeter. And any surprise that we've seen has been a positive, not a negative surprise, which is always nice.

Operator

And your next question comes from the line of Greg Hessler with Bank of America.

Gregory Hessler - BofA Merrill Lynch, Research Division

So my question is with the Harris Teeter acquisition, it kind of brought you back into the M&A market where you've been absent for a number of years. And I know you can't comment on market rumors, but internally, has there been any sort of shift or change in the way that you'd look at M&A opportunities?

J. Michael Schlotman

No, I'd say it's consistent with how we've always done it. And also, as I said in my prepared comments, our investment-grade rating is important to us and we continue to expect to allocate free cash flow to maintain our rating.

Gregory Hessler - BofA Merrill Lynch, Research Division

Okay. And I think with the Harris Teeter acquisition, you sort of temporarily went above that 2 to 2.2x net leverage target. I mean, how much flex do you feel like you have within the investment-grade rating band? And would you be able -- or would you be willing to even go maybe a little bit higher than that for the right strategic opportunity?

J. Michael Schlotman

Yes -- I'm not going to comment on that. And obviously, the only reason -- the reason we're above the 2.2x on Harris Teeter is the shareholders won't wait a year to get their check for the purchase of their shares. They want that upfront. We don't get a year's worth of EBITDA until the end of the year. So it's really just the fact we have all the debt and none of the EBITDA now, and we feel very good about our ability to get back under 2.2x in the time frame we outlined to the rating agencies.

Operator

And your next question comes from the line of Karen Short, Deutsche Bank.

Karen F. Short - Deutsche Bank AG, Research Division

A couple of questions just on your guidance. What is your -- in guidance, specifically. What is your guidance and planned D&A, as well as interest expense? It seems like -- I mean, we can kind of calculate interest expense or incremental interest expense related to Harris Teeter, but D&A was a little bit of a wildcard. So any color there?

J. Michael Schlotman

Obviously, from the write-off of the assets for Harris Teeter, the amortization of that will pick up. I don't have that in front of me, and I prefer not to go giving guidance on every line of the income statement. I might as well just hand you my business plan and let the whole world have it, which I think we give as much or more guidance than anyone. So you should be able to back into it just based on the public guidance we've given of what our earnings per share is and the number of lines we've given you.

Karen F. Short - Deutsche Bank AG, Research Division

Okay. And then looking at your MEPP guidance for 2014, I think it reflects kind of an 11% increase in the expense. Any color on why that increase is so high. That just seems high to me.

J. Michael Schlotman

The contributions into the plan?

Karen F. Short - Deutsche Bank AG, Research Division

Yes, the $250 million?

J. Michael Schlotman

It's just our expectation. There are some funds in rehab status that -- one of the ways you get out of rehab status is you put a little bit more money in, benefits come down a little bit and over time, it's an attempt to try to get them in a better funded position. It's -- while the percentage is fairly strong, it's not that much incremental cash that we're expecting next year.

W. Rodney McMullen

And it would be something that we'll work with the unions on to make sure that we try to get those funds in a status that's sustainable over time. And it would be an ongoing negotiation and relationship in terms of the balance between what money we spend on pension, what money we spend on health care and what we're able to do on wages. So it's really all together.

Karen F. Short - Deutsche Bank AG, Research Division

Okay, that's helpful. And just on your investment-grade ratings, getting back to that 2x to 2.2x, I guess what I'm confused about is why wouldn't they be looking at the pro forma number regardless in terms of your investment-grade rating [indiscernible] they are?

J. Michael Schlotman

Yes, I believe the rating agencies do that, which is why they did not downgrade us when we announced the merger. Obviously, the conversations were -- with them were our commitment to get it back down there based on a pro forma calculation you do for them, and that's what they got comfortable with. So from the rating agency standpoint, they would look at it that way. But from the number I have to report, my number is my number.

Operator

And your next question comes from the line of Chuck Cerankosky with Northcoast Research.

Charles Edward Cerankosky - Northcoast Research

Could you touch on a couple of categories in particular about how they did during the quarter, one would be general merchandise, especially at Fred Meyer and then prepared foods, please?

Michael L. Ellis

Yes, general merchandise, it was such an interesting holiday season with 6 less selling days between Thanksgiving and Christmas. And predicting our business and building our business plan around that was certainly -- it doesn't happen very often. But overall, the season came out pretty decent. It wasn't as different as we would've thought it would've been. I think we actually came out okay when you figure the changes in by Friday, the differences in the calendar and everything else that occurred. And so in general, I would say it came out okay. Jewelry, for example, for us, had a really stellar quarter, and general merchandise was fairly decent. I mean, I would say it came out okay. But in terms of -- what was the other question, prepared food?

W. Rodney McMullen

Yes -- and overall, it turned out better than we were expecting when you think about 6 less days and the economy and especially some of the weather in parts of the countries. But overall, we felt pretty good about it, prepared goods. Go ahead, Mike.

J. Michael Schlotman

Prepared foods continue to be a growing section of our business for us, so we're committing more and more space and better products all the time to those types of departments and items. So I wouldn't say there's anything really unusual when it comes to prepared food.

Charles Edward Cerankosky - Northcoast Research

All right. And finally, can you give us an update on sales trends, thus far, into the first quarter?

Michael L. Ellis

Obviously, it's very early in the quarter. Right now, we would be a little bit better than the high side of the range, but it's still very early, and we believe the weather has been a positive so far. As we've mentioned, as Mike mentioned in the prepared remarks, when you look at the year as a whole, we expect inflation to be reasonably modest throughout the whole year. But so far, so good.

Operator

And your next question comes from the line of Stephen Grambling with Goldman Sachs.

Stephen W. Grambling - Goldman Sachs Group Inc., Research Division

You did mention the innovation in digital on the YOU Tech acquisition. So can you actually maybe describe some of the synergies that come from that acquisition, what they are maybe bringing to the table that you didn't have already and just the contribution you're expecting there over the next, call it, 5 years?

Michael L. Ellis

Well, I'm not really so sure I can comment on synergies, but we do like what YOU Tech brings to us in terms of the technology and our ability to serve up coupons for our customers in a really meaningful way. And you couple that with dunnhumby, and we think that this really gives us a great platform to communicate better with our customer and provide them both technology and the coupons that they're looking for today. Because a customer can redeem coupons simply by taking their loyalty card into the store and scanning it, and they're receiving the things they want most and getting discounts on those items.

Stephen W. Grambling - Goldman Sachs Group Inc., Research Division

When I said synergies, I guess, I meant qualitatively. And I guess, the follow-up would be, as you look at developing this yourself versus making this acquisition, is this just the way to jumpstart moving to maybe even integrating some of the customized coupons to the customer?

Michael L. Ellis

Yes, well, it certainly helped us move faster. And the relationship with YOU Technology has moved us along a lot quicker than we probably would've done on our own.

J. Michael Schlotman

Yes, there's multiple levels to it, Stephen. When you talk about customized coupons, today, all of the digital coupons that are out there, there's a sort feature on The Kroger app that allows you to sort those coupons based on the relevance to you of how you shop and what you buy. So rather than having to search through all the coupons that might be attractive, the app basically does that for you based on how you actually buy product.

Stephen W. Grambling - Goldman Sachs Group Inc., Research Division

Great. And then I have a quick follow-up to I think it was Ken's question. And you had mentioned last quarter that you would expect the margin on natural organic items to converge over time with conventional. And as I think initially, it may have been viewed as maybe reduction in margin on those items, but given the consolidation in the space and your reallocation of the natural organic to be a little bit greater versus the center store, is there any reason to see the margin maybe even go up on the conventional items over time?

W. Rodney McMullen

It's a good question. I think it's pretty hard to say. We would not expect that as a general rule and we're really focused on figuring out ways to give the customer better and better deal.

Operator

And your next question comes from the line of Mark Wiltamuth with Jefferies.

Mark Wiltamuth - Jefferies LLC, Research Division

So Cerberus is one of the parties reportedly looking at Safeway. If you look at their behavior after their acquisition of the Supervalu banners, would you say they were more or less disciplined on price? And how is their behavior in the marketplace as a competitor after the move there?

W. Rodney McMullen

Obviously, in terms of a lot of specifics, we won't be able to give you that. But we look at Cerberus and Albertsons as a very good competitor, and we're really focused on what does our customer want and then how do we get better about delivering against that. They're a good competitor, but there's a lot of good competitors out there. So probably a little more focused on the basics every day, but I wouldn't say it's appreciable different.

Mark Wiltamuth - Jefferies LLC, Research Division

Okay, so you didn't see any C-change in pricing strategy or anything like that as they shifted there?

W. Rodney McMullen

No, not to the extent that you would think. It was a completely different person before. They do a better job on the basics. They also will consolidate stores. They ended up selling off some stores, things like that, but it's -- every transaction is different.

Operator

And your next question comes from the line of Todd Duvick with Wells Fargo.

Todd Duvick - Wells Fargo Securities, LLC, Research Division

Just looking at cash flow for 2014, can you tell us after the Harris Teeter acquisition, whether or not you expect working capital to be either a use or a source of cash? And can you give us kind of an order of magnitude?

J. Michael Schlotman

Yes, we continue to do a really good job on our working capital usage. If you look at the consolidated balance sheet, the way we look at it, and it's the balance sheet with Harris Teeter combined into it. We had just about $75 million or $80 million reduction in working capital overall for the year and we still have plans in place of things that we think could continue to improve that. We wouldn't budget in dramatic improvements and have that in expectation of as a source of cash, but we would expect to have some benefit from it.

Todd Duvick - Wells Fargo Securities, LLC, Research Division

Okay, that's helpful. And then I think you also indicated that you expect to contribute about $250 million to the multiemployer pension plans this year, and I assume that includes Harris Teeter. Can you confirm that? And can you tell us if there are multiemployer pension -- I guess, obligations were materially larger than your overall obligations?

J. Michael Schlotman

Harris Teeter is not a party or not a member of any of the multiemployer funds. They're 100% employee choice. So I guess, that would be total company, the contributions, but none of it has reflected the result of the merger with Harris Teeter.

Operator

And your next question comes from the line of Edward Kelly with Crédit Suisse.

Edward J. Kelly - Crédit Suisse AG, Research Division

Mike, my question for you is on CapEx. I don't think it was asked. But your guidance, Mike, looks like it calls for about, I don't know, maybe a $600 million increase in CapEx. I think Harris Teeter, based on what they've shown historically, could be a couple hundred of that. And you know what, obviously, your longer-term guidance was an additional $200 million a year. So could you just kind of help us understand where the increase in CapEx is coming from?

J. Michael Schlotman

Sure. If you go back to our December call, we were projecting a point estimate of $2.4 billion for this year. We came in at $2.3 billion. Some of that is just a little delay on some projects that caused it to be a little behind where we expect it. We would expect that catch-up to happen in 2014. So if you think about 2014 going off of a $2.4 billion base, the $200 million increase that we would've expected on an annual basis would get you to $2.6 billion. And then adding in the activity for Harris Teeter, which will probably be a little higher than the number you used, may continue to have some attractive opportunities and their own forecast would have had their CapEx continuing to grow because they were growing their company. That's really how we got the build up to $2.8 billion to $3 billion.

Edward J. Kelly - Crédit Suisse AG, Research Division

Okay. And then as we think about sort of beyond this maybe like '15, I -- we probably shouldn't throw $200 million on top of '14 number because of the catch-up, I guess, is how to think about it.

J. Michael Schlotman

It's a little early to give 2015 guidance, but for planning purposes at this point, I would be thinking about another $200 million internally.

W. Rodney McMullen

And Ed, the thing we're really focused on, and Mike mentioned it in his prepared comments, is the incremental capital we're spending, what returns are we getting for that and what's our ability to execute at that higher level because obviously it creates jobs and we have to find associates to staff those stores and run those stores. And as long as we're feeling good about being able to help develop our associates to run the stores and their performance continues to be strong, we would continue to expect to continue to increase capital.

J. Michael Schlotman

And as we said, we're coming close to picking a market to go into organically, which will take some capital as well.

Edward J. Kelly - Crédit Suisse AG, Research Division

And just a follow-up on that, Mike and Rodney, when you think about a new market, what are the dynamics that you're really sort of looking for to make that decision in terms of where you ultimately go?

J. Michael Schlotman

Well, we look at a wide range of topics, including the competitive landscape. We look at where the market may be situated compared to our existing infrastructure. It would be very nice if it winds up being a market that our current logistics and manufacturing systems can supply product to them, again, the dynamics of the market, not just the competitive landscape, but the growth that you see in a potential market. And then some customer research of what it is the customer wants from a grocery retailer and how we have been able to perform against that over time in the markets where we already operate. So it's a very long list of things. Those would be amongst the bigger.

Operator

There are no further questions. I will now turn the call over to Mr. Rodney McMullen for closing remarks.

W. Rodney McMullen

Thanks, Glenn. Before we end the call, I'd like to share some additional thoughts with our associates listening in today. First, I'd like to welcome our Harris Teeter associates to The Kroger family. We couldn't be happier. I'd also like to thank our associates for your hard work in connection with our customers. We finished 2013 strong because of your hard work to provide friendly service and fresh products to every customer every time, every day. You also helped keep costs under control so we can reinvest the savings in things that matter most to our customers. They are taking note of your efforts and giving us credit for making a difference. Special thanks to each and every one of you for all you do for our customers and each other.

This week, we will host our third annual associate recognition event in Cincinnati. Our 33 associate honorees come from across the company, including our retail divisions, fee stores, manufacturing and logistics facilities, Fred Meyer Jewelry, the Little Clinic and general office. They will be recognized during this 2-day event for their friendly service, strong leadership, dedication to their community and courage in the fight against cancer.

Finally, I'd like to say thank you to our Chairman, Dave Dillon, for his leadership and the powerful foundation he and our team have put in place. I am humbled to be serving as your CEO and excited to work with our outstanding leadership team. We're not done serving our customers, growing our business and performing for shareholders. Indeed, we're just getting started. That completes our call for today. Thanks for joining us, and thank you for all you do to partner with Kroger.

Operator

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