The Kroger Co. (NYSE:KR) Q3 2014 Earnings Conference Call December 4, 2014 10:00 AM ET

Executives

Mike Ellis - President, COO

Rodney McMullen - CEO

Mike Schlotman - CFO, SVP

Analysts

Karen Short - Deutsche Bank

Steve Forbes - Guggenheim Securities

Judah Frommer - Credit Suisse

Vincent Sinisi - Morgan Stanley

Rupesh Parikh - Oppenheimer

Scott Mushkin - Wolfe Research

Mark Wiltamuth - Jefferies

Stephen Grambling - Goldman Sachs

Kelly Bania - BMO Capital Markets

Chuck Cerankosky - Northcoast Research

Ajay Jain - Cantor Fitzgerald

Stacie Rabinowitz - ConsumerEdge Research

Andrew Wolf - BB&T Capital Markets

Operator

Good morning, and welcome to The Kroger Company Third Quarter 2014 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today’s presentation there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

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

Cindy Holmes

Thank you, Emily. 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 third quarter press release, which includes a reconciliation of certain non-GAAP measures discussed today and our prepared remarks from this conference call will be available on our Web site at ir.kroger.com. After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question and one follow-up question, if necessary.

Thanks again to those who participated in our October Investor Conference, in person or via Webcast. We appreciate that many of you made the trip to Cincinnati and, as always, we enjoyed the dialogue and the opportunity to show you our stores.

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

Rod McMullen

Thank you, Cindy, and good morning, everyone, and thank you for joining us today.

With me to review Kroger's third quarter 2014 results are Mike Ellis, Kroger's President and Chief Operating Officer, and Mike Schlotman, Senior Vice President and Chief Financial Officer.

Kroger continues to deliver consistently remarkable results. We are well on our way to achieving our 10th consecutive year of lowering costs and reinvesting those savings in our people, products, pricing and improved store experience, which together are driving our growth. Few can deliver this level of sustainable high performance. After a while, it can be easy to take this consistency and reliability for granted. So it's important to keep in mind that these results are possible only because 375,000 associates engage with our customers every single day.

Our associates delivered yet another quality quarter of inspired customer-first performance. We continue to implement our growth strategy and consistently deliver on the key performance indicators we first outlined in October 2012. In the third quarter, we achieved our 44th consecutive quarter of positive identical supermarket sales growth excluding fuel. We exceeded our goal to slightly expand FIFO operating margin without fuel on a rolling four-quarter basis and we continued to gain market share.

Our third quarter financial results were driven by strong sales and core business performance, which was better than we expected. Higher fuel margins drove our results above our previous guidance range.

Our guidance range for the full year assumes fuel margins will not be as strong in the fourth quarter as they were in the third quarter. Mike Schlotman will have more to say about our supermarket fuel operations in a few minutes.

How our customers are doing today depends on the stability of their family finances. Overall, our customers continue to spend a little more, as confidence in the economy improves over time. While inflation is apparent in certain commodities, fuel prices have been going down, which helps all customers, especially those on a budget. We try to help those customers stretch their food budget in a variety of ways. Our weekly promotions and fuel rewards help, along with price investments. We continue to make natural and organic foods affordable and accessible to all customers, especially with Simple Truth.

Our expansive corporate brands offering is resonating with customers seeking high-quality food at very good prices. In fact, our corporate brands had their best performance in several years in the third quarter. Our ability to deliver this combination of value sets us apart.

Now, I will turn it over to Mike Ellis to discuss our operational performance in the third quarter. Mike?

Mike Ellis

Thanks, Rodney. Good morning, everyone.

During the third quarter, we continued to grow the number of loyal households and our loyal household count grew at a much faster rate than total household growth, which incidentally was also up for the quarter. Loyal household growth is an important measure of our business because it lets us know how well we are connecting with our best customers.

Inflation increase in the third quarter as Rodney mentioned among commodities such as meat and pharmacy, an increased to a lesser extent in all other supermarket departments. As Mike Schlotman will discuss shortly, we raised our LIFO charge estimate for the year again this quarter due to the higher than expected inflation.

We estimate inflation was 3.5% excluding fuel for the third quarter. Even so, we saw strong tonnage growth in the third quarter compared to last year and in fact, it was slightly ahead of the second quarter's unit growth.

Corporate brands had an outstanding third quarter, representing 27.3% of total units sold and 25.8% of sales dollars, excluding fuel and pharmacy. In fact, corporate brands experienced its highest sales growth and total retail dollar share of any quarter in the last three years. Clearly, our rebranded opening price point and Kroger banner brands are a hit with our customers.

Simple Truth and Simple Truth Organics continued to earn double-digit unit and sales growth. A key driver of Kroger's sustainable growth is customer-first innovation. For the past few quarters, we have been highlighting innovations that are improving our connection with customers. This quarter, I will highlight some of the new and exciting work of our manufacturing team in the dairy department.

We recently opened a state-of-the-art dairy processing plant in Denver. We built and engineered the plant to deliver exceptional quality and freshness for our customers and to provide an avenue for innovation in the dairy category. We incorporated new technologies for our customers that ensure our milk will stay fresher longer than ever before. We are the first dairy in the U.S. to deploy robotic technology that enables us to pack cases and pick and palletize orders entirely by automation.

Another innovation that this dairy will bring is the ability for us to produce long shelf life products to meet growing demand for aseptic products and packaging. The dairy, our first ground-up manufacturing plant of any kind in 20 years, opened in May and began full production of fresh milk in August. We have been producing fresh milk, organic milk, juices and drinks and customer response has been very, very positive.

Now, I would like to give a brief update on labor relations. We recently completed several successful contract negotiations covering Smith's Associates in New Mexico, Fry's and Smith Associates in Arizona, Food 4 Less Associates in Southern California and Kroger Associates in Toledo, West Virginia and the Ohio Valley. We are currently negotiating with the teamsters covering several distribution and manufacturing facilities.

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 healthcare and retirement benefits for our associates. Kroger's financial results continue to be pressured by rising healthcare 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 profitably, which will help us create more jobs and career opportunities and enhance job security for all of our associates.

Before I turn it over to Mike Schlotman, I would like to thank our associates for the impressive quarter. Once again, you showed our customers how much we care about them and each and every day you continue to deliver. Because of your efforts, we are able to continue investing in our products, lowering prices, and improving the shopping experience in ways that generate customer loyalty.

Now, Mike will offer more detail on our financial results and our guidance for the remainder of the year. Mike?

Mike Schlotman

Thanks, Mike, and good morning, everyone. As you know, when we outlined our growth strategy in 2012, we identified the key performance targets for our shareholders to measure our progress. I would like to spend a few minutes discussing the results in each metric. Our first metric is identical supermarket sales without fuel. Identical sales performance is the best measure of our growing connection with customers over time. We are very pleased with our third quarter ID sales growth of 5.6% without fuel. This strong performance was supported by ID sales growth in every supermarket department and division, and our natural foods department continues to lead with double-digit growth.

Rolling four quarters FIFO operating margin excluding fuel and adjustment items expanded by 9 basis points. This exceeded our goal to slightly expand

FIFO operating margin without fuel on a rolling four quarters basis. We are not reporting our third metric, return on invested capital this quarter, because the calculation would actually overstate our result. We expect our year-end return on invested capital, which will fully reflect Harris Teeter in our calculation, to be similar to our return on invested capital at the end of fiscal 2013.

Now I'll share the rest of our third quarter 2014 results in more detail. Please note that this quarter includes Harris Teeter and Kroger's consolidated results of operations. Year-over-year percentage comparisons are affected as a result. In the third quarter, our net earnings totaled $362 million, or $0.73 per diluted share. This includes a $0.04 benefit in the third quarter due to certain tax items. Excluding these items, Kroger's adjusted net earnings were $345 million or $0.69 per diluted share for the third quarter.

We view these tax benefits as non-recurring, so as you begin to think about 2015, please note that we will not be growing off of that next year. Net earnings in the same period last year were $299 million, or $0.57 per diluted share. Last year's third quarter net earnings per diluted share benefited from certain adjustments totaling $0.04 per diluted share. Excluding these adjustments, last year's third quarter net earnings were $0.53 per diluted share.

We recorded an $85 million LIFO charge during the quarter compared to a $13 million LIFO charge in the same quarter last year, resulting in an incremental $0.09 per diluted share charge to net earnings in the third quarter compared to the same quarter of last year. We began fiscal 2014 estimating the LIFO charge for the year at $55 million. At the end of the first quarter, we increased our LIFO guidance to a charge of $90 million and at the end of the second quarter; we increased our LIFO charge estimate for the year to $100 million.

As reported this morning, we have again increased our LIFO charge estimate for the year to $180 million. FIFO gross margin decreased 2 basis points from the same period last year, excluding retail fuel operations.

Operating, general and administrative costs, plus rent and depreciation, excluding retail operations and the adjustment items decreased 21 basis points as a percent of sales compared with the prior year as a result of good expense control and strong sales leverage.

Now, for retail fuel operations. In the third quarter, our cents per gallon fuel margin was approximately $0.232 compared to $0.171 in the same quarter last year. This does not include debit and credit card fees. Last year's third quarter margin was well above historical averages, which means this quarter's margin performance was remarkable. Our long-term financial strategy continues to be to maintain our current investment grade debt rating, repurchase shares, have an increasing dividend, and fund increasing capital expenditures.

Achieving a 2 to 2.2 net total debt to adjusted EBITDA ratio by mid to late 2015 remains a key objective. Kroger took on debt to finance the Harris Teeter merger and has not yet realized a full year of Harris Teeter EBITDA. As a result, the company's net total debt to adjusted EBITDA ratio increased to 2.29 as of the close of the third quarter compared to 1.86 during the same period last year as described in Table 5 of our press release. This is an improvement from the 2.33 reported last quarter.

Kroger's net total debt is $11.5 billion, an increase of $3.4 billion from a year ago, including the debt related to Harris Teeter transaction and Kroger's share repurchase program. Kroger's strong financial position allowed the company to return more than $1.8 billion to shareholders through share buybacks and dividends over the last four quarters. During the third quarter, Kroger repurchased 600,000 common shares for a total investment of $29 million. All $500 million of the buyback authorization granted in June remains available.

Capital investments excluding mergers, acquisitions and purchases of lease facilities totaled $681 million for the third quarter compared to $641 million for the same period last year. We expect capital investments to be at the low end of the $2.8 billion to $3 billion range, including Harris Teeter for fiscal 2014.

Now I would like to review our updated growth objectives for fiscal 2014. Based on our strong third quarter results, we raised and narrowed our adjusted net earnings per diluted share guidance to a range of $3.32 to $3.36 for fiscal 2014. The previous guidance was $3.22 to $3.28 per diluted share. For the fourth quarter of fiscal 2014, Kroger expects identical supermarket sales growth excluding fuel of approximately 4% to 5%. We acknowledge this is a wide range for one quarter and we are seeing great strength and momentum at the start of the fourth quarter, but this year's fourth quarter is difficult to project narrowly because of the uncertainties relative to a year ago, including the positive effect that weather had on our identical supermarket sales during last year's fourth quarter.

As you start to think about fiscal 2015 estimates, we encourage you to build your models based on fiscal 2014 adjusted results, which excludes certain tax benefits and charges related to the restructuring of certain pension plan agreements. The fuel margins return to historical levels, we expect 2015 results to be closer to the low end of our long-term net earnings per diluted share growth rate guidance of 8% to 11%, and shareholder return will be further enhanced by a dividend expected to increase over time.

Now, I'll return it back to Rodney.

Rodney McMullen

Thanks Mike. Our third quarter performance is further evidence that Kroger is improving our connection with customers and delivering growth for our shareholders. We continue to increase capital investments, which creates exciting opportunities for our business and for our associates. We enjoy discussing several of those opportunities with you during our Investor Conference in October.

Our positive momentum is expected to carry through the fourth quarter and sets us up well as we look to 2015. More importantly, Kroger's to-do list remains longer than our done list. There is a lot more to come.

Now, we will look forward to your questions.

Question-and-Answer Session

Operator

Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question is from Karen Short of Deutsche Bank. Please go ahead.

Karen Short

Hi. Thanks for taking my question.

Rodney McMullen

Good morning.

Karen Short

Great quarter.

Rodney McMullen

Thanks.

Karen Short

Couple of questions regarding your guidance and then I guess also this quarter. So obviously, gas margins more than offset the higher LIFO charge this quarter and this year has been an incredible year from an earnings growth perspective. But I guess what my question's looking to next year, Mike; you talked about the lower end of the range of earnings growth. And I understand you're coming off of a very strong year. So my question for this current year is, was the strength more in overachieving on the Harris Teeter accretion side or was it brought broad-based across the core and Harris Teeter?

And I guess that would lead me to if it was broad-based across or if it was more Harris Teeter-related, that explains why you might be at the lower end of the 8% to 11% next year. But if it was broad-based across Harris Teeter and the core, are you just being conservative for next year, even though this year was incredibly strong?

Mike Schlotman

Wow. Like three or four questions in there. Which way do I go with the answer? Well, fundamentally, this has been a very strong year across the board for us. With the ID sales that we've had so far this year, and ID – positive ID sales in every department and positive ID sales in every geography, our core businesses is performing extremely well. It's not just incremental accretion from Harris Teeter. It's strong results from all of our core operations.

The primary reason for the conversation about being at the low end of 8% to 11% for next year is solely where fuel is at $0.23 for the quarter and really the last two quarters have been well above historical averages, with the amount of fuel gallons we sell in that kind of outperformance on historical fuel margins, we just want people to be aware as they start thinking about 2015 of that potential headwind. If you were to kind of take the business apart and look at our core operations for 2015, they would perform extremely well inside the 8% to 11% range and it's really just a headwind from a potential lower fuel margin per gallon for next year.

Karen Short

And is it fair to say that Harris Teeter has come in slightly better than expected for the year so far?

Mike Schlotman

I would characterize Harris Teeter as performing how we expected them to perform. As has been widely publicized, they have not been shy about advertising it. We've made the price investments in their business that we expected to make during the year. The customers are responding to those price investments. And I would characterize Harris Teeter as right on track with what our expectations would be relative to our overall guidance for the year.

Rodney McMullen

The Harris Teeter team has done a nice job running their own business, but the other thing is they have been incredibly helpful, helping teach all of Kroger some ideas as well. So it's been great so far and the synergies are moving along as we expected as well.

Karen Short

Okay. And then just last question on next year's earnings growth, what's embedded in terms of share buybacks?

Mike Schlotman

We'll give full guidance in March. We just know that at this time of the year with three quarters behind us, clearer fourth quarter guidance, since we only have one quarter left, people start to refine their 2015 estimates and we just wanted to give some insight of our view of a percentage growth rate and where we would expect to fall in that range, as you all start to prepare your estimates for 2015 we'll refine those estimates.

But we'll wait until we give full guidance in March. We feel we've gone far enough with the EPS because our Board has its annual business plan review meeting in January and it's probably better served to let them approve our business plan for next year before I give you too many lines.

Karen Short

Great. Congratulations. Thanks.

Mike Schlotman

Thanks.

Rodney McMullen

Thanks, Karen.

Operator

Our next question is from John Heinbockel of Guggenheim Securities. Please go ahead.

Steve Forbes

Hi, guys. It's actually Steve Forbes on for John today.

Rodney McMullen

Hi, Steve.

Steve Forbes

Regarding gas, so we've historically found it difficult to find any real correlation between gas prices and comps. What are you seeing during the most recent period of these declines? I know you briefly touched on it before, but is there any particular region to call out? You mentioned the lower end consumer. Is there any demographics that you can expand on as well?

Rodney McMullen

If you look at our own numbers, we would have difficulty finding some of the same correlations. When gas prices go up, our fuel Reward Program has a little bit more strength. As gas prices go down, people have more money to spend. So as you know, when we look at fuel, we just look at one more service that we're offering the customer and one more reason to come to Kroger. The comments that we made, that Mike and I both made, we continue to see improvement in the economy. It's slow, but it's going in the right direction. And it's really across all customers, but if you look at main stream and up, those customers have fully recovered. The customers that are on a budget are improving, but it's much slower and more constrained.

Steve Forbes

Okay. And then just on the deployment of these windfalls is there – I'm sure there's thoughts around how to invest these benefits, but do they occur too quickly in order to appropriately plan for the deployment? Or is it just better to let it flow through to the bottom line? How do you guys think about these one-time or short-term benefits?

Rodney McMullen

Well, if you look at like the tax settlements and stuff, we just let those, for the most part, be when they are and we just disclose it to let you know what it is. And it flows to the bottom line, but it's one-time. If its things that we think are things that are sustainable, those are the things that we would look at in terms of continuing to invest in the business, from a service standpoint and a price standpoint.

But it's – as you mentioned, it's always a balance between those two pieces and we are always focused on what's going on in the marketplace and what do we think is the best use of that opportunity when it happens. So it doesn't answer your question directly because the answer is actually different, depending on what we see the opportunities to be.

Steve Forbes

Okay. Thanks, guys.

Rodney McMullen

Thanks, Steve.

Operator

Your next question is from Judah Frommer of Credit Suisse. Please go ahead.

Judah Frommer

Good morning, guys. Jude on for Ed. You mentioned in the release and also on call the kind of rolling four-quarter ex-fuel operating margin being a little bit stronger than you expected it to be. Is that a way of saying you would have liked to maybe invest more in price or how should we kind of translate that?

Mike Schlotman

I don't think it's a reflection of having, wanting to invest more in price. It's really a reflection of having Harris Teeter in for a portion of the year and not all year compared to results last year that didn't have Harris Teeter in the numbers. And I would say that's the same thing for the – just the couple basis-point decline and the gross margin number I talk about.

If you were to strip Harris Teeter out of the prior year, you would have seen a much, a much bigger amount that we have invested in price to continue to give value to our customers. But it's really the fact that their historical numbers have been higher than ours and it's the meshing of those together that's driving some unusual comparisons. We have continued right on track with what our expectations were for investment in all four keys of our customer-first strategy, not just price, but the people, the products, and the shopping experience as well, and continue to be very pleased with the reaction our customers have for those investments.

Judah Frommer

Okay, thanks. And if I could just sneak one more in there, maybe shifting gears on natural organic, it sounds like it's still comping really well. You've mentioned in the past maybe eventually seeing some margin compression in the category and now that you have one of the bigger players in the space with the national ad campaign, now they are highlighting value, have you seen anything in kind of the near-term on margins there?

Mike Schlotman

I haven't really seen margin pressure overall. We continue to invest in price where we feel appropriate and the customer really drives our pricing strategy for the most part. But, you know, again, we had strong sales growth and double-digit growth, natural organics and if you go back to our Simple Truth brand, we'll hit a billion dollars this year and we're really proud of that and what it's contributing.

Judah Frommer

Okay, thanks.

Rodney McMullen

Thanks.

Operator

Our next question is from Vincent Sinisi of Morgan Stanley. Please go ahead.

Vincent Sinisi

Hi. Thanks very much for taking my questions and very nice quarter.

Rodney McMullen

Good morning. And thank you.

Vincent Sinisi

I also wanted to ask a bit more on the natural organic. Obviously, Simple Truth continues to perform very well. But can you also give us a little color on how some of the other categories and products within natural organic are doing and maybe touch upon also some of the Vitacost products?

Mike Ellis

Well, in natural foods, the expansion of item selection is continuing to grow and you're finding more and more products in the dairy category. We just introduced a new line of Simple Truth lunch meats. There's a lot of activity and we're still finding so many of our customers that didn't shop natural foods are beginning to migrate over to that business, which has been really, really good for us.

On the Vitacost piece, we're still in the honeymoon. It's only been a couple of months since we merged with Vitacost. And there's a lot of work going on. But we have big plans for Vitacost and we're excited about the merger. I've been to the facilities, down to their offices, to their warehouses, and it's a great business that we have and we're excited about where we're going to go in the next year.

Vincent Sinisi

Okay, great. Thank you. And just a follow-up, if I may. Regarding your relationship – the Humby relationship, as you continue to have nice growth in your loyal households and loyal customers, I know that part of what you're looking at is also not only continuing to have your current loyal customers purchase more, but also convert others into being loyal customers. Can you talk about any – if there are any either new strategies or learnings that you're finding as you're going through?

Mike Ellis

If you look at all of our data insights and Dunn Humby that you reference is obviously one piece of that, but there's a lot of other insights, you're continually getting insights and testing things and the things that work, you do more of and the ones that don't work, you stop doing. And that never stops. So it's an ongoing basis in terms of trying to understand customer needs. So if you think about your earlier question on natural and organics, that's some insights from our customers, but one of the things our customers are very clear, as they don't want to have to pay a premium for natural and organics. And we're trying to make sure that we have where they can get a good quality product at a price that's comparable to the non-organic brands and in some cases actually the same price.

So it's really – that would just be one example, but there's a whole host of things where you're continually trying to get insights on actually where to locate stores. It's broad parts of our business and it's actually getting that insight and using it is the key.

Vincent Sinisi

All right. Great. Thanks very much. And best of luck going forward.

Rodney McMullen

Thank you.

Mike Ellis

Appreciate it.

Operator

Our next question is from Rupesh Parikh of Oppenheimer. Please go ahead.

Rupesh Parikh

Thanks for taking my question. Congrats on a really nice quarter.

Rodney McMullen

Thank you.

Rupesh Parikh

So I just wanted to touch on inflation. Clearly you had a nice benefit from inflation this quarter. I was wondering if you guys can share maybe your early thoughts for inflation for the upcoming year.

Mike Schlotman

As we sit here today, we would actually expect – I'm always hesitant to go here because I've proven my inability to predict this with the fluctuations we have on our LIFO charge, which is tied to inflation, but we would expect inflation next year to be a little bit more moderate than it is this year. Clearly, the protein categories don't really show any signs of letting up on inflation. Chicken may happen if corn prices stay down at some point, but beef and pork, we would expect to see probably close to double-digit inflation again next year.

Milk at this point, again, as you know the milk prices are driven by a federal market order. As we sit here today, it looks like they may come in some, which would help a lot of categories next year. But overall, just given where some of the core input categories are, it looks like we should be a little bit lower than the 3.5% that's out there. That said, embedded in that 3.5% is pharmaceuticals, which continued to have, particularly in the generic category case, which continue to have quite high inflation in them.

Rodney McMullen

One of the things that we think is important when you look at inflation over the last 10 years, Kroger's been able to really manage in all inflationary environments, whether there's been deflation or inflation. There's always a transition. If it suddenly changes quickly very high or very low to manage that transition, but over time, we have found that we really are – our associates have the ability to manage in all environments.

Rupesh Parikh

Okay. That's helpful. And then maybe just shifting gears to your ID sales, do you feel – have you looked at your ID's this quarter, do you feel that you're maybe winning new customers at an accelerated pace from earlier this year?

Rodney McMullen

It's really – I mean, the thing that's exciting, and Mike mentioned it in his prepared comments, we're seeing good growth with our existing customers, but we're also seeing new loyal shoppers. And so it's really balanced across both and that's one of the things that's exciting, and it's been – it's a little bit higher now than earlier in the year, but it's, you know, it was strong earlier in the year as well. I don't know, Mike, if you want to add anything.

Mike Schlotman

No. I think you hit it. It's been solid. Yeah, thanks Rodney.

Rupesh Parikh

Okay, thank you.

Rodney McMullen

Thanks, Rupesh.

Operator

Our next question is from Scott Mushkin of Wolfe Research. Please go ahead.

Scott Mushkin

Hi, guys. Thanks for taking my question. Mine is actually much more of a kind of strategic long-term question and just trying to understand kind of the growth trajectory of the company. You guys were nice enough to take us to a marketplace store, I think that was converted from a regular grocery store and it seems like that conversion has gone quite well.

So I guess I'm just trying to understand, it seems as we think about Kroger that in a lot of ways you have a better mouse trap at this stage and that marketplace store is certainly one of the key elements. You guys went through, and this goes way back I think late '60s, early '70s into a big kind of store upgrade cycle and you became a good to grade stock in Jim Collins' work. How close are we to really getting into a big upgrade cycle on your store fleet, where you really deploy marketplace in a much more aggressive way? So that's my first question about long-term growth.

Mike Ellis

Well, as you know, when you were out in October, we are obviously very excited about the marketplace stores and the use of all our formats together. It's one of the reasons why a couple years ago we committed to increase our capital investment by $200 million a year and we continue to do that. We think that's a good amount to accelerate capital by in terms of the ability to operate the store at the level that you saw and balance in terms of the use of the cash flow. As long as – as we continue to get the performance from those stores as we expect, you'll see us to continue accelerating that capital investment. But that was the reason why in October of 2012 we outlined the need to increase the capital by $200 million a year. I don't know, Mike. Do you want --

Mike Schlotman

No, I would agree with that, and as you know, Scott, we continue to expect increased capital over the next several years by incremental amounts. If there's one disappointment I have so far this year, it's that actually that we're at the low end of our CapEx guidance. I know some people out there think we spend too much on CapEx, but that just means some stores aren't coming out of the ground as quickly as we hoped. It doesn't mean that we're less bullish on the new stores we're opening. It's just a matter of timing of those projects and they will get caught up. So we're very bullish on our ability to continue to open new stores and have them perform very well.

One of the comments we have, marketplace stores now in just about every division of our company across the country and the success we're having with the marketplace store has been really pleasing. But you asked about remerchandising and I know you saw apparel in some of our stores now and we're having success with some of these new brands and some of the products we're putting in. So we continue to work on the model to make it relevant to the customer but we're really pleased with what we have today.

Scott Mushkin

And as a follow-up – thanks for the color. That's just great. I mean any thought processes as to how many stores in the store fleet could eventually be marketplace?

Mike Schlotman

We probably do, but probably not for public consumption at this point, Scott. The other thing to keep in mind is, as we go down this path and you'll probably see it a little clearer as we get into next year, we continue to invest in our business and a fundamental piece of being able to invest in our business is continuing to generate a really good return on our new investments. And some of those dollars, we make conscious decisions of how many fall to the bottom line and how many we invest back into the business in the people, products, shopping experience and price.

And while I know a lot of you would think we should be at the end of investing in price, we still see plenty of categories in particular sections of the store where we have an opportunity to be more price competitive than we are today. So we're, in some respects, counting on that continued good results from that deployment of capital to both increase – to have the 8% to 11% earnings per share growth and have the dollars generated to invest back in our business.

Scott Mushkin

And then I just had one more and then I'll yield. It goes to the long-term growth again. M&A, we talked about it at the Analyst Day. It seems, again, Kroger, better mouse trap, fuel program Dunn Humby, customer insights, marketplace store. It seems as you guys evaluate, at least from my perspective, evaluate M&A activity, there's almost a check list of what you might want out of a company that you are going to acquire. But it does seem like it's a little bit different now, given the success you have with your business. Any thoughts – any additional thoughts? Again, I know I asked this at the Analyst Day, but I wanted to revisit it.

Rodney McMullen

I wouldn't say there is anything much different than what we answered as we talked about then. One of the keys on any merger is how are the people that run the business? And do we think culturally they have the same values we have? And that's one of the reasons why we always talk about mergers rather than acquisition. You get a more limited number of opportunities when you have that standard, but what we find is when people have that standard, they like going the other direction as well. And we always like to point out the fact that two of our last three CEOs came out of one of our merged companies and several of our senior officers --

Mike Ellis

And our current President.

Rodney McMullen

Yes, came out of one of the merged companies. So I think you're right when you say it's almost a check list, because it is, but it's something that's really worked well for us.

Mike Schlotman

Scott, something I would add to that, and I certainly understand your question and the seeming benefits we could bring to some M&A activity that may be not as strong as we may hope or not have everything on our check list. When you sit back and you have opportunity X and you look around the organization and the company in our geographies where we are today and you can clearly see where you can double market share in specific geographies by deploying your capital in those geographies and you have a base of people and the recognition in that market and already strong customer acceptance. We typically default to that fill-in strategy that we talk about because it's a mature thing, takes a lot less time and energy of the organization and significantly less management distraction. And we're perfectly willing to sit and almost wait, not necessarily troll around the country for those opportunities to come along like a Harris Teeter did.

Rodney McMullen

The other thing that would be needed for us to change our approach is, if we find that we are able to develop talent faster than we can use it within our existing growth, whereas because if we bought something that was something that needed to be fixed up, we would obviously need to figure out a way to put talent into it in a way that was effective. And that would require a different level of talent than we're producing today because we're really focused on developing the talent to support the growth we have.

Scott Mushkin

Thanks very much.

Rodney McMullen

Thanks, Scott.

Mike Schlotman

Thanks, Scott.

Operator

Our next question is from Mark Wiltamuth of Jefferies. Please go ahead.

Mark Wiltamuth

Hi. Could you give us a little perspective on just how much the gas gain was in EPS terms and what quarter should we really think about the headwinds starting to arrive as you lap the stronger margins from last year?

Mike Schlotman

Mark, we won't go into the benefit of the EPS benefit. But if you think about it, a $0.23 fuel margin and $0.17 last year, you get a feel; we talk about in a lot of places the number of gallons that we pump, so you should be able to back into a number that gets you relatively close. We just don't want to – we think about that department as any other department inside the company and it happens to be performing very well right now.

I would say clearly the second and third quarter of next year, if margins revert to a more historical kind of level, which start to experience some headwind from lower fuel margins, again, we didn't say when in the comments purposefully. We said if, because nobody can really predict where it is. And we typically turn fuel a lot faster than our competitors. So in down cycles, that's good. In up cycles, that's bad. If fuel were to turn the other way or oil was to turn the other way and circle it up that actually creates an incremental headwind, not just a normal headwind because we're turning the fuel so quickly but clearly, second and third quarter.

Rodney McMullen

And one of the things, as Mike mentioned earlier, we have a January meeting with our Board for them to actually approve our 2015 plan. Normally we would not share 2015 details until the fourth quarter earnings release. But we just thought it would be helpful to give a little bit of color on what we're thinking and what we're seeing before then for next year.

Mark Wiltamuth

That's fair. And then on the inflation in those meat categories where you're still seeing that double-digit inflation, are you passing all of that through? We are hearing some of the retailers are having difficulty passing it through.

Mike Schlotman

Inflation for us, inflation and deflation come and go all the time and we're constantly dealing with pricing and how we continue to give value to the customer through inflation and deflation, whether it's meat, produce, or any other part of our business. So we try to manage it in a way that still gives great value to the customer and the customer decides what they are going to pay. But I can tell you our tonnage is good and inflation is extremely high right now. We're just trying to really manage our way through it.

Mark Wiltamuth

Okay. Congrats on a great quarter.

Rodney McMullen

Thanks.

Mike Schlotman

Thanks, Mark.

Operator

Our next question is from Stephen Grambling of Goldman Sachs. Please go ahead.

Stephen Grambling

Hi, good morning. Thanks for taking the question. As you think about just the broader industry, I was hoping you could just talk maybe about where you think some of the gains that you're getting are coming from, how you see that evolving. I think it was at an Analyst Day a few years back where you discuss some of the regional players seeding share pretty consistently.

Are you seeing that accelerate? Are there anything else that you can just talk to broadly?

Rodney McMullen

As you know, we don't ever talk about specific competitors. In terms of where the market share is coming from, it's always easier to ask the question than it is to see. It looks pretty broad-based in terms of where it's coming from, but we see at some other national players that are gaining share as well. So we're not the only one. But there's still about half of the market that's out there that's not people with our economies of scale, and it's not necessarily just small, regional people. Some of them could be a little bit bigger. And then the other piece is we continue to add categories that we didn't even have before, which is helping some of our growth.

Stephen Grambling

That's helpful. And then are you seeing any difference in terms of the comp performance by the format of your stores? And do you feel like after so many years of positive ID growth or productivity growth, that you're hitting a ceiling in any of these?

Rodney McMullen

It's a good question. If you look at the comps, you always have pockets that are better than others, but it's very broad-based. And when you look at age and other things, obviously newer stores will have a higher comp than older stores. But outside of that, there's nothing that would cause us to say one thing or the other. And probably – I'm sure we have some stores that are getting close to capacity, but as a general rule, we have plenty of capacity within our existing stores to continue to increase business.

Stephen Grambling

Okay, guys. Thanks. Best of luck.

Rodney McMullen

Thanks, Steve.

Operator

Our next question is from Kelly Bania of BMO Capital Markets. Please go ahead.

Kelly Bania

Hi, good morning. Thanks for taking my question. Just wanted to ask about the guidance for the fourth quarter for ID's. You mentioned the difficulty in forecasting when you cycle that benefit from the winter weather last year. Just curious if you are able to, or have been able to at all look at your data and you have Dunn Humby and see how much of that boost that you may have had last year was from existing or loyal customers versus new customers and if there's any strategies in place to help kind of cycle that benefit that you may have had last winter?

Mike Ellis

Well, clearly, we can understand where that business is coming from in those – in regions where the snow or the weather's going to get volatile in a big way, you get a lot of people from all spectrums of the loyalty umbrella, if you will, from people who rarely shop with you, but they come to you because you might be the one that is in stock on product to your most loyal customers who come in and stock up. Obviously, we aren't – for the fourth quarter, Mike Donnelly and Robert Clark and their merchandising group isn't sitting back and just hoping for weather for us to be able to cycle the great sales we had last year's fourth quarter. They know what days and what weeks there was weather. And, they would have strategies in place to try to cover some of the uplift we had in the – from that snow.

But the amount of incremental volume you get in a 36-hour period from snow is phenomenal and it would be a Herculean effort on their part to be able to come up with strategies to overcome all of it. Clearly, we're going to do our best to overcome it the best we can. We'll have weather. We don't know when. We don't know where. We don't know what day. We don't know much how much. We don't know if it will be by the end of January, we don't know if it will be in February or March at the beginning of next year, but it happens every year. You just don't know when.

Rodney McMullen

The other thing is, when you look at weather, I have couple of friends that own a quite few fast food restaurants. And they always tell me they hate snow because it actually is the opposite effect on them. So it's actually some of our increase is getting business that customers would sometimes be going to other channels. And obviously, when kids stay home, they are eating at home versus eating at school. So some of it is just switching where somebody eats.

Mike Schlotman

Right.

Kelly Bania

Got it. That's helpful. And then just another question on gross margin, your FIFO gross margin ex-fuel only down 2 basis points, in spite of some of the high inflation you mentioned in some categories. Just any comments on the ability to pass that through and how that maybe compares to historical standards? I mean, are you finding it easier or the same in terms of passing along inflation at these high levels in some of the protein categories?

Mike Schlotman

As always, it's almost a category-by-category decision on where the inflation is and what the price points are doing to the customers. And if you pass it all on, what do you think the effect on units is going to be? And if you don't quite pass it all on, are you better off at the end of the day not passing all of it on. So it's a category-by-category decision. And I know Mike Donnelly and his team spend a lot of time trying to decide exactly what price points and how much of inflation to pass on and when to pass it on.

I do want to reiterate that the couple of basis point decline in gross margin would have been a more normal decline in gross margin. When I say normal, kind of the historical kind of numbers you would have seen in 2013 versus 2014, if not having Harris Teeter in this year not in the base. We continue to invest in price, actually, all four keys of the strategy this quarter. It's just that with Harris Teeter being in there at a higher gross than we think of typically have run; it makes that decline look smaller.

Rodney McMullen

The other piece in terms of looking at it on – from a historical standpoint, part of it is trying to decide how long is the inflation going to be in place. In some items, we would anticipate inflation's only going to be four to eight to 12 weeks, depending on if it's weather-driven, or if it's industry and other driven, that will also affect our ability and influence on how we try to pass it through as well.

Kelly Bania

Great, thank you.

Rodney McMullen

Thanks Kelly.

Operator

Our next question is from Chuck Cerankosky of Northcoast Research. Please go ahead.

Chuck Cerankosky

Good morning, everyone. Great quarter.

Rodney McMullen

Good morning. Thanks Chuck.

Mike Schlotman

Thanks Chuck.

Chuck Cerankosky

If you were mentioning sales were off to a strong start thus far in the quarter. Can you give us a little detail on that, including general merchandise sales and how you did thus far in the holiday selling period?

Rodney McMullen

So far, if you look, it would be kind of fortunately similar comments we made earlier, or I guess really last quarter. So far, we would be at the top end of the range. It's broad-based in all departments, so it's across the whole store, so we feel really good. The thing that makes it a little more complicated is we haven't cycled – we're just now starting to cycle some of the weather from a year ago, so that's one of the reasons why we would get the wide range and kind of Mike's comments earlier.

Mike Ellis

Yes, I understand on the weather comparisons. That's just going to be tough to predict and deal with, but just wanted to see what the actuals look like so far.

Rodney McMullen

And jewelry also is good so far and obviously that's one of the most discretionary areas that we have.

Chuck Cerankosky

I didn't know it was discretionary.

Mike Schlotman

Oh, I have so many comments.

Chuck Cerankosky

Also, could you repeat the private label percentages? I missed those earlier in the call.

Mike Ellis

Mike?

Mike Schlotman

Well, overall, we are really pleased with the total private label sales, and, our Kroger brand, which is our work horse, showed really strong sales growth again and in fact, all the different banners, brands, excuse me, really performed well, whether it's Simple Truth or Private Selection all of those. But, Kroger brands in the third quarter represented 27.3% of total units and 25.8% of sales dollars. That's without fuel and pharmacy.

Chuck Cerankosky

Thank you.

Rodney McMullen

Thanks, Chuck.

Operator

Our next question is from Ajay Jain of Cantor Fitzgerald. Please go ahead.

Ajay Jain

Hi, good morning. My question is guidance-related. I can understand why you might be slightly cautious in your outlook for next year if fuel margins revert to more normal levels. But your outlook for the fourth quarter I think is around 10% EPS growth if I use the midpoint of the range. So first, as a comment, I would have thought the benefit from fuel could be potentially even higher in the fourth quarter based on the difference between the retail pump prices and wholesale prices and then looking at the year-over-year comparisons.

So I was curious if you had any comment on that. And then apart from fuel, are there any reasons why you're guiding to earnings growth lower in Q4 on a sequential basis?

Mike Schlotman

It would be primarily where fuel has been. Also, keep in mind our LIFO charge continues to go up throughout the year and that's a bit of a headwind to earnings per share as well and the single reason for the conversation about 2015, and again, I remind you, we use the word 'if' because it's difficult to project, it's really just a headwind that fuel potentially represents, 23 – a little over $0.23 margin on fuel. We've been in the fuel business a long time and I personally don't remember a time where we've had anywhere near that kind of a number and it's really difficult to predict where that may go. And again, we're trying to be transparent and let everybody know what we're thinking.

Ajay Jain

And what the key assumption is.

Mike Schlotman

Yes. What the key assumption is. Right.

Ajay Jain

As a follow-up, I think in November, you cycled the snap reductions from last year. Is that a material benefit at all in terms of how you are looking at it? And then are you factoring in any recent changes in the competitive environment or shift in behavior by the consumer around the holidays into your fourth quarter outlook?

Rodney McMullen

When you look at Snap, when you look at that customer overall, their spending may have been down on Snap specifically, the customers are using and have been using more of their own cash. So when you look at that like customer base, it actually increased.

Hopefully, that customer increased spending in cash is driven because their economic situation is better. That, we don't know. But that's been up all year and we continue to see the household spending for Snap household increase. It's not increasing at the same rate as the overall company, but it is going up.

Ajay Jain

Okay. And finally, you may have mentioned this previously, but did you disclose the quarter-to-date comps the actual figure?

Rodney McMullen

No, we did not.

Mike Schlotman

Just said that is --

Rodney McMullen

High end.

Mike Schlotman

High end of our range for the quarter.

Ajay Jain

Great. Thank you very much.

Rodney McMullen

Thanks, Ajay.

Operator

Our next question is from Stacie Rabinowitz of ConsumerEdge Research. Please go ahead.

Stacie Rabinowitz

Thank you. You had mentioned that you were actually thinking about specific categories for further price investment. And I was wondering if you could elaborate on those and then the extent to which, either the increasing protein prices or the decreasing gas prices are changing how you're thinking about where you're investing in price?

Mike Ellis

We're very guarded about our plans and where we would invest in price because we don't want to announce to our competitors where we plan to become more competitive. So we hold that very close to our vest.

Stacie Rabinowitz

Are you seeing anything so far as the gas prices are dropping in terms of shifts in where consumers are being more or less price sensitive?

Mike Ellis

Not in any big way. Okay.

Operator

Our next question is from the line of --

Rodney McMullen

We'll have time for one more question.

Operator

Thank you. The last question will come from Andrew Wolf of BB&T Capital Markets.

Andrew Wolf

Thank you for squeezing that in.

Mike Schlotman

Only because it's you.

Andrew Wolf

I appreciate it. I'll ask another natural foods question. I think you mentioned earlier that you're seeing more conversions, people who weren't shopping, customers who weren't shopping, the category coming into it. So if you would, if you could, some of your segmentation work, kind of elaborate on, is that segment sort of driving the current growth you are seeing, contrast that to maybe folks who are already shopping the department and the penetration rates?

And the third category, if you would address it is, there's been a prevailing theory for a long time that supermarkets like Kroger would kind of see at a natural foods shop and then some point if they really converted to that life-style would lose them to Whole Foods or an independent or somebody who could fulfill their whole basket. So I don't know if you're willing to talk about it, but are you trying to address that and are you seeing, as they get to some point, like, hey, half their basket is this and all of a sudden they drop out, so if you would address that question, that would be terrific to hear your response.

Mike Ellis

Well, there's about four questions in that question. But the last piece, the folks we have converted, I think if we can continue to offer the products, selection at the prices they are willing to pay, I think we can maintain them. I don't have data to really support if they leave and go to competitors. But some of the things we're doing around the country with vitamin shops in our stores and really well-done, expanded natural foods selection offering, and we've worked really hard on price in the whole natural and organic area too. So we are the number two retailer for natural and organic sales today and we just are going to continue to push hard. We love that customer. And they are really a great customer for us.

Rodney McMullen

You shouldn't expect us to willingly give up any customer and when you look at the products, a lot of the natural food competitor's offer, you can find the exact same item at Kroger and as a general rule, at a very good value. You want to add?

Mike Ellis

The last piece is, it's a large and growing segment of people who are trying to eat healthier, but they want to do so at a reasonable price and I think historically it hasn't been that way. And today, you can shop for natural and organic and do it at a fairly reasonable price and we are really trying to continue to make that offering, both selection and price.

Andrew Wolf

Okay. Just a follow-up, because I know it was a long question. What about this trend you cited for – is there an acceleration in new users, folks who are dabbling for the first time?

Mike Ellis

Definitely. There are people moving into the category, new customers entering natural organic and healthy foods all the time, again, a lot of it's because selection is better I think for us and pricing is much stronger.

Rodney McMullen

But it's kind of interesting. A large part of our customers that switch over is because some items they think taste better. Actually is driven by the taste and in some situations, it's driven by the innovation of the product. So it's not just exclusively people wanting to live and just buy and eat natural products and organics. It's much broader than that.

It's one of the things that we get excited about having a store that has a lot of flexibility in it, is that we can change what's inside the store based on what the customers' needs are and how those change. So we're excited about the category and we're excited about the potential even more.

Andrew Wolf

Okay. And just on the guidance very quick, it's probably been asked, but I'll ask it again. If you take out the gas this year in Harris Teeter's accretion, at least you gave range, it looks like you're coming in around the high end of the 8% to 11% secular growth, or maybe at the high end or a little better for the core business, ex those two.

And as you look at guiding to next year, towards the lower end, is it more, you know, normalization of sales trends and maybe inflation or more, gas – you can't budget gas the same level as this year as you are just sort of putting out this broad, look to the lower end as sort of early guidance?

Mike Schlotman

As I said earlier, if you were to look at – if you were to strip out the core grocery business, it would be higher in the range, but when you add the fuel in, the fuel margins revert to the mean, it would be the fuel that's driving it down.

Rodney McMullen

Thanks, Andy.

Andrew Wolf

Thank you.

End of Q&A

Operator

This concludes our question and answer session. I would like to turn the conference back over to Rodney McMullen for any closing remarks.

Rodney McMullen

Thank you. Before we end today's call, I would like to say a few words about Dave Dillon, who is listening in this morning. All of you know Dave well, and this is his last official meeting as Kroger's Chairman. Dave has been a friend and a leader to all of us and a mentor to many of us. Thousands of associates can relate to that comment. For me personally, Dave has been a partner like no other. On behalf of the entire Kroger family, we wish Dave and his family all the best, as they begin the next chapter together. Dave, thank you from all of us.

Finally, I would like to share some thoughts about our associates listening in. During the next few weeks, there will be a lot of activity in our stores, as we help customers prepare for their holiday celebrations. Thank you for helping make the holidays brighter for our customers and the communities we serve and live in.

During Kroger's season of giving, with your help and the help from our customers, we will donate 30 million meals to local food banks. Customers will have the opportunity to add their support by dropping change into coin boxes at check stands and donating non-perishable food in collection barrels in stores.

Thank you for all that you do for our customers and each other. Merry Christmas, Happy Holidays to you and your family. That completes our call today. Thanks for joining.

Operator

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