The Kroger (KR) Earnings Report: Q1 2016 Conference Call Transcript

The following The Kroger conference call took place on June 16, 2016, 10:00 AM ET. This is a transcript of that earnings call:

Company Participants

- Kate Ward; The Kroger Company; Investor Relations
- Rodney McMullen; The Kroger Company; Chairman & CEO
- Mike Schlotman; The Kroger Company; EVP & CFO

Other Participants

- Ed Kelly; Credit Suisse; Analyst
- John Heinbockel; Guggenheim Securities LLC; Analyst
- Shane Higgins; Deutsche Bank; Analyst
- Scott Mushkin; Wolfe Research; Analyst
- Rupesh Parikh; Oppenheimer & Company; Analyst
- Andrew Wolf; BB&T Capital Markets; Analyst
- Ken Goldman; JPMorgan; Analyst
- Zach Fadem; Wells Fargo Securities; Analyst
- Mark Wiltamuth; Jefferies LLC; Analyst
- Robby Ohmes; BoA Merrill Lynch; Analyst
- Chuck Cerankosky; Northcoast Research; Analyst
- Alvin Concepcion; Citigroup; Analyst
- Kelly Bania; BMO Capital Markets; Analyst
- Priya Ohri-Gupta; Barclays Capital; Analyst
- Ajay Jain; Pivotal Research Group; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to the Kroger Company first-quarter earnings conference call.

(Operator Instructions)

Please note this event is being recorded.

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

Kate Ward (Investor Relations):

Thanks, Operator. Good morning. Thank you for joining us.

Before we begin, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions and actual events or results can differ materially.

A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings. But Kroger assumes no obligation to update that information.

Both our first-quarter press release and our prepared remarks from this conference call will be available on our website at ir.Kroger.com. After our prepared remarks we look forward to taking your questions.

In order to cover a broad range of topics from as many of you as we can, we ask you please limit yourself to one question and one follow-up question if necessary.

Thank you.

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

Rodney McMullen (Chairman & CEO):

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

Our associates delivered another solid quarter. We continue to execute our growth plan and to deliver on our financial performance commitments. Most importantly, we continue to strengthen our connection with our customers, growing loyalty and market share and achieving Kroger's 50th consecutive quarter of positive identical supermarket sales growth, excluding fuel.

Most companies can only aspire to achieve these results. It says a lot about our consistently remarkable performance and our ability to grow in a balanced way with a long term focus. We've managed through nearly every conceivable operating environment and demonstrated through different cycles that by providing value to our customers and partnering with our associates, we'll continue to make a difference for our customers, associates and communities.

And when we do that, we create value for shareholders, as evidenced by our growing dividend and our consistent net earnings per diluted share growth above our long-term guidance of 8% to 11%. In fact, our net earnings per diluted share growth rate on a compounded annual basis was 14.1% for three years and 18.8% for five years.

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

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

Despite record low unemployment figures, when we held a one-day hiring event in every supermarket location in May, we received more than 116,000 applications. From that pool, we hired more than 12,000 new associates. We see our opportunity culture as a competitive advantage.

We are expanding our digital presence and marching steadily toward a time when we can provide our customers with anything, anytime, anywhere. As you know, we are taking a disciplined approach to digital growth, testing new offerings in local markets so we can make sure we get it right before we scale offerings more broadly. Our Click List and Express Lane offerings are now available in 25 markets with more to come.

Our merger with Harris Teeter gave us a base of learnings that allowed us to ramp up quickly the development of Click List. Customers now have downloaded nearly 3 billion digital coupons and offers from our mobile app and website and we continue to experiment with Vitacost.com's ship-to-home technology and platform.

Earlier this week, Kroger's technology business unit was named one of the top 100 places to work by Computer World Magazine. We are obviously very proud of this honor. We've launched a new website, Kroger.com\liveKT to connect with and recruit top talent from around the world to join the Kroger team.

Similarly, we are finding out that Click List also serves as a great tool to both hire and retain great people. Kroger is a fantastic place for tech talent to build careers because the technology they create can improve the lives of millions of customers each and every day.

In April we announced a strategic investment in Lucky's Market, a specialty grocery store chain focused on natural, organic and locally grown products currently operating in 22 locations. We invested in Lucky's because of their great people and unique go-to-market strategy which includes smaller-format stores that resemble an indoor farmer's market, plus a culinary department that showcases amazingly restaurant-quality prepared foods.

Lucky's approach is very much aligned with our efforts to provide affordable, fresh, organic and natural foods as part of our customer-first strategy. We expect to learn a lot from each other.

There are a lot of questions about the economy and the customer, inflation or lack thereof, consumer sentiment or competition. These are all issues that we've managed through, some several times over the last 50 quarters. Inflation for example, I've often said that a 2% to 3% inflation would be a great environment to operate in; however, you rarely get the perfect operating environment.

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

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

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

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

Mike Schlotman (EVP & CFO):

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

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

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

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

We continue to work diligently to keep operating costs in check. As you know, this is the fuel we use to run our customer-first strategy. As Rodney just said, this is an area where our to-do list is longer than our done list.

Now for an update on retail fuel.

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

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

Our integration with Roundy's is well under way. Synergies are coming together nicely. We are beginning to focus on the physical assets in Wisconsin while continuing to open new Mariano's stores in Chicago. Roundy's associates share our deep commitment to putting our customer first, which makes it easy for us to work together as one team.

For our corporate brands portfolio, we are off to an exciting start on the new innovations in 2016. Last quarter we told you that we had just introduced Simple Truth household and personal care products, expanding our popular natural and organics line into a true lifestyle brand.

Customers have responded enthusiastically, as both sales and unit volume have exceeded our expectations in all categories. We continue to launch new Simple Truth offerings in laundry, household, baby, and health and beauty care.

We also continue to push the boundaries of culinary trends with new private selection spices, marinades, condiments and cooking sauces. Customers are savoring global flavors in our delicious private selection products such as Korean black garlic calby marinade and Peruvian Aji Amarillo hot sauce. During the first quarter corporate brands represented approximately 7.9% of total units sold and 25.9% of sales dollars, excluding fuel and pharmacy.

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

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

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

I will now provide a brief update on labor relations. We recently agreed to new contracts governing store associates in Houston, Indianapolis, Portland and Roanoke. We are currently negotiating contracts with the USCW for store associates in Little Rock, Nashville and Southern California.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality affordable 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 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 our associates.

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

For the full year net earnings, we expect 2016 range of $2.19 to $2.28 per diluted share. As Rodney said earlier, based on current fuel margin trends, we expect to be at the low end to mid point of our guidance range. We expect fuel margins will be at or slightly below the five-year average.

Shareholder return will be further enhanced by a dividend that is expected to increase over time. In thinking about the cadence of our quarterly results compared to our long-term 8% to 11% guidance, we believe that the second quarter will be the toughest quarter with slight growth over 2015. Keep in mind the second quarter last year grew by 26%. Both the third and fourth quarters will be at the low end to mid point of the range.

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

Rodney McMullen (Chairman & CEO):

Thanks, Mike. We are proud of our team's performance during the quarter, especially in light of the challenging operating environment. We have been through business cycles like this before.

The best thing we can do is to deliver on our promise while investing for the future. We will continue to execute our customer-first strategy and by doing so will create long-term value for our shareholders.

Now we look forward to your questions.

QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Ed Kelly with Credit Suisse.

Ed Kelly (Analyst - Credit Suisse):

Hi, good morning, guys.

Rodney McMullen (Chairman & CEO):

Good morning.

Ed Kelly (Analyst - Credit Suisse):

Could we start off with color on the cadence of the IDs through Q1? What you're seeing so far in Q2?

And then, Rodney or Mike, could you dissect tonnage trends versus inflation trends?

And then lastly, as part of all of this, the impact that Roundy's had on the Q1 comp?

Rodney McMullen (Chairman & CEO):

Okay, Ed, I'll start out and let Mike fill in. If you look across the quarter, I would say it bounced around a bit. Part of that was driven by weather. Earlier in the quarter we had basically no weather benefits this year versus a lot in the prior year. As you get toward the end of the quarter, Memorial Day moved from the first quarter to the second quarter and early in the quarter you had Super Bowl. So there's a lot of things going on.

The other thing on inflation -- inflation, we had expected that it would start picking up some and when we look going forward we just don't see that picking up. If you look at so far this quarter, we're inside the range, just slightly below the mid point of the range of the 2.5% to 3.5%. But as you know, it's still very early in the quarter.

Overall, the core continues to be strong and we're cycling incredibly strong numbers from last year. Tonnage continues to be solid. Mike, anything else you'd want to add or thoughts?

Mike Schlotman (EVP & CFO):

One of the things we have done is if you look at our real growth that's IDs minus the inflation number that we give. If you look at a two-year stack of that, it's amazingly consistent quarter to quarter, less than a 50 basis point swing when you look at it over the last five or six quarters. So when you look at things over a little bit longer time frame and you take out the effects of inflation on the reported numbers, our results have actually been amazingly consistent.

Ed Kelly (Analyst - Credit Suisse):

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

Mike Schlotman (EVP & CFO):

It's about 30 basis points.

Ed Kelly (Analyst - Credit Suisse):

Great, thanks, guys.

Rodney McMullen (Chairman & CEO):

Thanks.

Operator:

John Heinbockel with Guggenheim Securities.

John Heinbockel (Analyst - Guggenheim Securities LLC):

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

Rodney McMullen (Chairman & CEO):

As you started out your question, it's obviously very early. And as I mentioned in the prepared comments, we're now in 25 markets.

What we're finding is almost anything you say would be correct, so there's some new customers. And we find in some situations a customer will spend more with us.

But as you know, we're so focused on what the customer wants and needs are, and what we have is some of our customers tell us they really appreciate it. That's really why we're focused on it and continue to roll it out because some customers find it incredibly helpful.

We definitely, from everything that we see, we find it's an and not a or. The Click List customer continues to come into the store and it really is just one more way of making their life a little bit easier.

John Heinbockel (Analyst - Guggenheim Securities LLC):

Okay, and then as a follow-up, do you see -- do you think there's any difference in how you will run Click List or customer behavior in a marketplace versus a traditional food retail store, given size differences and so forth?

Rodney McMullen (Chairman & CEO):

We have it in both types of stores and we really find the behavior isn't that much different. But we do not have the marketplace product on the website. So if somebody wants to buy something from the marketplace side, they have to put it in a comments section, can you get me that. And obviously we will.

But we don't see differences in behavior between one type and another. One of the things that's always part of the consideration is do we have space to do it in a store. That's driven as much the decision on a size of store -- there's some marketplace stores we don't have it in that we would like to have it in because we just really don't have the space to do it.

John Heinbockel (Analyst - Guggenheim Securities LLC):

Okay, thank you.

Rodney McMullen (Chairman & CEO):

Thanks, John.

Operator:

Shane Higgins with Deutsche Bank.

Shane Higgins (Analyst - Deutsche Bank):

Good morning and thanks for taking the questions. How would you guys characterize the macro environment in the quarter? Any color you have on the consumer sentiment overall? I think you guys mentioned that units per transaction were down slightly. Is that any indication that the consumer might be a bit softer? Any color there would be great.

Mike Schlotman (EVP & CFO):

Yes, when you look at the units per basket they were down slightly. But that was overcome by more trips, making more trips to drive more units during the quarter. If you just looked at those two metrics, it would have been a slight increase in the tonnage. And then the new households pushed the tonnage to be nicely positive.

I think Rodney touched -- there's clearly a lot going on out there. The macro environment, there's the inflation-deflation, there's gas retails were rising during the quarter. It was an interesting quarter because there's so many unusual things out there.

Our own comparison to a lot of -- like what Rodney said -- the Super Bowl this year, then no weather and then Memorial Day moving. As Rodney said, the cadence of ID sales was really a little bit all over the board depending on the week you're looking at.

Our fundamental approach is focused on the customer, make sure we're delivering on the value propositions that they want. Based on how they're shopping with us, it sure seems like we're hitting the mark on that.

Rodney McMullen (Chairman & CEO):

On the economy -- to me, Mike and I've talked about this -- it's really hard to describe and it's very mixed. How much of that is driven because of the election and everything else, I'll let somebody that has better insights into that than us to try to speculate on that.

The strength certainly doesn't feel as strong as the numbers suggest. With that said, if you look at the things that would be discretionary items or more upscale items, if you look at wine, Boar's Head, Murrays, Starbucks , all of those continue to grow very nicely from an identical standpoint and well outperformed the total. So it's really pretty hard to describe from what we can see.

Shane Higgins (Analyst - Deutsche Bank):

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

Mike Schlotman (EVP & CFO):

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

Shane Higgins (Analyst - Deutsche Bank):

All right, thanks, good luck.

Rodney McMullen (Chairman & CEO):

Thanks, Shane.

Operator:

Scott Mushkin with Wolfe Research.

Scott Mushkin (Analyst - Wolfe Research):

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

Rodney McMullen (Chairman & CEO):

Correct.

Scott Mushkin (Analyst - Wolfe Research):

Does that include or exclude the Memorial Day shift?

Rodney McMullen (Chairman & CEO):

That would include the shift for Memorial Day.

Scott Mushkin (Analyst - Wolfe Research):

Okay, that's perfect. So you're at the little below with the shift included. Okay, that's perfect.

And then my big question, obviously you've got a large competitor making a lot of noise around price. Have you seen anything in the marketplace where they've got more competitive?

And they have done and delivered what they said they are going to deliver as far as cleanliness and in stock. How seriously do you guys take their comments about several billion dollars of price investments? They're even willing to take deflation in their own comps or lower their own comps to get that done. What's the plan at Kroger to combat that if it ends up happening?

Rodney McMullen (Chairman & CEO):

Well, if you look, we take all competitors serious. To say we only focus on one, we really do look at all competitors and we think it's incredibly important to make sure we focus on what our customer needs are.

As you know, if you look on an annual basis, we are investing $3.6 billion in price today versus when we started on the journey. So we would have every intentions to continue to maintain our price position.

But when you look at overall, the total customer, the way they look at value, it's much more than just price. As you know, we stay focused on the total customer needs and fresh products are incredibly important. What's the shopping experience? How long is a customer in line? How do they get treated by associates? All of those things are equally important.

And we really are focused on continuing to improve all of those and we've made substantial improvements in all of those. A customer doesn't make a decision to shop, where to shop based on only one dimension. We think some of those other things create a very large competitive advantage for us.

Scott Mushkin (Analyst - Wolfe Research):

Okay, great. And then I had one question. Obviously the ten-year bond has been falling quite steadily here over the last three or four months. That obviously has impacts on pensions and wanted to get you guys' thoughts on this.

We've seen it drop, what, like 50, 60, 70 basis points or something like that. How should we think about pensions next year? Any framework there, Mike, on that? Do you think about this or no?

Mike Schlotman (EVP & CFO):

Well, of course I think about it. The effect of the interest rate, it's odd how a lot of pensions are calculated from the liability used in the interest rate to present value of the liability. If you look at state and local and federal pensions and multi-employer pensions, their liability is actually calculated using the expected rate of return as the discount rate.

So UFCW plans, the way they calculate their unfunded status is really unaffected by changes in the interest rate unless they change their expected rate of return. It the same way -- just the way it's mandated to be done.

It would affect the Company plan a little bit but, remember, our Company plan's a frozen plan. There continue to be benefits earned by those who are still working and are participants in it, but there's no new participants in it.

We try to maintain the funded status of that enough so we don't have to do some reporting issues to participants. But I never want that fund to go over-funded because as the last person winds up getting their check, there's no easy way to get any excess money out of that. So we purposely manage that to be slightly under-funded -- to be under-funded because some day rates will go up and I don't want to put a bunch of money in now and then wake up in five years and have the fund be over-funded because I can't do anything with it.

Scott Mushkin (Analyst - Wolfe Research):

Any idea, a rule of thumb, what the expected rate of returns on the EOCW plans are? And then I'll yield, thanks.

Mike Schlotman (EVP & CFO):

They're a little bit all over the board. I would say in the 7%s is the most common.

Scott Mushkin (Analyst - Wolfe Research):

Great, thanks guys.

Mike Schlotman (EVP & CFO):

Not a lot different than state and -- all of the state pension plans, they all do it the same way.

Scott Mushkin (Analyst - Wolfe Research):

Perfect, thank you.

Rodney McMullen (Chairman & CEO):

Thanks, Scott.

Operator:

Rupesh Parikh with Oppenheimer.

Rupesh Parikh (Analyst - Oppenheimer & Company):

Thank you for taking my question.

Rodney McMullen (Chairman & CEO):

Good morning.

Rupesh Parikh (Analyst - Oppenheimer & Company):

On the topic of food inflation-deflation, this morning the government data again showed a decline in food prices. Wanted to get a sense what your latest full-year outlook is and how you're thinking about the cadence going forward.

Mike Schlotman (EVP & CFO):

Well, as I said in the prepared remarks, we would have expected to start seeing a little bit more inflation right now than when we were sitting here three or four months ago thinking about it. It just hasn't happened. As I sit here today, it certainly doesn't feel like we're going to have the pick-up in overall food inflation.

Milk would have been projected to start having some cost increases but the federal market order on milk isn't showing any upward trend or not any significant upward trend. So I think we're going to wind up most of the year in a fairly low inflationary environment.

Rodney McMullen (Chairman & CEO):

But as Mike mentioned before, tonnage continues to improve. We continue to improve market share. If you look at year on year, we continue to improve the connection with the customer. And our gross profit dollars in departments remain strong as well. I think it's important to look at all of those things together.

Rupesh Parikh (Analyst - Oppenheimer & Company):

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

Mike Schlotman (EVP & CFO):

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

Rupesh Parikh (Analyst - Oppenheimer & Company):

Okay, thank you.

Rodney McMullen (Chairman & CEO):

Thanks.

Operator:

Andrew Wolf with BB&T Capital Markets.

Andrew Wolf (Analyst - BB&T Capital Markets):

Good morning.

Rodney McMullen (Chairman & CEO):

Good morning.

Andrew Wolf (Analyst - BB&T Capital Markets):

On food retail trending slightly deflationary, this echoes Scott's question. Is that being driven at all by competitors taking pricing down either more so than the deflation or just taking it down to try to get business going? Or is that all as far as you can tell, or mainly as far as you can tell, from the lower product costs?

Rodney McMullen (Chairman & CEO):

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

Mike Schlotman (EVP & CFO):

No, I absolutely agree.

Andrew Wolf (Analyst - BB&T Capital Markets):

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

Mike Schlotman (EVP & CFO):

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

Andrew Wolf (Analyst - BB&T Capital Markets):

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

Rodney McMullen (Chairman & CEO):

When you're in the start-up period, obviously it's a headwind or it's more expense versus the other way. We certainly see that if you look at a model, we feel very comfortable the model can scale out to where, from a profitability standpoint, the customer can do either one and we're completely indifferent.

One of the things that our team has done a lot of work on is trying to make sure we design a Click List model that can scale to whatever the volume it scales to. So if it's 5% of the business, we'll do fine at 5%. If it becomes 20%, we'll do fine at 20%. Our team has really done a lot of work to try to make sure we've designed a model that can scale and scale from a profitability standpoint. And the customer will lead us to what percentage they want it to be.

Andrew Wolf (Analyst - BB&T Capital Markets):

Thank you.

Rodney McMullen (Chairman & CEO):

Thanks, Andrew.

Operator:

Ken Goldman with JPMorgan .

Ken Goldman (Analyst - JPMorgan):

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

Rodney McMullen (Chairman & CEO):

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

Ken Goldman (Analyst - JPMorgan):

Not remotely correct meaning it's lower than 100 or higher? I'm hoping lower.

Rodney McMullen (Chairman & CEO):

It's not even close to 100.

Mike Schlotman (EVP & CFO):

You're not even in the right ballpark.

Ken Goldman (Analyst - JPMorgan):

I've never been so happy to be wrong but I appreciate that. (laughter)

Rodney McMullen (Chairman & CEO):

I am as well. And if that's the impressions that's out there, I've never been so happy to help you be wrong.

Ken Goldman (Analyst - JPMorgan):

That is the impression. So we'll be smiling in the wrong house together. And then I wanted to follow-up on EPS. And forgive me if this was asked, I didn't hear it, coming in closer to the bottom or the mid-point of the range. The reason that was cited was fuel.

But you didn't -- unless I missed it, you didn't change your guidance for fuel margins coming in at or slightly below the five-year average. That was the same verbiage you used last quarter. So I wasn't quite sure what actually changed to cause you to reduce the outlook.

Mike Schlotman (EVP & CFO):

Fuel continues to be very volatile. It certainly -- again, I'm sitting here in June trying to predict the rest of the year and it certainly seems from what we see today, that fuel will be coming in at that or below it.

We pumped a couple billion gallons of fuel in the first quarter and a very small change in that retail cents per gallon adds up to a lot of money very quickly. So it's not like fuel has to change by $0.04 for it to affect our numbers in a big way.

It certainly seems that the trend would be closer to the below the five-year average than at the five-year average. Again, overall it's really tough to predict. The last four days oil has gone down. Is that going to lead to lower wholesale price of unleaded fuel? We'll know in the next few days.

Rodney McMullen (Chairman & CEO):

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

Ken Goldman (Analyst - JPMorgan):

Okay thank you, everyone.

Rodney McMullen (Chairman & CEO):

Thanks, Ken.

Operator:

Zach Fadem with Wells Fargo .

Zach Fadem (Analyst - Wells Fargo Securities):

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

Mike Schlotman (EVP & CFO):

I don't think I'll go down to that level of detail and walk through all of the individual numbers. We continue to make the investments we'd planned to make in price throughout the first quarter. Certainly the dynamics of deflation, when you look at the whole gross profit margin for the entire Company, makes it kind of interesting. Because as you have deflation, if you pass on exactly the lower cost to the customer it drives your gross profit rate up, it's just simple math.

Pharmacy continues to be a bit of a headwind to the gross profit numbers as well with some of the inflation in there and where the reinvestment rates are. So it's a really big mixed big. I would need several hours, probably, to explain it to you.

Zach Fadem (Analyst - Wells Fargo Securities):

Okay, we'll take that one offline then. (laughter)

Rodney McMullen (Chairman & CEO):

Sorry to interrupt but when you look at it overall, it was pretty close to where we expected it to be. We executed our plan, as Mike said.

Mike Schlotman (EVP & CFO):

I absolutely agree with that.

Zach Fadem (Analyst - Wells Fargo Securities):

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

Rodney McMullen (Chairman & CEO):

I want to answer it but I don't want it to sound flip. The short answer is absolutely. As you can imagine, we would look at any and all approaches. The thing that's important is if we find somebody to make an investment in that they would value the leverage that we bring to the party as well and assign some value to that. So it's not just something that has pure option value in the way they're getting valued.

The short answer is yes, we would be very open to doing it on our own or doing it with somebody. I think if you look at our track record we've had both approaches.

Zach Fadem (Analyst - Wells Fargo Securities):

Great, that's helpful. Thanks for taking my questions.

Rodney McMullen (Chairman & CEO):

Thanks, Zach.

Operator:

Mark Wiltamuth, Jefferies.

Mark Wiltamuth (Analyst - Jefferies LLC):

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

Rodney McMullen (Chairman & CEO):

I don't know that I'm going to go into specifics because if you look at over the last, say, two years, you're going to find that type of variance among all retailers when you get down to a specific market. It's really which market are you looking at.

I would hesitate to say there's something that's fundamentally changing because you'll see those behaviors in specific markets all the time. Because any of us, there may be some market that we're trying to cause something to happen.

As you look, as you know for us, we have invested a ton of resources and labor improving the freshness of our products and especially in the produce department. And our customers are telling us we're making meaningful improvements in what they see, from a freshness standpoint in produce specifically. We're getting the same thing in other departments but produce would be one as well.

For us, it's really important, the progress we're making, to continue to make improvements from that. As you know from an organic produce standpoint, we find that we have an outstanding variety of organic. And customers continue to connect with that in a much deeper way.

Mike Schlotman (EVP & CFO):

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

Mark Wiltamuth (Analyst - Jefferies LLC):

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

Mike Schlotman (EVP & CFO):

I currently have exhausted the authority the Board has given me. If you lock at our history, we don't like to be without authority for any particular point in time. And we have gotten a cadence over the last couple of years of front-end loading our buyback for the year. But we always want to have dry powder if the stock reacts in a way that we don't think is prudent based on our view of the underlying value of the Company.

Mark Wiltamuth (Analyst - Jefferies LLC):

Okay, thank you very much.

Rodney McMullen (Chairman & CEO):

Thanks, Mark.

Operator:

Robby Ohmes, Bank of America Merrill Lynch.

Robby Ohmes (Analyst - BoA Merrill Lynch):

Hey, thanks for taking my question. Actually I wanted two questions. One, I wanted to see if I could dig a little bit more into the inflation or deflation versus your outlook. Mike or Rodney, you guys have been talking about good deflation versus demand-driven deflation. Are you -- I just wanted to clarify -- are you starting to see some demand-driven deflation in your outlook that we should be concerned about?

And maybe also it was helpful that you comment on milk and perishables. What's the center of store inflation outlook for you guys now? Has that changed since you guys spoke to us last quarter? And then I have a follow-up.

Mike Schlotman (EVP & CFO):

Yes, I would say it hasn't really changed very much other than it looks like it's going to come slower, which could lead to less inflation for the full year by the time we get to the end of the year. And really, as Rodney said earlier, everything we're seeing is really price-led deflation not demand-driven.

I'm not sure -- trying to understand the view of demand-driven deflation on the fly here. Because the number we're talking about is what we pay for a product versus what we paid for it last year. So I'm not sure -- the demand would have to change rather dramatically in the marketplace for it to affect a grocery category. But everything we're seeing is just a little bit less inflation than we expected right now and it looks like that's going to persist.

Robby Ohmes (Analyst - BoA Merrill Lynch):

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

Rodney McMullen (Chairman & CEO):

If you look at overall, it's tracking on plan. I would say the thing that's taking a little longer than we would have expected is to get the actual thing started. So if you look at Wisconsin, obviously I mentioned it in the prepared remarks, but on remodeling stores and making some of those changes, it took a little longer to get started than what we would have guessed.

Now, why we thought we could have got it started so quickly, I'm not sure and we'll learn that for the next time we do something. (laughter) Because we're still doing it faster than what we could do within one of our historical Kroger divisions.

The thing that I would say that I'm extremely pleased with is the associates at Roundy's and how welcoming they are and how excited they are to be part of Kroger , and making sure that we leverage the size of Kroger . The synergies continued to actually come in better than what we were expecting a little bit. As you know, we'll continue to invest those synergies into driving our business. Mike, you work on it closer than I do.

Mike Schlotman (EVP & CFO):

I agree. And I do agree with Rodney's comment, I'm not sure why we were as bullish as we were being able to get remodels started. Because with an early termination of the HSR filing, the time from announcement to close was very quick. And then you had the holidays because we closed on December 18.

It just takes awhile to get plans drawn and get signed off on how we remodel the stores and things like that. But you can rest assured that if you found the right part of Wisconsin to go to, you would see a lot of activity going on in and around a lot of stores today.

Robby Ohmes (Analyst - BoA Merrill Lynch):

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

Rodney McMullen (Chairman & CEO):

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

Robby Ohmes (Analyst - BoA Merrill Lynch):

Great, that's really helpful. Thanks so much, guys.

Rodney McMullen (Chairman & CEO):

Thanks, take care, Robbie.

Operator:

Chuck Cerankosky.

Chuck Cerankosky (Analyst - Northcoast Research):

Good morning, everyone. Nice quarter.

Rodney McMullen (Chairman & CEO):

Thanks.

Chuck Cerankosky (Analyst - Northcoast Research):

I'd like to take another crack at that question about the economy, but not so much about how the US economy is growing or slowing or whatever the case may be, but really looking at customer behavior as they look at some of these fresh departments and experience lower prices. What are you seeing between, say, types of protein? Are we seeing trading between those categories simply because people are more impressed with the lower price than they were last year?

Rodney McMullen (Chairman & CEO):

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

Mike Schlotman (EVP & CFO):

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

Chuck Cerankosky (Analyst - Northcoast Research):

All right, thank you.

Rodney McMullen (Chairman & CEO):

Thank you, Chuck.

Operator:

Alvin Concepcion, Citi.

Alvin Concepcion (Analyst - Citigroup):

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

Mike Schlotman (EVP & CFO):

Again, we won't go into specific competitors or geographies. We always assume the environment around us is going to get more competitive when we build the business plan. If you happen to have a year where that's not the case, that just makes the year a little bit better.

But the industry has always been very competitive and we see nothing out there that would cause it to be less competitive. We go into every year with that assumption and build a business plan of how we can invest the dollars we have to invest for our customers' benefit to drive more tonnage and more trips to the store and increase loyal households.

As we continue to do that, you see the results. As the number of our loyal households continue to grow, their trips to the store continue to grow. And then the units they buy on a monthly or quarterly basis continue to grow. That really winds up being our focus.

As Rodney said earlier on competition and pricing environment, we don't ignore anybody. We know what they're doing but we always come back to what's our customer wanting and how can we satisfy that need.

Alvin Concepcion (Analyst - Citigroup):

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

Mike Schlotman (EVP & CFO):

We are EMV complaint where you have to be EMV complaint, the C-stores and fuel pumps and things like that have a different deadline to be implemented. Some of our merged companies aren't completely there yet because they started later than we had started. We're working to get them caught up.

But if you look at -- Roundy's has work to do on EMV compliance, relatively small piece of the total pie. Those things won't affect us. What was the first part of your --

Rodney McMullen (Chairman & CEO):

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

Alvin Concepcion (Analyst - Citigroup):

Got it, thank you very much.

Rodney McMullen (Chairman & CEO):

Thanks.

Operator:

Kelly Bania with BMO Capital Markets.

Kelly Bania (Analyst - BMO Capital Markets):

Hi, good morning. Thanks for taking my questions.

Rodney McMullen (Chairman & CEO):

Good morning.

Kelly Bania (Analyst - BMO Capital Markets):

Wanted to circle back on Roundy's. Seems like the performance there was better than your expectation. Curious what drove that, was that Wisconsin markets or Chicago? Do you think that 30 basis points -- are you looking for that 30 basis points drag for the next couple quarters? Or do you think that could continue to improve? Any color there.

Mike Schlotman (EVP & CFO):

I would think the 30 basis points is what it will wind up affecting the full year by. They continue to have, obviously with it being a headwind, their sales trends are below the rest of the Company.

It's not like flipping a switch and all of a sudden you put a program in and they're done. We're going about this in a very methodical way, for lack of a better word, of making sure the stores are cleaned up and making sure they're reset, making sure stores are remodeled that need to be remodeled. Some may wind up being relocated.

And then you step back and you figure out how to give the best value proposition to their customers, like we've done pre-merger with Roundy's. The good news is, this is a game plan that we've used before as we invested in taking a business who had sluggish sales in Kroger at the turn of the century to a company that has very robust sales. It's a strategy we would expect to implement in Wisconsin as we go throughout the year. But it won't be flipping a switch where all of a sudden they'll turn on a dime.

Rodney McMullen (Chairman & CEO):

If you look at our overall Roundy's strategy when we announced the merger, we really look at it as a three-year approach. Obviously some of the things that we've talked about is part of it. But as Mike just mentioned, real estate would be part of that remodeling stores, expanding stores. All those things would be part of the total package.

One of the reasons why we got excited about Roundy's was obviously Mariano's. But in addition in Wisconsin, the quality of the real estate. Most of the real estate they have there is very good locations and for the most part, good store sizes as well.

Kelly Bania (Analyst - BMO Capital Markets):

Okay, thank you, that's helpful. Then wanted to ask, when you look at your households, your increasing penetration with new households in particular, I'm wondering if you have any color on what kind of customer that you're getting there, that new customer? Is that a higher-income customer, a lower-income customer? Is it a diverse group? Any analysis that you've done around that would be helpful.

Rodney McMullen (Chairman & CEO):

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

Kelly Bania (Analyst - BMO Capital Markets):

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

Mike Schlotman (EVP & CFO):

I don't -- I actually don't have that calculation handy.

Rodney McMullen (Chairman & CEO):

For the year, that would be pretty close.

Mike Schlotman (EVP & CFO):

For a quarter, it wouldn't -- as Rodney said, for the year it would be fairly close.

Kelly Bania (Analyst - BMO Capital Markets):

For the year.

Mike Schlotman (EVP & CFO):

Yes.

Kelly Bania (Analyst - BMO Capital Markets):

Perfect, thank you.

Rodney McMullen (Chairman & CEO):

Thanks, Kelly.

Operator:

Priya Ohri-Gupta with Barclays.

Priya Ohri-Gupta (Analyst - Barclays Capital):

Great, thank you so much for sneaking me in. Mike, just a quick question on your view of the refinancing market right now. It looks like you had about $1.2 billion in CP, and you have $800 million maturing later this year. I wanted to get your view on continuing to use the CP market to roll some of your maturities versus terming them out in terms of the long-term market, given where rates are. Thank you.

Mike Schlotman (EVP & CFO):

Yes, we do have the $800 million later this year and a little over $500 million in January. I would see us, as debt matures, terming that out as it comes closer. We have been putting interest rate hedges on that debt throughout time to take some of the interest rate risk off of the table if rates got away from us quickly, relative to the commercial paper.

You'll probably see us maintain commercial paper in that range. It's the easiest way -- particularly with where commercial paper rates are today -- it's the easiest way for us to get exposure to floating rates. If you want to modify your exposure to floating rates quickly, it's easiest to do that with commercial paper. Because, assuming the markets are open, I can always term it out.

If I have swaps or hedges or if I've done a three- or five-year floating rate note, you really can't change that quickly or eloquently. So that will continue to be part of our strategy.

Priya Ohri-Gupta (Analyst - Barclays Capital):

Thank you very much.

Mike Schlotman (EVP & CFO):

We probably have time for one more question.

Operator:

Ajay Jain, Pivotal Research.

Ajay Jain (Analyst - Pivotal Research Group):

Yes, hi, good morning.

Rodney McMullen (Chairman & CEO):

Morning.

Ajay Jain (Analyst - Pivotal Research Group):

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

Mike Schlotman (EVP & CFO):

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

Ajay Jain (Analyst - Pivotal Research Group):

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

Rodney McMullen (Chairman & CEO):

In Chicago, it's completely different. Obviously the condition of the store base is substantially very, very good, most of the stores. The first store was opened in 2010. They had acquired a bunch of stores from Dominic's when Dominic's left the market. They're in the process of remodeling those stores. But the rest of the stores are very good condition.

The biggest thing in Chicago is just cycling a lot of sister-store impacts because there were so many incremental new stores because of the Dominic's acquisition. But really the focus there is to continue to execute the plan, continue to connect deeper with customers and grow our market share. Chicago is a fantastic market that we really like.

Ajay Jain (Analyst - Pivotal Research Group):

Okay, great, thank you.

Rodney McMullen (Chairman & CEO):

Thank you. Before we end today's call, I'd like to share some additional thoughts with our associates listening in today. As you know, I always like to tell our associates a few comments because we have so many that listen in.

First, I want to take a moment to extend our deepest sympathies to the family and friends of those who lost their lives in the recent horrific attack in Orlando. What happened is tragic and heart breaking. I also want to thank the first responders who put their live in danger every day to protect us.

I know our family of associates, those at Axiom Healthcare outside of Orlando, across Florida and throughout the rest of the country, is deeply saddened by what has happened. We stand in support of the LGBT community. An event like this affects each and every one of us. No matter where we live or work, it serves to remind us of what is most important, and that is taking care of each other.

I want to thank our associates everywhere who demonstrate our values of diversity, inclusion and respect every day. To treat all with dignity, to seek and embrace the differences among people and to lift each other up. That completes our call today. Thanks for joining us and have a good summer.

Operator:

The conference has now concluded.