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The Kroger Co. (KR)

Investor Meeting

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MANAGEMENT DISCUSSION SECTION

Rebekah Manis

Director-Investor Relations, The Kroger Co.

Hey. Good morning and thank you for joining us. I'm Rebekah Manis, the Director of Investor Relations. And I'd like to welcome you to our 2019 Annual Investor Conference. We are excited to be in New York this year and we appreciate you spending the time with us. On behalf of the management team, we are pleased to have the opportunity to share an update on our Restock Kroger strategy and future financial framework.

Okay. We'll – a little slow on the clicker here. Okay, well, we'll just walk through it and apologies for that. But we want to let you know that today's agenda was designed based on the feedback we received from each of you. We listened and now you want to hear more about the health of our core business and the levers to accelerate profitable growth. You want to know about the capital deployment philosophy under our new CFO, Gary Millerchip; how Ocado fits into the digital ecosystem and why that's the right solution for Kroger, and taking a deeper dive into alternative profit streams and future opportunities for growth. Overall, I'd like to take this opportunity to thank you for your candor, insights and perspective. Kroger has always and continues to welcome engagement and dialogue with our investors. So, again, thank you for helping us shape today's agenda.

You'll be hearing from a variety of our executive leadership team. Our CEO, Rodney McMullen, will begin, followed by Kroger's CFO, Gary Millerchip. Then, based on the feedback we received from you, we will spend the majority of our time doing a deep dive into the core business including our seamless ecosystem. This will be the bulk of the agenda before lunch. We'll take a quick lunch break, come back to hear about our alternative profit streams, and there will be an opportunity for an extensive Q&A session with our executive leadership. So again, thank you for your engagement, dialogue and insight that helped us shape today's agenda.

And with that, we'll get down to business. That of course starts with our IR housekeeping items upfront. So, I'd like 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. Kroger assumes no obligation to update this information. During this presentation, we may discuss certain non-GAAP financial measures for reconciliation of non-GAAP measures, as well as other information regarding these measures. Please refer to the Investor Relations section of our website.

So with that, I'm pleased to turn the day over to Kroger's Chairman and Chief Executive Officer, Rodney McMullen.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thank you, Rebekah. Good morning, everyone, and thank you for joining us today. I'd like to begin today by grounding us on our strategic framework, Restock Kroger. Restock Kroger is repositioning our business by widening and deepening our competitive modes in four main areas, redefine the grocery customer experience, where we are enhancing the customer connection in our core grocery business by creating an experience that is seamless, that is simple, easy and intuitive; for customers to get the food they want, when and how they want it. We are using our data to drive personalization and our physical stores are a competitive advantage, because winning means owning the customer relationship throughout this total seamless ecosystem.

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Partner for customer value is where we're collaborating with icons such as Microsoft and Walgreens and innovators like Ocado and Nuro in order to enhance the customer experience and do things together that we cannot do without each alone.

Develop talent is where we're putting the right talent and teams in place to focus on growth in our core supermarket business and our alternative profit businesses. And live our purpose, which I want to stress is not a platitude, but a business imperative, because increasingly customers, associates and investors are choosing where to shop with, who to shop with, where to work, who to work for and companies to invest in that are purpose driven and are actively making the world a better place.

For example, we've found that when customers are aware of our Zero Hunger | Zero Waste social impact platform, they rank our reputation among the best in the world. The outcome of our focus on these drivers is shareholder value creation. At Kroger, we have an aspiration to deliver strong attractive total shareholder return year-over-year. TSR isn't a language that we've traditionally used. Our focus for the last two years and in 2020 is on Restock Kroger, and transforming our business model. We still have a lot of work to do moving forward, but you will increasingly hear us talk about TSR, which is a combination of business growth, free cash flow and dividend. At the heart of Kroger's TSR is our strategic capital deployment. Gary will talk more about what that will mean for 2020 and beyond.

We started on our Restock Kroger journey two years ago. Throughout the day, we will be transparent about what worked well, and what has not gone as anticipated, and most importantly, how we're going to win as we look to the final year of our three-year plan and beyond.

As we update you on Restock Kroger, there are four key themes we want to stress with you today. Our speakers will provide details around each theme, which you'll also see adds up to delivering shareholder value. We are on track with a stable and growing core grocery business as a result of our customer obsession and renewed intensity around operational excellence, add in the asset-light margin-rich alternative profit streams, which also enriches our core supermarket business, equals building business for long-term growth. A lot of what we talk about today, we will over index on 2020, because this is where we are in our journey and because this is the feedback that our investors and other partners have said they want to hear. But we are equally excited about and have a model for that supports growth beyond 2020, and all of these generate a consistently strong and attractive TSR.

We believe the food industry is special. Obviously, we love food. It is a huge industry, $1.5 trillion market. And it's especially important to note for new investors, because that means there is a lot of room for share movement. It is big enough for different models to coexist and ours will be one of them, because Kroger is uniquely good at food. And that is another reason why our industry is special. Not only do people have to eat, people love to eat. Cultures are defined by food, communities gather around food. Food isn't just a commodity it's the center of our lives. And when food is at the center, people do better.

Research tells us that families that share meals together have children who are more successful in nearly all aspects of their lives. Our research suggests that consumers make 221 food-related decisions each day. And when Stuart and the 84.51° team put the research together, it was one of those where are you sure. And they went through the details, but each one of us makes 221 food related decisions a day. And customers deserve a partner like Kroger, who can provide an inspiration and fulfill their passion for food. And each one of us would have a different passion for food, because unlike our national competitors, Kroger is food first. We believe that no

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matter who you are, where you're from, how you shop or what you like to eat, everyone deserves affordable, easy to enjoy, fresh food that tastes amazing. Kroger's ability to be that partner is a huge competitive advantage.

Now I'd like to spend a few minutes walking through our scorecard at the midway point of our transformation. But before we dig in, I think it's important to note that our transformation journey is about the – is in the context of an industry undergoing massive change. You've heard us say in the past that retailers need to transform themselves every 12 to 14 years in order to stay relevant. But the demand for change is more rapid today than ever before. So, now we look at this task really as an ongoing journey of constant evolution. We are also more convinced than ever that we made the right decision to implement Restock Kroger, when we did because the business that we are doing, we are doing the hard work of – that aren't doing the hard work of transforming themselves are not in a position to win. We are in a position to win and to win with our customers, associates, communities and investors in the future.

So, let's take a look at the progress we've made, what hasn't gone as anticipated, and where we see the opportunity to further deepen Kroger's competitive modes. First, the good, we invested in that customer and associate experience that includes our investment to build a seamless ecosystem that combines the best of the physical store experience with the digital customer experience.

We are well on our way to making the Kroger experience available to 100% of America through the combination of stores, our pickup, delivery and ship platforms. We generated over $1 billion in cost savings in each of the last two years, and we expect to do the same for next year as well. The asset light margin-rich alternative profit streams are where we expected them to be. And we have a lot of runway in front of us. We've also made good progress in the partner for customer value pillar. We started to establish partnerships that have strategic value beyond our three year Restock Kroger plan. We're also proud of the work that we've done to improve employee retention in one of the tightest labor markets in years. You'll hear it later that the cost associated with this success is a bit of a headwind.

As I suggested earlier, our associates expect more from companies today than ever before. We are investing to ensure that we have the right talent and teams, and we are disciplined around our structure to ensure that we have them in the right areas for focus and also to drive both the core business and drive our alternative profit businesses. We are focused on developing, training and promoting internal talent. And at the same time, we're hiring a lot of seasoned food industry executives to drive our retail supermarket business, and external talent to drive our alternative profit businesses as well.

For example 12 of the 28 leaders who are new to officer, division president or vice president positions are external experienced industry leaders. And through this work, we continue to support our inclusive and diverse culture. It was exciting to see Kroger recognized among the top five companies in the Wall Street Journal diversity and inclusion ranking for the S&P 500 companies based on metrics that include representation of women, age and ethnic diversity and whether the company has diversity programs in place. In a world where change is a constant force, customers, associates and other stakeholders including investors are more interested in choosing who to partner with based on a purpose and shared values. I'm pleased to report that our associates know our purpose is to feed the human spirit. And our aim is to bring this to life every day, and when we do, it's special.

One of the most meaningful ways our company lives our purpose is through our award-winning Zero Hunger | Zero Waste social impact plan, which is the centerpiece of our best-in-class ESG program.

Now, for the difficult. Overall, we assumed things would go according to plan more than we should have. We didn't build in enough margin for error in what we control, or margin for the unexpected and what we don't control.

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For example, we asked our store associates to do too many things at once in 2018. We pursued several initiatives that individually were the right things to do, but the cumulative effect of them made it difficult for our stores to execute. Space optimization and rapidly expanding our pick-up business are two examples. To do better, we are simplifying and focusing on the fundamentals in our stores, and we're seeing the benefits already. For space optimization, specifically, we've eliminated what didn't work and we've incorporated the parts that did work into our current plans to further our connection with customers.

Another unexpected headwind is the industry-wide gross margin pressure in the pharmacy business. Pharmacy is very important to our customers overall and it still makes money. And therefore, we are managing to mitigate the headwinds, while continuing to focus on growing this business.

In the improving category, we are laser focused on driving three differentiating strengths even more intently in 2020. This includes a strategic choice to invest further in the fresh experience with the idea of fresh for everyone at the center of Our Brand, and you will see shortly Kroger ranks the best in fresh among big box competitors. We are of course not satisfied, and we hold ourselves accountable to get even better. We aspire to be known to by our customers for providing fresh, affordable food that tastes amazing.

We are also focused on getting more Americans to experience Kroger's Our Brand products. Nearly, all large retailers offer private label products, but customers tell us Our Brands are just objectively better. In fact, in blind taste tests compared to other leading private label branded products, Kroger's products consistently score higher for quality, and Joe will share some of that later. We invest significantly in the quality of Our Brand products, because our customers tell us Our Brands differentiates Kroger and is one of the compelling reasons why they choose to shop with us.

And we are also focused on data and personalization, long an area of competitive advantage for us, and even more so now with new technologies and abilities to better enhance the customer connection. We're also leveraging our data expertise as a tool to help CPG companies to improve the effectiveness of their advertising spend. These are three areas where we are providing and driving sustainable competitive advantages in our core grocery business, where we are widening and deepening Kroger's competitive moat to win in 2020 and beyond.

We're now up to speed on Restock Kroger. We have made good progress in many areas and even though some things have not gone according to plan, we've made a series of smart financial and strategic moves and have swallowed some difficult pills that sets Kroger up for a stronger future. As we look forward, we are focused on enhancing our customer connection and driving TSR.

Restock Kroger is the right strategic framework, because it gives us the ability to invest in our customer connection and why our customers choose to shop at Kroger for today and the future. This is especially true for our investments and seamless, because customers want to shop on their terms for anything, anytime, anywhere. We have transformed our business model and capital allocation strategy and we are generating more than $1 billion a year in cost savings to fund incremental investments in these key areas.

We will continue to invest both capital and expense to make a world-class seamless experience available to our customers, and we are well positioned because several of our grocery competitors are not taking these steps today. We are also making good progress on several key areas of our business and we are reconfirming our 2019 guidance. We have regained identical sales momentum and continue to expect 2% to 2.25% identical sales results in 2019.

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We also continue to expect adjusted earnings per diluted share of $2.15 to $2.25 for 2019. Gary will talk about our expectations for 2020 and beyond. By executing against our Restock Kroger framework, we expect to generate nearly $5.1 billion in free cash flow in 2017, 2018 and 2019 combined. We have returned $4.8 billion of cash to our investors through dividends and share buybacks for between 2017 and year-to-date 2019.

Gary will outline this in more detail, but when you look at 2020, we would anticipate a TSR in the 7% to 11.5%. As we look beyond 2020, we expect Kroger's TSR to be at a minimum of 8% and more in some years. We are confident we can deliver this stronger TSR in the future because of our strong free cash flow and good sustainable net earnings growth. This is why Restock Kroger is the right strategic framework for our business to grow in 2020 and the future.

What you will hear today is a clear message about what we've learned over these last two years and how we are applying that experience to drive growth in 2020 and beyond. We are clear eyed about what worked and what didn't. We own both. Most importantly we are meeting both our challenges and our opportunities with intensity and discipline. It all starts around our intensity about customer obsession. Everything we do supports our vision to serve America through food inspiration and uplift.

Mike Donnelly, who you all know is our Executive Vice President and Chief Operating Officer. Joe Grieshaber is Senior Vice President Merchandising, and runs all our merchandising functions, and many of you may know Joe from a few years ago. He's had several different roles in merchandising and he's ran several of our divisions; recently was promoted to his current role. Mary Ellen Adcock is Senior Vice President and is in charge of operations, and has several of our divisions reporting to her as well. Mike, Joe and Mary Ellen will outline and detail how we are driving results in our core supermarket business through operational excellence and disciplined store execution and by focusing on these – our three strategic levers to drive identical sales growth; the fresh experience, Our Brands and personalization.

Yael Cosset, who's our Senior Vice President and Chief Information Officer; Yael, as you know, is new to his current role, but all of you know from his previous role has been then leading our digital efforts for the last several years.

Stuart Aitken, who in the past you would have known as the CEO of 84.51°, earlier this year took on the expanded role of the responsibility for all of our alternative profit businesses. And as you know, Stuart has had a tremendous amount of success over the last several years on helping drive 84.51° both inside Kroger and outside Kroger on developing relationships with CPG.

And Cara Pratt, who's our Vice President of Kroger Precision Marketing at 84.51°. Cara is a media professional. She has experiences at Dunnhumby, IRI in addition to 84.51°, and has a ton of experience in the media space in the past. Yael will discuss how the digital ties all this together in a total seamless experience for our customer, followed by Stuart and Cara's presentation and update on our asset-light, margin-rich alternative profit streams, which support our growth algorithm, while at the same time enriching the customer shopping experience.

Gary Millerchip, who's our Chief Financial Officer, and Gary has been in role for about seven months now has hit the ground running. And Gary will first provide you some additional color on how we've transformed our business and financial models to drive investments that will enhance our customer connection and provide a deep dive into our growth algorithm for 2020 and beyond.

With that, I'll turn it over to Gary.

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Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Thanks, Rodney, and good morning, everyone. It's great to be with you for my first investor conference as CFO. During our time today, my goal is to give you a better understanding of how we're building the business for long-term growth, and how we plan to generate consistently strong and sustainable attractive total shareholder return.

I plan to cover three main topics. First, building on Rodney's comments, I'd like to share some more color on our strategy, and why we believe we have the right to win the $1.5 trillion retail food industry. Second, I'll share some reflections on our Restock Kroger journey so far. And then, finally, I'll provide you with an update on our future expectations to create value for shareholders including detailed guidance for 2020.

Earlier, Rodney shared his views on how the US retail food industry is undergoing immense change. We believe Kroger is well-positioned to win with the unique value that we deliver for our customers every day. Kroger is a market leader, holding the number one or number two market share position in 90% of the major markets, in which we operate and we see further opportunity to grow in the future. A third of the traditional grocery industry is highly fragmented. We believe this represents a significant opportunity to win more customers as we leverage our investments in customer experience, in price and building a digital seamless ecosystem. Note that these investments many of our smaller players in the market are unable to make.

We also see the food away from home market is an exciting growth opportunity. We believe we can grow our market share of this segment as we continue to evolve our Fresh for Everyone campaign. Later this morning, Joe will talk more about how our merger with Home Chef, and the evolution of our in-store fresh prepared meal solutions will allow us to meet a larger share of the customers' meal needs in the future.

Kroger continues to invest in digital, as we build a seamless ecosystem for our customers. We know our customers value the increased convenience this provides, and our data shows it's an essential component of growing overall loyalty. That being said, it's important to remember 97% of the US population shop for groceries in a brick-and-mortar store. For that reason, conveniently located physical stores continue to be vitally important to our customers, and our insights show that this remains a competitive advantage and a primary reason why customers choose Kroger.

Another insight that shows up in our data suggests that as a customer decides where to shop for food online, this is heavily influenced by the quality of the in-store experience, further underscoring the important dependency between these two modalities.

Beyond the convenience of our stores and the seamless ecosystem we are building, Kroger is redefining the grocery customer experience by delivering a differentiated experience for our loyal customers in a number of important areas. Our customers tell us that compared to our national big box retail competitors, we continue to offer better experience with the quality of our products and fresh offering, the quality of our private label brands, and our ability to personalize both the shopping experience and the value we offer for customers. You will hear from Mike, Joe and Mary Ellen about how we will continue to separate ourselves from the competition in these areas later. Yael will share how we are building our seamless digital ecosystem to offer increased convenience and personalized solutions for our customers.

Turning now to our partner for customer value pillar of Restock Kroger, we believe partnerships will continue to play an important role in accelerating Kroger's food ecosystem and provide further growth opportunities for Kroger beyond 2020. Partnerships allow us to build capabilities that deliver on important elements of our strategy at a

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faster pace and lower risk. At the same time, we are being very deliberate in selecting partnership opportunities and partners that are a great fit for Kroger. A good example of this is in the area of digital and supply chain. While we are developing many capabilities internally to support seamless, we also recognize there are external technologies that can accelerate our progress. We are excited to partner with Ocado, who we see as a market leader in supply chain automation.

We are also testing self-driving vehicle delivery through our partnership with Nuro. Our exploratory pilot with Walgreens provides exciting opportunity to increase our relevance with existing customers and also engage new families across the country. In our test markets, we are creating unparalleled convenience to meet customer shopping needs both inside the Kroger store and inside a Walgreen store as well as offering Kroger pickup at Walgreens. Through this process, we are building an understanding of how we can work together to optimize sourcing and supply chain capabilities.

Creating value through partnerships is not new to Kroger. We have an established approach and successes include Kroger Personal Finance, 84.51° and Murray's Cheese. We are applying these learnings to ensure we maximize value from the Partner for Customer Value pillar in a thoughtful, disciplined and targeted way.

I'd now like to transition to some reflections on Restock Kroger progress and some of our key learnings. As Rodney shared in his opening remarks, we believe Restock Kroger is the right strategy. We remain committed to executing on the four drivers of Restock Kroger that will create value for our shareholders. Our strategy includes making significant investments in the business to ensure we position Kroger for long-term success, and we believe they are critical to delivering sustainable growth in the future. Over the three-year time horizon of Restock Kroger, we are investing to deliver more value for our customers in the areas that matter most to them and those we believe will build long-term loyalty.

This includes investments in the quality of our products and freshness, the talent in the stores and pricing, which includes delivering a greater value through personalized rewards. As I mentioned previously, we are also investing heavily in seamless. While we're pleased with the progress we're making, not everything has gone according to plan and we have experienced some unanticipated headwinds. Over the three-year Restock Kroger time horizon, these headwinds will come to nearly $800 million. And while we've been able to overcome some of the impact, the magnitude of these three categories led us not to reconfirm the $400 million of incremental operating profit guidance during our second quarter earnings call.

First, the scale of industry-wide gross margin pressure in retail pharmacy has been much greater than we anticipated in our plan. Second, while investing in our associates was contemplated as a key component of Restock Kroger, the level of investment has been greater than we originally expected, as we operate in an historically tight labor market. Finally, identical sales did not accelerate as quickly as we had expected. We now recognize some of this was self-inflicted as we attempted to execute multiple initiatives in our stores at the same time. Mike Donnelly will provide some additional commentary on how we've addressed this area.

I'd like to spend a few moments going into more detail about our retail pharmacy business. While profitability is lower than we had budgeted this year, it remains an important part of our strategy. Loyal customers who use our pharmacy program are significantly more loyal to Kroger, spending three times more than a non-pharmacy shopper. We are also starting to see customers think more holistically about food and the connection to their health and wellness. With our depth of customer data and food expertise, we believe Kroger is uniquely positioned to help customers accelerate this connection, while at the same time deepening loyalty and generating new revenue streams.

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In spite of the current gross margin headwinds, I should also reinforce that our retail pharmacy business continues to generate strong returns. I'd now like to turn to the progress we've made in many areas of the business as a result of our decision to embark on the Restock Kroger journey. We're pleased to see identical sales momentum is building. We achieved improvement in 2018 over 2017. This has continued into 2019, and we expect this trend to continue into 2020. We are also delivering adjusted earnings per share growth for our shareholders through the Restock Kroger timeframe, supported by a disciplined approach to returning cash to investors, which I'll talk more about in a moment.

A major success has been our cost saving program, which identifies waste that can be taken out of the business without impacting the customer and simplifying work for our associates. We achieved our $1 billion goal in 2018 and we remain on track to achieve our plan in 2019. The key components of our cost saving plan are productivity improvements and automation, sourcing of goods for sale and goods not for resale, administrative efficiencies and waste reduction. We expect our successes and learnings in this area to continue to drive further cost saving improvements in 2020 and beyond.

Kroger continues to generate strong free cash flow. Over the course of 2017 to 2019, we expect to generate $5.1 billion of free cash flow, excluding the sale of strategic assets and company-sponsored pension contributions. Our cash flow has proven to be resilient throughout the economic cycle, and our free cash flow yield in 2019 is expected to be greater than 8%. We have also been disciplined in returning cash to our investors. Since 2017, we have returned $4.8 billion to investors via share repurchase and dividends through the end of the second quarter of 2019. This year, we increased our dividend by 14%, the 13th consecutive year of increase, and it represents a compounded growth rate over that time period of 13%.

Part of our disciplined approach to capital management included the sale of three businesses. These are businesses that we successfully grew by leveraging Kroger's unique assets, and when they reached a point where the external value was higher than the future value within Kroger, we divested to maximize shareholder value. As a reminder, the three businesses were convenience stores, which we sold for $2.2 billion; Turkey Hill Dairy that we sold for $215 million; and You Technology that we sold for $565 million. At the same time Kroger has been returning cash to investors, over the last year, we've also reduced our net total debt by $1.3 billion. And Kroger's net total debt to adjusted EBITDA ratio was 2.46 in the second quarter, inside our target range of 2.3 to 2.5. We remain committed to operating consistently within this target range going forward.

Now, I'd like to walk you through how we are thinking about our future model to create value for shareholders and our financial expectations for 2020 and beyond. As Rodney shared earlier, our model for a strong and durable retail supermarket business begins with the customer and our obsession with increased customer loyalty. We believe that our intensified focus on execution and continued improvements in the value and experience we deliver for our customers will drive increased identical sales across our store and digital ecosystem.

To drive sustainable sales growth, we will continue to invest in areas of the business that are important to the customer. This includes ongoing investments in talent, in price, digital and store experience with an even greater emphasis on freshness, Our Brands and personalization. As we are demonstrating through the first half of the year and reconfirmed guidance for 2019, we will be very deliberate in balancing these investments with disciplined execution of cost savings that simplify our business. These include productivity through automation, sourcing of goods for sale and goods not for resale, administrative efficiencies and waste reduction.

We will ensure the operating performance of our supermarket business, which we consider to include fuel and pharmacy, demonstrates stability and maintain the strong free cash flow that underpins our financial model. Our core supermarket business and the traffic and data this generates also now serve as the foundation from which

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we were able to drive higher growth in our asset-light, margin-rich alternative profit business. Stuart and Cara will provide more color on our progress and expectations in this area after lunch. We continue to expect this to accelerate our results in 2020 and beyond.

We will be disciplined in allocating capital to projects that drive our model and have a strong return. We expect our model to deliver improved operating results over time and continued strong free cash flow. We expect this to translate into a consistently strong and attractive total shareholder return through EPS growth driven by sustained net earnings growth and return of cash to shareholders via share repurchase plus a growing dividend over time.

As a leadership team, we've employed an even greater level of detail and rigor in our 2020 planning process and incorporated additional checks and balances along the way. It's been exciting to see the collaboration on the plans and commitment across the teams to deliver on the guidance I'm sharing. As you know, we typically share guidance in March. But this year, we have pulled guidance forward by several months. Because of that, I'd like to point out that all year-over-year growth rates used are based on the midpoint of our 2019 guidance.

Building on the momentum we are seeing in 2019, we expect identical sales growth of greater than 2.25%. We will continue to invest in areas of the business in 2020, and these investments will be balanced with incremental cost savings of approximately $1 billion. We expect an essentially stable core supermarket operating performance in 2020 across the combination of food and grocery, pharmacy and fuel. Alternative profit businesses are expected to grow operating profit in the range of $125 million to $150 million. We expect adjusted FIFO operating profit of $3 billion to $3.1 billion and adjusted net earnings per diluted share to range from $2.30 to $2.40.

Capital investments are expected to range from $3.2 billion to $3.4 billion. Free cash flow is expected to be in the range of $1.6 billion to $1.8 billion, and as we anticipate staying within our target debt to EBITDA ratio in 2020, we expect to repurchase shares in the range of $500 million to $1 billion. As a reflection of our board's confidence in our plan for 2020, they recently approved a $1 billion share repurchase program replacing the prior authorization. Through the lens of TSR, we expect to generate EPS growth of 4.5% to 9% coming from growth in earnings and the $500 million to $1 billion share repurchase. Combined with our dividend yield of approximately 2.5%, this represents an estimated TSR of 7% to 11.5% in 2020, assuming no change in Kroger's PE multiple.

Turning specifically now to capital allocation in 2020, as I mentioned earlier, capital will be allocated to high-return projects, and we are holding ourselves accountable to ensuring that every dollar we spend creates value in our model. The majority of our investments in 2020 will be allocated to driving profitable sales growth in stores and digital, improving productivity, and building a seamless digital ecosystem and supply chain. The increased capital forecast for 2020 compared with 2019 reflects our investment in the roll-out of the first Ocado facilities, which will start to go live in 2021.

The cost of the first facilities has been a little bit higher than we originally anticipated primarily due to increased land and construction costs. We continue to work with Ocado to engineer the most efficient design, and our analysis still shows we expect a strong ROI from our investment in Ocado facilities. Kroger's ROIC is well above our cost of capital and is expected to be essentially flat in 2019. As we increase the intensity with which we deliver on our value creation model, we expect ROIC to gradually improve over time. This will be achieved through improved business performance, a rigorous and disciplined approach to capital allocation to ensure projects achieve a return greater than 11%, and an effective portfolio management process, including asset pairing where appropriate.

I also want to take this opportunity to reinforce our financial strategy and how we'll prioritize the use of free cash flow going forward. We will continue to use our strong free cash flow to invest in the business to drive long-term

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sustainable growth through the identification of high-return projects that support our strategy. At the same time, by maintaining our net debt to EBITDA range of 2.3 to 2.5, we are committed to maintaining our current investment-grade debt rating. We also expect to continue to grow our dividend over time, reflecting the confidence we have in our free cash flow, and will continue to return excess cash to investors via share repurchase.

So, in closing this section, I'd like to reinforce that the framework I shared with you earlier isn't just our approach for 2020. It's how we think about creating long-term sustainable value and I therefore like to leave you with a recap of the key components of the model. It begins with our customer obsession and our expectation that we'll continue to drive identical sales growth. We'll continue to make the right investments in the areas that matter most to our customers, and we'll balance these investments with disciplined execution of cost savings, where we see continued opportunities for savings beyond 2020. We expect operating performance of our supermarket business to be more stable going forward. We expect our fast-growing alternative profit businesses to continue to deliver significant incremental profit growth in the medium-term.

We will be disciplined in allocating capital and expect to continue to generate strong free cash flow throughout the economic cycle, which will allow us to generate consistently strong and attractive TSR through EPS growth and a growing dividend over time. By executing on this framework, we are targeting total shareholder return of between 8% and 11% beyond 2020. This will be driven by 3% to 5% growth through improved earnings and growth in our free cash flow payout rate through a combination of share repurchase and dividends. This range excludes any potential change in our PE ratio and the opportunity for additional growth beyond 2020 through our strategic partnerships.

Thank you for your time this morning. As Rebekah shared earlier, there will be time for Q&A later. But now, I'd like to welcome Mike Donnelly to the stage, who will discuss how we are on track with a stable and growing core grocery business. Mike?

Michael Joseph Donnelly

Chief Operating Officer & Executive Vice President, The Kroger Co.

Thanks, Gary. Good morning, everyone. We are excited to be here today. Shortly, Joe, Mary Ellen and Yael will cover the state of the business and our plans going forward. But I want to share with you why we are optimistic about the business and the future of Kroger.

So, it all starts here. Everything begins with our people. They are the face of Kroger. They are 460,000 strong, who take care of our business every day. They bring the energy and create the magic that keeps our customers coming back.

We have never been more focused on the customer experience. This video has become an inspiration for our associates across the company. I want you to see the passion and feel the energy our associates bring to our stores and our customers every day.

[Video Presentation] (00:46:38-00:48:10)

That is an amazing video, and our people truly do make the difference. You heard from Rodney. We asked a lot of our stores in 2018. We learned a lot. We took the learnings and quickly adjusted our plans for 2019. We minimized the disruption in our stores and regained focus on the fundamentals. You'll hear us talk about full, fresh, friendly and inspired selling. It's the foundation of what we do, and in 2020, we will remain focused on the fundamentals and the customer experience.

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Our core business is the source of Kroger's strong free cash flow. We are committed to delivering greater shareholder return in 2020. Our core is strong and durable, and there is a number of factors. 11 million households shop with us every day. 30% of our households are loyal. 70% of our sales come from 30% of our households, and they are eight times more valuable. We continue to see loyal customer growth quarter-on-quarter.

Additionally, our footprint is a major competitive advantage. We're either number one or number two in 90% of our major markets we operate in. And data remains our strongest asset. We continue to learn and leverage our data as a competitive advantage.

Many claim to be customer-driven. At Kroger, we live it every day. The customer remains at the center of all we do and the decisions we make. Whether it's pricing, assortment or delivering personal offers and fuel rewards to our loyal customers, our relentless passion for customer-first will continue to support the core business and drive strong results in the years to come.

So, up next, Joe will take us through our plans to drive identical sales in three very important areas, personalization, Our Brands and Fresh for Everyone. He'll also give you a sneak preview of our new marketing campaign, which I hope you will enjoy. Next up, Mary Ellen will share how we will plan to continue the momentum around customer experience and cost initiatives. And then lastly, Yael will talk about how our digital strategies come to life to create a seamless customer experience.

With that, I'm going to turn it over to Joe. Here you go, Joe.

Joseph A. Grieshaber

Senior Vice President-Merchandising, The Kroger Co.

Thank you, Michael. Good morning and it's good to be with everyone and excited to talk about our plans to drive identical sales at Kroger. Let me start by saying I'm very confident in our sales momentum from quarter two will continue. And as a reminder, quarter two was our strongest identical sales since the transformation began. Identical sales will be driven by three important sales drivers, personalization, Our Brands and Fresh, and I'm going to talk about each one of these sales drivers and our plans to grow customer loyalty and identical sales.

We've been focused on growing loyalty for many years. As was mentioned earlier, our data is a key differentiator for Kroger. Many retailers have transactional data, but no one has the customer data and the insights that Kroger has to make decisions on behalf of the customer. We continue to see incredible effectiveness and efficiency from a focus on loyal customers and investing in their satisfaction. Loyal households, as Mike mentioned, are our most valuable customers, representing 70% of our sales. They are eight times more valuable than our non-loyal, and they visit our stores four times more frequently.

Loyal households engage in higher numbers with our total value proposition of good prices, exciting promotions and relevant rewards. For loyal households, the value they receive is enhanced significantly from personalized rewards, and this reduces the price they pay. Personalizing these rewards is a key to growing engagement and driving loyalty. These tools are efficient and effective. We've used fuel rewards and personalized communications for many years as the workhorses of our loyalty efforts. 10 million customers engage with fuel rewards each and every month, and customers tell us over and over again they love their fuel rewards.

We've tested point multipliers on fresh food categories, trip challenges that unlock bonus fuel points and personalized offers that give customers a choice of awards. Going forward, we will increase the promotion and

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personalization of fuel rewards to drive excitement and incremental in-store spend. An amazing 83% of our loyal households engage with our fuel rewards program each year.

Personalized communications is an important lever to drive strong incremental trips and units. We utilize best-in-class one-to-one personalization science to send the right offers to the customer based on their shopping habits and their household needs. We mail 1.5 billion coupons to customers each year, and going forward, we are evolving our best customer communication plan to increase frequency, expand reach and emphasize reward offers to drive even more trips.

As customers engaged with our digital properties, we see strong incrementality. Digitally engaged households visit us more frequently and they spend more with Kroger. On average, digitally engaged households visit three more visits per month and customers downloaded over 2 billion digital coupons last year. And then, we were presenting those to the customer in a personalized fashion that leads to even greater basket building.

Yael will talk about our – a little later on this morning about our path forward with the seamless visual experience and its incrementality for Kroger. Looking forward, we are testing several additional initiatives designed to more deeply connect with our most loyal households. We have a variety of membership programs in tests and they're showing promising results and provide new insights in growing customer loyalty. The key takeaway from this slide is that personalization is important to the customer. They appreciate that we know their households and they appreciate the rewards they receive from engaging with us in-store and online. For Kroger, we optimize our price and promotional spend with customers that in turn spend the most with us.

Our Brands has been a sales driver and a competitive advantage for Kroger for many years. The Our Brands strategy is to drive sales, enhance gross margin, and engage and grow loyal households. Our Brands sales continue to grow year-on-year faster than our total store sales. As this chart reflects, we enjoy strong year-on-year growth across the assortment, with particularly strong growth in our higher margin Private Selection and Simple Truth brands, and we have plans to continue Our Brands at a similar pace going forward. When we test Our Brands versus others, customers prefer Our Brands. The Net Promoter Score is 30% to 40% higher for Kroger, Private Selection and Simple Truth versus comparable tier of competitive store brands. Additionally, they prefer Our Brands over national brands as well. For example, Simple Truth's Net Promoter Score was 34% higher than the highest scoring national brand.

Let's look at how Our Brands are growing loyalty real quickly. Private Selection is purchased by over 30 million households and is growing at over 7%. When Private Selection is in the customer basket, we know the basket has more in it and is larger. New product development is a key driver of the Private Selection growth. This brand is a point of difference. It drives sales. It enhances gross margin. Simple Truth enjoys 32% share of the natural and organic branded foods category and is delivering strong double-digit growth. We expect significant new item growth from Simple Truth in 2020, and I'll talk about that in just a few minutes.

Finally, the Kroger brand is the huge brand that is loved by millions of customers, and in 2018, our sales were over $13 billion. 87% of all households shopping our stores engage with the Kroger brand. Our 2019 sales trends are at a similar pace to 2018 and we expect that pace to continue going forward into 2020. Innovation is the key to our growth in Our Brands. As we look to the future, we will leverage our best-in-class trend mapping to develop innovative new products, brands and flavors that excite and entice customers, while driving Kroger's reputation as the food authority.

As an example, last October at this conference in Cincinnati, we shared Kroger's top food trends for 2019, and we predicted at that time that plant-based alternatives would be a category to watch for growth. I can tell you today

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that plant-based alternatives will be a key driver to deliver double-digit Simple Truth brand sales and category margins in 2020. This year – this past year, we introduced 22 new plant-based products in Simple Truth, and in 2020, we'll introduce an additional 58 new items.

The Plant Based Food (sic) [Foods] (00:59:32) Association predicts that the growth in these products – this industry will be five times that of total food sales, and Kroger is on the leading edge of that growth with Our Brands. To talk a little bit about our approach to innovation, we have a brief video that we'd like to share with you.

[Video Presentation] (00:59:52-01:01:46)

Okay. You'll have the opportunity to try these wonderful Cuban chips at lunch today, so we're excited to get your feedback and see if they live up to the video. So, the key takeaway from this slide is our brands are loved by our customers. They are our competitive advantage for Kroger. Kroger has world-class our brand's innovation and world-class our brand's results. The third and an important driver of sales for Kroger is Fresh. Our Fresh departments drop trips, loyalty and gross margin; and they're a true differentiator. Our product standards, selection criteria and supply chain are core strengths; and are built to deliver first-to-market and best of the season fresh products across the United States. Customers tell us they choose the store they shop based on nine key categories; and they're all fresh.

Produce meat and dairy lead that list. Dinner tonight is the top reason customers go to the store on any given day. But replenishing produce meat and seafood quickly follow. And finally, as we look at advertising testing, we see a clear pattern where spots that focus on fresh score more strongly on key customer measures including likelihood to shop and brand love. So with that insight it's no surprise we're focused on fresh. Fresh for everyone is a focus on making great fresh foods available all in one place. Customers tell us again and again they want to get everything in one location. They want high-quality standards and they want options from fresh ingredients to ready-to-heat to ready-to-eat. We will meet customers where they are whether they like to cook, don't know how to cook or don't have time to cook. Additionally, customers want knowledgeable and ready-to-serve associates. As Mike mentioned earlier, we continue to invest in our team.

We have over 2,000 cheese stewards, 2,000 meat cutters and thousands of cake decorators and florist. These associates make a difference for our customers every day. From holiday dinners, birthday celebrations to one of my favorites the roses for The Kentucky Derby, the blanket of roses, our teams touch our customers in many ways large and small. We are laser-focused on continuously improving the quality standards of our fresh products and I have a few examples I'd like to share today. One the 17 Kroger dairies across the United States allow us to be vertically integrated in dairy manufacturing. And by controlling the entire process Kroger is the only retailer to guarantee 10-day shelf life on fresh milk for our customers. And we're the only national retailer to partner with Apeel Sciences to improve the quality and shelf life of Fresh Produce.

We're starting with fresh avocados, which is the second largest tonnage item in Fresh Produce. We're expanding this science to other fresh products including fresh asparagus and limes, two time sensitive products. This science, improves the at-home shelf life for the customer, lowers our distribution costs and improves quality. Fresh meal concepts continue to be a growth engine for Kroger in 2020. We're growing our meal kits, ready to cook and ready to eat assortment. In 2019, we expanded the home shelf assortment from 725 stores to over 2,000 stores today. And we have expanded beyond the original meal kits to include oven-ready kits, ready-to-heat sides and entrees. We are seeing double-digit growth in fresh meals and expect that momentum to continue in 2020.

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Innovation is key to staying relevant and fresh. And we have several activities that are in test right now. Starting this week we have a first in the US produced growing effort in two stores in Seattle, Washington with in-farm from Berlin, Germany. We're doing that with our QFC brand in Seattle. We also have food halls and restaurants like the Kroger on the Rhine that opened in Cincinnati in early October. And lastly helping our customers addressed the most common chronic diseases impacting our population that are heavily influenced by the food we eat. We call that food as medicine and it's a dedicated educated and personalized approach to eating and enjoying fresh food so we can live healthier lives and prevent illnesses before it starts. We continuously look for opportunities to improve our fresh assortment, strengthen our quality and provide service and convenience based on our customers' feedback.

So the key takeaway from this slide is that Fresh for Everyone is a differentiator for Kroger. Our customers visit our stores more often because of the fresh food assortment, quality and service. For Kroger by delivering for our by delivering for our customers our Fresh sales will grow faster than the total store sales. So in conjunction with our focus on Fresh as a sales driver in 2020, we will re-launch our brand with a new strategy this week. We are launching with Fresh in a big way. We will be delivering a great experience across all touch points our customers have with our brand from advertising, the store and the site experience. But as we look around we operate in a Sea of Sameness that is also occupied by most of our competitors in the grocery category. We did an audit of our advertising across our work and that of several of our competitors.

And here you see a snapshot of that audit including screenshots from TV ads, online videos, and Instagram and it's impossible to tell one brand's ad from another. As we briefed our new campaign, we set as a core objective to break through this Sea of Sameness, to ensure our customers recognize our advertising and attribute the key messages and benefits to Kroger. And we know breakthrough creative executions when delivered consistently, also ensure our marketing dollars work as effectively as possible. So I'm excited to introduce our new campaign Fresh for Everyone. Our one line articulation of the campaign strategy is as America's favorite grocery store, we believe that no matter who you are, where you're from, how you like to shop or what you like to eat, everyone deserves to have affordable, easy to enjoy fresh food.

And you may have noticed that we're using animation as our creative device to bring this to life. The characters you see here represent a world we're creating to reflect and engage our customers and our associates. They are the everyone in Fresh for Everyone. Through Kroger's history we have always been a brand that's of and for the people and the communities where we're a part of and we're excited to bring that to life in a fun, welcoming and inclusive way. And we know that Kroger is uniquely positioned to deliver this given our size, our scale and a 135 year passion for food in our customers. So, we'd like to share with you a sneak peek at our TV launch that will go live tomorrow across the United States.

[Video Presentation] (01:09:31-01:10:02)

So here we go. So one of the things you may have heard is free pickup in this commercial and with the busy holiday season here we will be offering free pickup for a limited time in select markets across the United States. We are excited to offer this limited time promotion when many of our customers will most appreciate the opportunity to utilize the efficiency and effectiveness of pickup. We will learn from this program and use the data to inform future decisions around our digital offer. As you saw in the TV spot we are also leveraging a new approach to food photography to breakthrough that sea of sameness, to contrast those top-down beautiful plated images of food that everyone is using, we are adding motion and energy to gorgeous real food is our new signature style.

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When paired with the animation, the food pops out and catches the customer's attention as a real hero element. Always like that one right there, that's a good one. Our marketing efficiency will continue to grow behind this new campaign as well. We know that consistent creative execution will allow us to further our media investments. Based on studies from Cantor, Nielsen, Google, we know that the impact of creative execution can be huge accounting for up to 50% of advertising impact. And finally animation creates production efficiency especially in a world where we need an exponential amount of content for digital and addressable marketing.

If you think about a traditional world where we must rent sets and hire talent for every spot we build shooting each frame we need. With animation the sets and the talent are created, placed in a library and are used again and changed again and again in a much more modular way. So, I ask you, can you find Kroger now? We will be instantly recognizable and recalled with this simple yet new unique new approach. It can quickly become ownable and allow us to break through the Sea of Sameness in a way that is strong and has strong impact on our customer and on our business. Thank you for the opportunity to share our sales and marketing strategies today.

And I'm excited and confident about our plans to grow identical sales in 2020 and beyond. Now I'd like to introduce Mary Ellen Adcock, our Senior Vice President of Retail Operations. And as Mary Ellen comes up to the podium, I want to emphasize that growing identical sales is really a partnership between merchandising and operations, executing operationally at a high level is critical to growing sales. And at Kroger our merchandizing and operations teams work together to deliver every day for our customers.

So Mary Ellen?

Mary Ellen Adcock

Senior Vice President-Retail Operations, The Kroger Co.

Thank you, Joe. Yes. It takes operations and merchandising working as dedicated partners. And it's this combination of customer obsession and operational excellence that generates ID sales growth. And today we are shared – we are pleased to share with you how we are demonstrating operational excellence. And by this we mean delivering cost savings that are not relevant to the customer. Well, at the same time executing the customer experience that goes above and beyond. We strive for our customers to love the experience with Kroger. Last year at our investor conference we shared with you that we were tracking ahead of our savings plan. And we not only delivered but we exceeded with over $1 billion in savings.

This year we are also on track to deliver our savings plan, which is incremental to the $1 billion last year and we have a clear pipeline for 2020. And while we're making good progress on cost savings we are not sacrificing the customer experience. You saw this in Gary's presentation. This chart shows how our customers compare us to national big box retailers and as you can see we outperformed the competition in areas that matter to our customers. You can also see these are not new characteristics. These fundamental areas are still important to our customers. Our customers value their time and quite frankly so do we which is why whether in-store or a pickup having products fresh and available, associates friendly and products in-stock are still important to customers. The fundamentals remain essential to the customer experience.

And to keep us focused on executing with excellence on this priority, our associates and our stores use leading indicators to ensure that we're full or in-stock providing fresh products and friendly associates and we measure this at a store level for execution and its working. Our progress and our leading indicators in full fresh and friendly are absolutely contributing to our sales momentum and our business results. It's not the only thing that this improvement is a driver of our increased sales. And also our customers are noticing and they are telling us about it. We love to hear uplift stories from our customers bringing it to life and making it personal. These are just a few examples of what we aspire for our customers to see and feel every day.

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Great selection, it's fun to browse for inspiration with friendly associates, I love my Kroger and my kids do too. But it's not just about in-store. Kroger Pickup is also part of our convenient experience. By the end of the year we'll have more than 2,000 locations and it's the fastest growing area of our business. So while we are committed to the customer experience, we also have an obligation to continue to drive cost out of the business and we're doing this through productivity and process change. And so when we say process change, we mean streamlining or simplifying task for our associates so they can spend more time in areas that are relevant for the customer. We're also using data and technology aggressively for process change.

Examples like machine learning in self check out for improved order accuracy. Robotics to simplify work for associates that's manual and difficult. Visual analytics for on-shelf availability to improve in stocks. And so these are just a few examples. We have many others. These are all actively in process in our stores in various stages from test and learn. But we wanted to give you some insight into how we are delivering the cost savings target for 2019 and building the pipeline for 2020. Cleaning is another example where we spend hundreds of millions of dollars and through technology and equipment we are making cleaning faster, easier and more consistent. Another example is using our operational data to maximize product placement by using the data and analytics to predict the highest sales to allocate the most efficient space. It's not all technology driven.

Our customers continue to want convenience because time savings is so important. Grab and go options appeal more and more to our customers. And how we package and display them can also be more efficient for our associates and easier to shop for our customers. Shrink is another area where you might remember last year was part of our cost savings plan. We not only delivered, but we continue to build on this in 2019. And so just to give you some perspective every basis point of Shrink improvement equals $0.01 per share. Additionally we've not talk as much before about this also improve the product freshness for our customers. So what we want you to take away is that we're delivering value through strong execution, cost savings and a customer experience that makes our customers love to shop at Kroger, and drive business results.

And finally to reiterate how our customer obsession and operational excellence is generating ID sales You heard from Joe how personalization our brands is a press for everyone and now combined with the customer experience and cost savings are growing our business. It takes both merchandising and operations in an integral partnership for our customers and it's this collaboration in combination of customer obsession and operational excellence that makes us confident about our ID sales growth. And now I'd like to invent Yael Cosset, our Chief Information and Digital Officer, because the seamless experience is so critical to go in our business.

Yael Cosset

Chief Information & Digital Officer & Senior Vice President, The Kroger Co.

Thank you, Mary Ellen. Good morning everybody. My name is Yael Cosset and I lead our technology and digital team and efforts. And we thought as we enter the last year of our three-year Restock Kroger program would be important time to provide an update on – maybe I have the wrong clicker, no, I don't, provide an update on our seamless experience and strategy. So first, I'll reiterate the importance of that strategy. I'll give you an update on some of the results we are seeing with our customers and how it's impacting our business. And last but not least, I'll provide you some details on how we're continuing to expand our competitive advantage. So why does it matter for the customer? As you heard earlier today, the customers, our customers face over 200 food-related choices every single day.

It's an overwhelming process to make these choices what should I eat. Is it fitting in my budget? Is it healthy? Do I have time to prepare it? Does my family like that flavor? This is overwhelming. And while the customers are wanting more and more choices in terms of breadth of assortment, quality of fresh food, as well as meal solutions

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they also do not want to compromise on the convenience, that convenience come through the seamless experience through the personalization that we bring to life in our experience. So on one hand it's about providing all these options to our customers, making sure that we meet them where they want to be, whether they want to shop in our stores, pick it up at a store after ordering online, getting it delivered or directly shipped to their home.

Seamless also means meeting them on their terms on their schedule if they want it immediately, if they want it same day or next day we need to provide these options to our customers. And as we build our portfolio of experiences under the seamless umbrella, we have developed a competitive advantage. We have developed a competitive advantage emphasizing our efforts in investment and being available, accessible and relevant and I'll provide you some more detail shortly. Last but not least we're also evolving our distribution network to create economic leverage, economic advantage and I will also share some of this details with you in a little bit. Our seamless strategy remains the same. It hasn't changed. We are focused on our three key pillars, available, accessible and relevant.

Available, making that service available to every single customer of ours, leveraging our assets, our brick-and-mortar footprint as well as all the modalities that we've brought to life, pick up, delivery and ship and make it simple for them to access these services. Accessible is about building the right technology platform to interface, interact with our customers in the way that matters the most to them be it mobile, voice, web, but it's also making it simpler to get access to their product, their services of choice bringing it to life under the seamless umbrella. Relevant is the last piece of the puzzle. As you bring more of these experiences, it is critical to remain relevant to the customer to not compromise on that simplicity and that is where our data and the personalization that supports the seamless experience come to life and have a huge impact on our customers and how they engage with us.

As we look back at the past year, the past 12 months, we have delivered great results, great impact on our customers. We have greatly invested in coverage. We've gotten to a place where we'll be at over 2,000 stores by the end of the year for pick up and over 2,300 store equivalents supporting our delivery services. All-in-all, we will be exposing our 97% of our customer to our pick up or delivery service by the end of the year. This is a huge accomplishment that truly is pushing the envelope in terms of being available to all of our customers. The second key investment or result for 2019, the past 12 months is the improvement in the quality of the expense, improving conversion, improving reliability, quality of that expense on all of its aspects from an interaction perspective as well as an execution standpoint.

And that is translating in a growth of our share of wallet with our customers. Our digitally engaged customers shop with us more frequently, spend more with us to the tune of 2x to 4x depending on their loyalty level, compared to their non-digitally engaged counterparts, massive impact on our business. And that is translating and what we're projecting to be about a 30% growth for year-on-year for the total of 2019. The one metric I really want to leave you with actually is a separate metric and it's the incrementality. The incremental nature of our business in pickup and delivery and other modalities means that over 50% of that revenue of that business comes from our competitors. As customers engage with us more frequently across more modalities, they bring more of their spend, more of their engagement from their – from our competitors back to Kroger.

That is a massive tailwind for the company and a massive opportunity moving forward. Equally important, that incrementality actually increases over time. The more customers engage with us, the more they use different modalities, the more they get exposed to that personalization to that special experience and the more they bring to The Kroger ecosystem. So, we are very pleased of the progress we have made so far in our Restock Kroger plan when it comes to the seamless expense. As we look at where we are, we have delivered great growth, created a competitive advantage expanding the portfolio of experiences under the seamless umbrella, more

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options, meeting the customers where they want to be, how they shop, how they want to shop with us, when they want that orders to be fulfilled whether it's coming to our stores or through pick up or delivery.

And that has continued to expand our competitive advantage. And I'll give you an update on some of the work we've done and are continuing to do in that area. The second part that I will share with you is also how we're evolving our distribution network not only to support these experiences, complex experiences from a fulfillment perspective, but also to create an economic advantage against the rest of the industry. So let me dive into these two areas for you. First on the experience, we have continued to invest in our core foundation technology, quality of experience, reliability of the experience across all of the modalities, all of the touch points from our customer perspective and that has driven significant improvement impact on usability and customer satisfaction, which drives more engagement, which drives more loyalty.

And while we have generated significant growth in 2019, we've also made difficult choices. We've decided to hold back on some of our launches or delay some of our launches which has impacted our ability to hit our projected run rate in 2019. But that has allowed us to solidify our portfolio of experiences to reinforce the stability and the scale of our technology platforms. And that's not the end of the journey. We're continuing to bring new capabilities, expanding the technology capabilities that we put in front of our customers to improve their experience, to improve every single touch point. We've also made it easier for our partners to bring their experiences into our ecosystem, developing a set of APIs making it more seamless for them to connect again impacting our customers bringing more products, more services that they want to engage with under our seamless experience.

At no point, bringing these experiences need to come at the cost of convenience or simplicity which is why it is critical to bring the lens from the customer perspective of all the personalization capabilities that we have, again simplifying that engagement, simplifying that experience. If you look back, when we brought seamless delivery in our portfolio, so combining pickup and delivery under the seamless umbrella about a year ago, we saw an improvement in average order value and average basket size of double-digit improvement instantly not just in delivery, but also in pickup, again amplifying the fact that when you bring more experiences together it has a halo effect not just on the new experience but also all the adjacent experiences.

Coming to personalization, we are continuing our investment in that area and you heard Rodney and Gary and Joe and Mary Ellen talk about the power of our data, the breadth of our data assets and how it's coming to life through personalization, and digital experiences is the best way to surface that personalization, because you truly can have that one-on-one experience that one-on-one engagement. Our efforts in 2019 and going forward is to constantly evolve, fine tune that personalization, fine tune that science, but also find other opportunities to surface that personalization, improving simplifying that journey. A lot of work has been done on the basket building cycle. How do I predict that next item? How do I predict the cycle, the frequency at which you replenish a specific item? What is your preference? Where are you from a budget perspective or health prioritization? How do I embed that personalization in every single touch point in that experience? As a result of it, today, we already see over 75% of the items purchased through our digital ecosystem being directly impacted by our personalization. While that is a very large number, it is not the end of the world. We are constantly looking for opportunities to fine-tune that personalization, but also embedded an additional functionality.

The next frontier for us from a personalization perspective is about bringing the context of your day to life and that experience. Think about the location you are in, the day of the week, the time of the day and how that actually impacts how you want to interact with Kroger. That context knowing what matters to you at that moment in time allows us to further simplify that journey.

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A good illustration of an early win in that area is how when you use our mobile app, depending on your location, depending on the time of the day, you will see very different content, not just on the merchandising side, which is very critical, focusing on meals when it's around meal time or replenishment when it is not – of the – replenishment of the pantry when it is not, but also from a feature perspective. And if you were to walk next to a store – into a Kroger store today, you would see the mobile app would look vastly different than if you're sitting at home looking at your mobile app. It would surface the features, the functionalities that mean the most to you, that are most relevant to you at that moment, reminders, your shopping list, digital offers that you may have identified and then attached to your account or digital wallets and payment capabilities to complete the transaction, all [ph] of this (01:32:02) seamlessly being context aware and it's just the beginning of that journey.

So, as we just shared, significant investment in the seamless experience, expanding the opportunities, the options we give our customers on how they shop, when they shop, all on their terms. And that's not the end of the journey. That competitive advantage is now being matched with an economic advantage. As we are evolving our distribution network to support these experiences, but also take advantage of some of our assets, the reach, the scale of our footprint, brick and mortar and integrated supply chain, we have an opportunity to accelerate that transformation and create further separation from our competitors.

It starts with the complexity of the customer experience. As mentioned earlier, customers want ever-increasing options from an assortment perspective, more choice, higher expectation in terms of the quality and the breadth of the assortment, the freshness of that assortment and they are also expecting that to come to us or be available to them in a different set of ways, whether it's pick-up, delivery or in-store, but also different level of immediacy.

And the only way to really truly support all of these experiences is by evolving our distribution network to take advantage on one hand, our stores, their proximity, the depth and breadth of the assortment, best to fulfill the unexpected demand or immediate demand from our customers. And on the other hand, as you walk up the spectrum really looking at the opportunities when you reach that tipping point where you have the opportunity to create scale, create economy of scale by aggregating demand, whether it's a small, medium or large facilities. And that is our effort today. That is how we are developing and optimizing our distribution network, taking advantage of proximity when it matters and scale and aggregation when we have that opportunity.

One of the examples of a partnership that is helping us accelerate that transformation is our relationship with Ocado. Through Ocado, we are able to impact our seamless ecosystem in three ways. Ocado is a technology company, an e-commerce company. They have been operating in the UK for over two decades now, has built a set of capabilities, a set of features that are extremely impactful for the seamless customer, and we are in the process of integrating these capabilities, and this will translate in benefits customers will definitely appreciate. They tell us it matters.

Seamless integration, the ability to get to close to 100% fill rate accuracy. It does matter. The customer who orders online for pick-up or delivery does not have the opportunity or the desire to then go back in-store for an item that may be missing. So that accuracy, that reliability of experience is a huge differentiator, and we see it in our data today. As we have improved the quality of the experience, we see the repeat rate going up as well. And that's not – there are other features, functionalities around transparency of the experience through data. One that comes to mind that is particularly relevant in a world where freshness matters first is the ability to see expiration dates for all the items. So that reliability, that quality of experience will have a huge impact on the seamless customer.

Number two is the ability to greatly impact the quality of our operations. And it's very simple, whether you're looking at small, medium or large facilities, as you bring scale, as you bring aggregation of demand, you impact

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the economic model of that facility, you impact the model of fulfillment, massive impact on shrink with – Mary Ellen talked about earlier, but also pick efficiency, at least, twice as well – twice as good as what we see in our stores. So, again, as you move the demand and aggregate that demand, the ability to leverage scale and automation and technology to change the economic model is significant.

The third area, which, I think, is probably underestimated, is the flexibility that Ocado brings to the Kroger ecosystem. Flexibility to fulfill demand, pick-up or delivery, while they focused on delivery in the UK, in the US, because of our physical footprint, because we have proximity to the customer, they will also help us fulfill some of our pick-up demand. Flexibility in term of immediacy, depending on location, depending on the size of the facility, small, medium, large, they will have a different proximity profile which also helps us – allows us to fulfill some of that demand regardless of the immediacy dimension.

And third is really flexibility of their technology. Ocado continues to invest in their platform and have invested in their platform for the past 20 years. And every time they bring innovation, bring improvement from an operation perspective that transpires to the platform and how we integrate it into seamless. That flexibility – this level of flexibility is one of the good examples of what contributes to us creating an economic advantage.

When you think about our customers, when they start engaging with us, when they go from just interacting with us in our physical stores to engaging with us on pick-up and delivery modalities, it does create a headwind, as we shared before. We have to incur additional cost, operational, labor cost that does create a headwind when you compare that, brick and mortars, household-only versus a multimodality customer. But as I mentioned, through that engagement, through the seamless experience, we create massive incrementality, customers engage more frequently, visit our stores, but also our online modalities more frequently, spend more with us.

And as I mentioned and as Mary Ellen mentioned earlier, we're also creating productivity improvement in stores and of course, our supply chain. So, as we grow that engagement, as we generate that incrementality and that incremental business, we first reach a point of breakeven where we are able at that point of maturity for that customer or that cohort of customer to breakeven and ultimately reach that point of indifference. We have that customer – that specific engagement, their incrementality, their stores, their online spend is such and is so much higher than a customer who only engages with us in-store, we get to that point of indifference where that profit index is basically matched, and that is not the end of the road for us.

When we look at the distribution network and the evolution I mentioned earlier, it is about accelerating that economic advantage. It's about obviously leveraging the proximity of our stores, but also constantly deploying additional capabilities, aggregation of demand and scale through automation to create that additional leverage, that additional economic leverage, that in turn creates value for our customers and for our shareholders.

2019 was, has been, still is a great year and we are seeing great impact on our customer engagement, great impact on our customer loyalty. And as we look and project for the balance of the year, we are expecting about – an impact of about 70 basis points, a little higher than 70 basis points on average in terms of ID sales contribution for 2019. And on a go-forward basis, we will be sharing ID sales contribution on a quarterly basis. That's not it.

As we look at the improvement and productivity gain in our stores and store fulfillment, we're also seeing a path to profitability and like I said earlier, to that point of indifference. As we look ahead, 2020 is also very promising. We will continue to expand our portfolio of experiences, constantly improve the quality of the experience, the quality of that personalization and we expect and project about a 20% growth year-on-year in e-commerce revenue alone. And that does not factor in any of the halo effect we have on the store business.

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As I said earlier, customers who engage with us digitally also visit our stores more frequently, spend more in our stores. So, very excited about the projection and the path forward in 2020. And as we roll out more of [ph] its (01:41:07) capabilities with Ocado, integrating our supply chain, evolving our distribution network, we anticipate that, again, the seamless experience, the digital ecosystem will become less and less of a headwind.

So, thank you for your time. I'll be back with the Q&A later on. But I think at this point, I am handing over to Rebekah.

Rebekah Manis

Director-Investor Relations, The Kroger Co.

Thank you, Yael.

Yael Cosset

Chief Information & Digital Officer & Senior Vice President, The Kroger Co.

Thank you.

Rebekah Manis

Director-Investor Relations, The Kroger Co.

Okay. So that wraps up our discussion on the core. And so, now, we want to shift our focus to talk about our alternative profit streams for the company. And then, after that, we'll take the brief lunch and then have a Q&A session.

So, with that, Stuart, I'd like to welcome you to the stage.

Stuart W. Aitken

Senior Vice President, Alternative Business, The Kroger Co.

Thanks, Rebekah. Good morning, everyone. We're excited to share our progress we've made since announcing our alternative profit strategy last year. Alternative profit streams are really important part of the Restock Kroger plan.

We're transforming the growth model at Kroger and it starts with redefining the grocery customer experience. That, in turn, drives data, traffic that we can leverage to drive alternative profit streams across the Kroger ecosystem. This allows us to invest in the grocery customer experience, as well as drive traffic back into Kroger properties.

The assets we are leveraging range from stores and distribution networks, our scale through partnerships and new services. We also have insights on our large audience of 11 million customers a day. And I ask you this. If you had a TV show that had 11 million viewers a night, do you think you could sell some advertising? So do we, and our audience has intent to buy and the value of that is huge when at shelf 50% of all decisions are being made. We are investing in the core to keep customers in our ecosystem. Examples of those include the new modalities Yael just talked about, pricing, as well as enhancing our customer experience through our investments in our associates. This is truly a symbiotic relationship and the strength of the two will drive the Kroger growth model.

We have defined four key alternative profit pillars. These represent the alternative profit streams that are most meaningfully impacting our dollars today. Our fifth pillar is where we are developing new streams for the future.

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And our goal is to have asset-light, margin-rich streams leveraging traffic, our capabilities, or our physical assets to drive our overall opportunities. Many of these pillars that we are developing, we're developing internally. Others, we are partnering to maximize the speed and return and speed to market. A great example of this is our customer data insights pillar. We've just developed a game-changing customer insights platform called Stratum, and we did this internally.

We partner with over 1,250 CPGs who leverage these insights today and we leverage them for all the other alternative profit streams that we drive. We're also leveraging our data and partnering with companies like TrueCar, like Priceline who offer targeted services for our customers beyond the grocery space for speed and maximum return. And we're doing this under the umbrella of the Kroger services platform. These are the first of a number of partnerships that we're innovating in and will be bringing to market shortly.

We're going to highlight three of these streams for you today. Kroger Precision Marketing, Ventures and our Kroger Personal Finance business. All of these are underpinned by our core asset of analytics, which include data from 60 million households, 4 billion transactions analyzed annually and 10 petabytes of customer data. Just to give you a realm and size of what that is, if you had an MP3 player of music, it would take you 2,000 years to listen to just one petabyte of that data.

Our proprietary data asset, science platform, combined with traffic create a differentiated, commercially rich capability driving Kroger's industry-leading knowledge of customer needs. And I want to give you three examples of those. The first is collaboration tools grounded in shopper insights that connect ideation and innovation to operational science that scales across Kroger, otherwise known as Stratum. Secondly, our predictive science grounded in customer patterns and insights that supports Kroger picking winners across categories and brands. And I'll talk a little bit more about that in a moment.

And then, thirdly, our richer data and activation of science through own channels closer to the point of decision that powers our targeted media that surpasses industry norms. To take you through that, we'll have will have Cara dive deep into our media business. Cara was with dunnhumby for over 11 years. She was with IRI for a number and been at 84.51° for two years. Cara is a great example of the type of talent we have in the Kroger associate family. So, with that, we're going to kick off with a short video to introduce the section.

[Video Presentation] (01:47:48-01:49:00).

Cara Pratt

Vice President, Kroger Precision Marketing, The Kroger Co.

Good morning. We're pleased with the early journey we've been on in our first two years with Kroger Precision Marketing, which powered by 84.51° is created to improve brand advertising through data and science with new digital assets to activate off Kroger properties and on our owned and operated property, our website, the Kroger app and the email channel. Kroger Precision Marketing augments our proven loyalty marketing and in-store advertising assets, which have created engaging moments for customers for decades.

As we look forward, our media ecosystem will continue to evolve to stay relevant to advertisers and, of course, to consumers. We have plans to add new inventory to our existing channels and to unlock completely new media opportunities in 2020. The end result will be even more moments of influence, more personalization, more brand engagement, more predictive performance and more seamless shopping.

We're in a category that's not only still growing, but ripe for disruption. I'm going to speak to some of the challenges facing marketers here shortly and how Kroger Precision Marketing is delivering against those needs.

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In the meantime, it's important to understand that investment is coming from many different funding sources, from e-commerce teams, to brand agencies, to shopper marketing teams. This is being driven by a change in how customers are shopping and how they're consuming media. The market opportunity for retail media is significant. Importantly, these influences and media investment choices impact both on-property, as well as off-property advertising opportunities.

The digital advertising world is plagued with inaccurate targeting data, poor user experiences and soft metrics, which can't be optimized against true sales impact. These are the questions marketers are asking as they consider their media investments. Advertisers want to know about their audience. They want to create engaging moments and, of course, they want to increase the effectiveness of their media. We're delivering against all of these industry needs.

Kroger Precision Marketing exists to become a preferred media partner for CPGs and we have vowed to be the most transparent. We can deliver against this promise, because 97% of our sales are connected to the loyalty card and that allows us to passively evaluate behavior over time and importantly tease out the impact of media specifically.

We've built Kroger Precision Marketing to solve these problems by being addressable, being actionable and being accountable. We're addressable. We identify the right shopper with our first party data. In fact, our scale and our data allow us to know more about US grocery shoppers than anyone else in the business. We're actionable. We have the right media ecosystem and user experience for our grocery shoppers. We make shopping more seamless by connecting customers directly into our commerce platform to buy online or in-store, for pick-up or delivery. We're accountable. We have the data, we have the tools and we have the expertise to measure business impact.

In a media industry with lots of ambiguity, we stand out by showing the true incremental impact of advertising, matching ad exposure to verified sales. This ecosystem is well too sophisticated to let vanity metrics like click-through rate and viewable impressions be a leading KPI on media performance. It's our time to elevate the dialog. Marketers should demand metrics that matter. They should demand sales incrementality, unit incrementality, household penetration gains. We are committed to measure media on commercial outcomes. The end result is a powerful media solution for brands with touch points across the consumers' entire purchase decision journey.

Let me talk a little bit about that purchase decision journey, which begins with thousands of brands seeking to build more demand for their products. We have created an ecosystem of off-site media to connect brands to the right shopper in the right place at the right moment. We reach shoppers wherever they consume media online or through their connected devices. This makes every ad exposure more relevant, and importantly, more shoppable, shortening the connection between advertising and commerce.

We have a right to win because our data and science works. We have been effective at driving lift in key metrics like household penetration and sales per household, with many campaigns delivering a return on ad spend over 10x what was invested. These upper funnel advertising decisions are influenced by large advertising agencies and brand marketing teams who historically have not had any exposure to retail media. So, we've hired advertising agency sales specialists and adjusted our operational readiness to fit the needs of agencies and brand marketers.

Meanwhile, we continue to win in lower funnel shopping moments on our owned and operated properties, where brands need to convert that demand into sales. Our data science optimizes personalized experience for our shoppers. This includes on-site ads, through search results, emails, offers, push notifications and more. This

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allows brands to make an impression during the shopping experience within a digitally constrained shelf when consumers are at the moment of decision-making, very valuable real estate for the advertising community.

Our great track record with over 1,000 brands gives us the right to win, but we keep making improvements to stay ahead and deliver more value. To grow Kroger Precision Marketing efficiently, we're scaling our operations through automation and marketing science. PRISM is an exclusive tool that we've built integrating intellectual property on our incredible customer intelligence with machine learning. This allows us to not only automate routine media functions like campaign management and reporting, but also most importantly, allows us to unleash our data science at scale, optimizing our audience targeting against specific marketing goals.

So far, the results not only save data analysts' time, but most importantly, increase the effectiveness of our campaigns. Preliminary releases have resulted in a 15% higher sales lift for programs that are running through this machine learning science-led process. PRISM is just one more reason for suppliers to prefer working with Kroger Precision Marketing.

We've been active for two years now and our results are getting noticed by brand marketers and agencies alike. For example, Kraft Heinz, they're excited about our full funnel assets that will allow them to create a connection with customers throughout their path to purchase.

And Mindshare, part of the WPP family, one of the largest media agency holding companies in the world, realizes how our pinpointed targeting can influence brand preference. Kroger Precision Marketing has made big strides, but we aren't stopping here. We look forward to the continued disruption in the advertising ecosystem and the role Kroger will play within it.

With that, I'm going to turn it back to Stuart for more details into our other alternative profit pillars.

Stuart W. Aitken

Senior Vice President, Alternative Business, The Kroger Co.

Thank you, Cara. Thank you, Cara. I noticed a couple of you looking for that PepsiCo quote at the end of the video, we'll make sure you get that too. Earlier this year, we announced the forming of PearlRock Partners with Lindsay Goldberg, a private investment firm that focuses on founders and management teams seeking to actively build their businesses. This new platform will identify, invest in and help grow the next generation of consumer product brands.

We will invest in and foster the growth of innovation for consumer brands that customers will love, leveraging our ability to detect emerging trends at a nascent stage that creates leverage for PearlRock to place strategic bets across the emerging brand ecosystem.

It's not about creating artificial demand. It's about detecting emerging consumer demand for products and accelerating its growth through two things, access and visibility. We'll also leverage Kroger's scale and distribution to drive the small brand ecosystem. This is ultimately a win for small brands. It's a win for customers by having access to great new products. It's a win for PearlRock and it's a win for Kroger by being a leader in product innovation.

Our next pillar, KPF, has aligned around a customer obsessed vision, something Rodney is pushing all of us, all of our businesses to be focused around, something Mike talks about all the time, and every one of these pillars, including media, is focused on that customer obsession. And KPF is no different. It's there to build trusted

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relationships with our customers by providing them value and convenience on a wide array of financial, gift card and telecom services.

Our household penetration is up 80 basis points year-over-year and that's great to see, but we are striving for much more. We are working on continually understanding current and emerging customer needs. We're going to use this information to evolve and grow the various offerings we have in this fast moving space of financial services, both in terms of what we deliver online and in-store. The teams are continually innovating new products based on the changing industry needs. You've all seen what's happening in fintech and it's a huge opportunity for Kroger and our customers to get the services and needs that they want from their local Kroger.

We have proven our ability to generate substantial incremental growth across alternative profits in 2019. We are reaffirming our guidance of $100 million of growth from these initiatives in 2019. We're also pleased to share with you all today that we expect accelerated upward momentum in alternative profits in 2020, and are guiding between $125 million and $150 million of incremental growth in 2020.

We continue to add new initiatives to alternative profit portfolio and believe our unique assets give us the right to win and allow us to continue to deliver substantial long-term growth for our customers and our shareholders. The strong progress we have seen thus far in these initiatives are enabling us to continue to reinvent the traditional retail approach to generating profit. We have laid a solid foundation thus far on these initiatives and we are enabling and we are excited about the growth opportunities before us.

And before we hand over to lunch, I'm going to hand it back to Rebekah. Thank you.

Rebekah Manis

Director-Investor Relations, The Kroger Co.

Thank you, Stuart and Cara. So, plan is let's take a 45-minute lunch break and reconvene around 11:45. So, be sure to grab a bag of the Cuban chips that Joe was talking about along with the other Our Brands snacking items.

After lunch, we do have one hour worth of Q&A scheduled with our management team, before Rodney officially concludes the event. Management will also be available for 10 to 15 minutes following the event to take any questions or follow-up questions that maybe you were not able to get in during the hour window.

So, with that, please enjoy lunch and we'll see you in a few.

Unverified Participant

Ladies and gentlemen, our Q&A section will begin in two minutes.

Rebekah Manis

Director-Investor Relations, The Kroger Co.

Okay. Welcome back. Hope you enjoyed lunch and Our Brands products that we have there. So, this next hour, we're going to spend in Q&A. So, with that, we have [ph] Shawn (02:02:04) over here running a mic for questions and we have [ph] Sam (02:02:09) as well. So, we'll try to get as many people as we can. And with that, I would like to turn it over to Rodney to help facilitate Q&A.

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QUESTION AND ANSWER SECTION

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Okay. Thanks, Rebekah. And whoever wants to start, start.

Simeon Ari Gutman
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. Simeon Gutman, Morgan Stanley. You mentioned that your prior plans didn't build in enough contingency. Can you talk about what that contingency look like and then can you talk about the contingency this time in the financial plans? Can you talk about what rate SG&A will grow, what happens to gross margins and if there's any real estate gains embedded in the core?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. I'll let Gary get into the details. In terms of it, if you look at Restock Kroger, the time for it to take – to get us some momentum to it was a little longer than what we would have originally expected. If you look at the opportunities that we have for cost reductions, we actually see opportunities more than what the original estimate is, it's just it will take longer than the three years that were part of Restock Kroger.

If you think about like on the pharmacy headwind that we ended up with, we really didn't build in. We built in some internal headwinds, but not headwinds that would've been totally external. So, if you look at the pharmacy, if you look at the thing that Gary talked about or wages, we had to do more, those things, we really didn't build in. In terms of going forward and some of the other parts, Gary I'll let.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Sure. Thanks, Rodney. Yeah. So, really as we shared in the earlier presentation, a lot of thought went into what are the learnings from what we found through the first 18 months of restocking, how do we make sure that we're building those into the planning process going forward. As you've heard us talk about guidance earlier from an – as we look at what we're expecting to deliver on ID sales growth and as we think about the balance between investments that we know we want to continue to make, the three year – so many that I shared on my slide around the $800 million, that builds in the learnings from those pieces into 2020. So, that was a number that covers the 2018, 2019 and 2020 timeframe. So, we've captured those elements into our planning process. And as I mentioned, what we really tried to do is to build some checks and balances into our planning processes to say, okay, so certain things and the levers that we're pulling will work really well. Certain things, we may hit some headwinds. How do we make sure we have the right contingencies in the process and how do we make sure that we feel confident that as we look at our data and have that showing the results that we expect to achieve that we'll be able to deliver in the guidance. And that's what's really given us the confidence to say let's take those headwinds and build them in. Let's look at the plans that we have and how we learn through that process and make sure that we feel really clear about the rigor in which we see where the levers that we'll pull to drive the value.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

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Yeah. And obviously, the identical sales momentum took longer than what we expected which ended up being a headwind as well. And I mentioned it in the prepared remarks, we just asked our stores to do too much at the same time. Individually, great things, but all at the same time, really should spread it out over a longer period of time.

Q

Actually, can you just clarify from that last question if guidance assumes asset sales in 2020 and beyond or includes?

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Yeah. So, no – not – no strategic asset sales. I think just to kind of clarify maybe some of the journey we've talked through this year. In any given year, there are certain portfolio changes in stores and real estate. We called out the one in the first quarter of 2019, because it was more material. I think it was $57 million in total gain. We're not seeing in the way we're thinking about the model of like a dramatic sale or leaseback strategy or any major real estate change, but I just want to be transparent that every year, there are real estate transactions in the low tens of millions of dollars. It's just that it was more transparent in this year. So, I can't tell you there aren't going to be individual quarters where there may be one-off transactions, but we're not contemplating anything that's dramatically significant in the guidance and certainly not of the order of magnitude that we saw in Q1 2019.

Karen Short
Analyst, Barclays Capital, Inc.

Q

Yes. [indiscernible] (02:06:25) Karen Short from Barclays. But in terms of your 2018 guidance, you gave a free cash flow number for 2018, 2019 and 2020 of $6.5 billion.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Yeah.

Karen Short
Analyst, Barclays Capital, Inc.

Q

So, now you've obviously given us free cash flow numbers for 2019 and 2020 to think about and we obviously can back into 2018, but can you just talk about the apples to apples free cash flow that you're looking for the three years now on your current definition versus your prior year definition and then what changed the definition?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah, go ahead, Gary.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

So, thanks for the question. It's a good question, because we did change the definition in the slide that we shared today and I'd maybe just like to answer first by sharing why we did that. We got some feedback from a number of you that creating our own free cash flow calculation. While the intent was understood, created some confusion and an inability to maybe to see it so transparently as to how is it calculated. So, we did decide to change it and

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what we shared today is how we'll think about sharing free cash flow going forward which is taking it from the operating cash flow statement and then, obviously, pulling out any strategic asset sales. Today, the traditional operating cash flow would have included the tax for the sale of those assets. So, what we did in the new definition is we pulled out the tax payment for the sale of the convenience stores, the tax sale for the value we receive for new technology. So, we pulled those out to recognize that that's just the way GAAP requires us to report it, but it's not obviously a number that you'd expect to be in our traditional free cash flow. And then we had a couple of lump sum payments to the corporate pension plans a couple of years ago. So, we took those two out, they're very clearly defined in the free cash flow statement, but we felt going forward using a more traditional calculation would be more clear and more helpful. If I bridge that too, what we shared originally about the $6.5 billion, there are a couple of things I would call out. So, there are a couple of pieces that are apples to oranges comparisons. The first is, we don't include in that new free cash flow calculation any cash proceeds from stock – employee stock transaction. So, when options are executed and we receive cash for those, they would have been in the original $6.5 billion, they're not in the traditional cash flow operating statement, so that would be a disconnect.

And the second would be the sale of Turkey Hill Dairy and You Technology, they would generate close to $100 million of free cash flow a year. So, those two would be reasons why it's an apples to oranges comparison. If you adjust for those then there'd be about a $500 million delta between the $6.5 billion and the $6 billion out of the new numbers, so it'd be about $500 million below our original expectation and that would be caused by two factors. One would be, firstly, the operating profit performance. Obviously, we've shared that we're bringing our guidance down from the $3.5 billion to $3.0 billion to $3.1 billion and then, secondly the Ocado investments were not in the original assumptions. So, I think we had always called out that Ocado would likely require some additional capital and that would be over and above. So, between those two, they would be the main reasons for the lower number when you bridge it back to the $6.5 billion.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

John Heinbockel, Guggenheim. So, two things when you think about next year and beyond. How do you think about the incremental impact on IDs from digital growth, right. So, if you're getting maybe 50% of that business is coming elsewhere, the impact that that would have say in 2020 on ID, 2021 on ID, et cetera. And then, secondly, the impact of Ocado and the investments in 2020 and beyond, obviously, there's a capital piece, but from an EBIT perspective, there – much of an – I guess, 2021, we see more of that impact but, putting that into the context of your longer-term growth rate, how much of a drag is that roughly speaking?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. Gary, I'll let you start, but then Joe and Mike and Yael, the other parts of that question.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Okay. So, talk about the Ocado [ph] transaction first (02:10:33)?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

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So, I think what you said, John, is right. In 2020, there's not going to be a material impact on the operating performance of the business. As you think about 2021 and beyond, it really comes down to where we are on the digital journey. So, it's important I think to tie it back to the slide that Yael talked about around how customer profitability evolves over time. So, in certain markets, if you think about Cincinnati and Monroe where we'll be opening a Ocado facility that will support Indianapolis, Columbus and Cincinnati, we've already got many customers that are already on that maturity curve where we start to get towards the point of indifference where from a customer profitability point of view, they've started to show enough incrementality that we're kind of agnostic about what channels they're using to shop with us. In that scenario, you think about bringing in Ocado, it obviously helps as you're quickly scaling up that solution, you're able to start to create more efficiency in the back end of that service as that can start to fulfill the delivery to home needs of the customer, but also the pick-up at store, so we can start to free up some of the capacity in the store and leverage that 2x productivity improvement that Yael talked about. Whereas if you think about Florida, that's going to be much more of an investment in 2021 because that's very much a test for us of how do we learn, how to build in a new market customer demand and how do we connect and resonate with the customer effectively. So, overall, we certainly are thinking about how we see it building into the model, but we feel good around that long-term guidance of how we believe that will play in in terms of accelerating in one end and balancing that with investments as we're learning how to grow new market share.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Can you talk about the [ph] Identicals (02:12:10)?

Stuart W. Aitken
Senior Vice President, Alternative Business, The Kroger Co.

A

Yeah. I mean, I think the second part of your question, John, was around ID contribution and I commented that in 2019, we're projecting high-70s basis points in terms of ID sales contribution for the full year. We are not guiding for next year, but we will be sharing what their contribution is on a quarterly basis.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

And the 70 bps was gross or incremental?

Stuart W. Aitken
Senior Vice President, Alternative Business, The Kroger Co.

A

Gross.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Okay. So it wouldn't – that part wouldn't add to the comp necessarily, that's just a shifting from maybe stores to online, but there is an incremental piece that would take the comp up one year versus the next?

Yael Cosset
Chief Information & Digital Officer & Senior Vice President, The Kroger Co.

A

That's correct. And because it includes what I would say what's filled from store and also directly connected to store pick-up and delivery. That path – the right way to look at it would be to only look at the incrementality, if you

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wanted to get the answer to your question. But for other modalities like Ship to Home and the Home Chef experience and so forth, that is 100% incremental result net new businesses. So...

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

Joe, anything you would want to add?

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.
A

No.

Ken Goldman
Analyst, JPMorgan Securities LLC
Q

Hi. Ken Goldman, JPMorgan. Two from me, if I can. One, I wanted to clarify in your outlook for both 2020 and the out years and maybe you addressed this and I missed it, but what is the expectation for fuel profit per gallon? And also what's the expectation for your volume for fuel, because I think if you back into some of the volume numbers, especially last quarter, it was a little bit lower than what it had been? I'll just leave it there.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

Okay. Gary, you want to...

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.
A

Yeah, sure. Thanks for the question. So, in terms of our 2020 guidance, maybe I'll broaden the answer a little bit. We do – we built into our plan from the learnings, as I mentioned earlier, around our overall guidance that, I was very deliberate in sharing that we think about the supermarket ecosystem as the store, fuel, and pharmacy as an overall how do we maintain and grow stable profitability there. We are expecting that fuel will be somewhat of a headwind in 2020 and we are also assuming that pharmacy will continue to be somewhat of a headwind. I wouldn't say that we're expecting it to be dramatically different, because I do think there's a – both on the fuel side of the business, I think the – what we see is that there's a different level of – there was a different structure maybe I should say in the way that the market is behaving than it was two or three years ago. But we do believe that the level that we've seen in the last couple of years is likely to depress somewhat and that's built into our assumptions for the year.

But overall, we feel between fuel and pharmacy and the core business, if you like, we believe that that will be a more stable environment as we continue to take out the cost that I mentioned. And then, of course, we have the [ph] old (02:15:00) profit accelerator in there. Sorry – second part of the question.

[indiscernible] (02:15:05]

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.
A

Yeah. So, I do think – well, we would expect gallons to be relatively flat next year is the assumption that we have, maybe a slight decline because the market's declining. We wouldn't expect it to be dramatic in terms of the change of year over year growth gallon, certainly not – we have seen a little bit of a decline in the last 6 to 12

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months. I would maybe like to add a little bit more color around that, because our fuel profitability has been very strong this year. Part of it is, as we've mentioned on our earnings calls that we are seeing significant improvement in cost of goods through the work the team's doing to manage the price of fuel and being dynamic in how we do that. I would say our focus on fuel is a little bit similar to what Joe and Mike talked about on how we think about our core businesses is that we already focus on loyal shoppers to Kroger. And when you think about our fuel business today, we invest hundreds of millions of dollars in extra discounts. So, I was speaking to a couple of people earlier in the break and we talk about fuel and we're competitively priced with the main market, but we're above the club operators.

While the reality is our club members are the loyal customers that get fuel rewards and when you add in the average fuel discount those customers get, it actually brings it down to, at least, as comparable; in many cases, a cheaper price that our customer is getting. So, I would say that we've pivoted a little bit in making sure that – I would say there may have been times in the past where we may have chased every gallon of fuel believing that wherever it came from, we should look for the growth, and I would say that we've been very deliberate in saying we're going to be positioned very well on price on fuel and we make sure we're always competitive in the market.

But at the same time, we're making sure that it's loyal customers that we're really growing their fuel engagement with. And we continue to pay out more fuel rewards. So, this year, even though you're seeing gallons decline, our fuel rewards are actually increasing this year, because we're seeing more engagements and we're using it to personalize the offer to the customer to drive behavior with our loyal customer base. So, as we cycle that sort of view, that's another reason why we see fuel gallons being more stable next year as we come through that journey.

Robert Ohmes
Analyst, Bank of America Merrill Lynch

Q

Thanks. Robbie Ohmes, Bank of America. I wanted to ask about the pretty incremental $125 million to $150 million from alternate profit streams. How much of that – I think it was coming mostly from financial services last year, a lot of that strength in that line item. How much of that is that shifting into media or digital advertising and I think you've laid out a slide, I think you have digital advertising for CPG companies around $11 billion, $100 million doesn't seem like a large part of that market. Can you sort of help us when could you start doing more like a $1 billion in digital advertising, et cetera?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah, Stuart, I'll let you get started.

Stuart W. Aitken
Senior Vice President, Alternative Business, The Kroger Co.

A

Thank you. And thanks for the question, Robbie. For us, if we look at 2018, Kroger Personal Finance was a big piece of that but by no means all of the incremental sales we saw last year. Those four pillars are laid out for you earlier today is how we see the growth going forward. As we look at media, media without question is a huge growth vehicle for us and doing incredibly well. I'll let Cara dive into some of the details of that in a moment. But if we look forward we're also investing in new pillars, new seeds to help drive that business and help drive the future out years of alternative profits. Specific – we haven't laid out how much each is at this point and don't have plans to. But for us it's about how we profitably grow our profit across those pillars and additional pillars but do it in a way that values customers similar to how Gary just described fuel especially for our loyal shoppers and how do we provide value back there and in turn drive profitability across a broad array. Diving into media?

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Cara Pratt
Vice President, Kroger Precision Marketing, The Kroger Co.

A

Yeah from a media perspective we're early in the journey. We feel really good about the progress that we've had so far. The advertising ecosystem is disrupting considerably. I'm investing talent in New York and Chicago specifically so we can be closer to agent fees and make sure we have the right level of awareness on how our assets with these shopping moments can create a more meaningful connection for brand. How we're leveraging brand equity that they have, right, and beautiful creative and then we're leveraging our commerce and our audience assets to make that moment even more impactful for that that impression.

We, the ad industry is evolving considerably, agencies are changing how they operate, three out of the top five agencies have shifted in the last 12 to 15 months, some structural change to support retail media. So we know this is early, we know that it's going to continually evolve as we go. In addition to that the programmatic space is evolving considerably. There's a lot of M&A that's underway, there's a lot of consolidation as they go forward. And so we keep a close eye on our ad-tech partners, our data partners, our publisher partners, and we feel strongly that we're going to be in a good position to take a dent into the total programmatic space.

Robert Ohmes
Analyst, Bank of America Merrill Lynch

Q

And as a follow up how much, what are you seeing happen to the traditional treat spend as you push to digital?

Yael Cosset
Chief Information & Digital Officer & Senior Vice President, The Kroger Co.

A

I'll take that one. It's something we are tracking very, very closely and we are looking at trade spend per SKU and our trade spend per SKU is doing well. We do separate what our brand spend on media versus trade spend and track that all the time. So at this point we are very comfortable with where trade spend is and incremental dollars we are getting in the media space. We are very comfortable.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. I think maybe just a follow up on that, maybe Joe can talk a little bit about the whole CPG trade funds issue and where that's at?

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

Yeah. We watch that very closely, Robbie and work with Stuart and his team to make sure that – we're talking to our community – our CPG partners in the right format and we separate those two and really watch this – my team manages the trade spend and work with the CPG partners to make sure we're driving the business with the traditional trade spending dollars and make sure that we're not diverting those dollars in other ways. And we meet with the marketing teams from those CPGs at a high level. You saw some of the quotes from Kraft Heinz and PepsiCo for example where they bring their teams in to meet with Cara and Stuart's team and we do that jointly so that we know that we're really managing those dollars holistically and put them in the right buckets.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

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But I think it's a great question because it's certainly on our mind and we think about it – through our CCO process it is something that we look across the whole enterprise and we have those discussions with the CPGs and our partners. So...

A

And if you look at the buckets that we talk to those brands with, Joe is exactly right. The collaboration is phenomenal. But we talk about brand dollars, we talk about shopper marketing dollars, we talk about digital dollars and tapping into those versus the pool that is trade.

A

And it's really Stuart and Cara talked about it but we really think there's an opportunity to disrupt and help people spend the money far more effectively than they spent in the past and it's a really big market and it has a margin that's completely different than anything that we're used to in the supermarket business. So we think we can really, one, everything that we're doing is totally transparent. So we don't believe we deserve to get paid unless we actually help somebody accomplish what they're after to accomplish and we have great data to help them see that.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

That's right.

A

And it's a really big market. And I think under [ph] Karen (02:23:11) and Stuart's leadership I think we're just getting started, but it's an exciting start.

Kelly Bania
Analyst, BMO Capital Markets (United States)

Q

Hi. Kelly Bania from BMO Capital. Two questions just to clarify first in the press release this morning there was a mention of some momentum in IDs. So just curious if you could clarify that, is that quarter-to-date beyond the [ph] 2.2% (02:23:34) last quarter or just where you're referring to that? And then beyond 2020 the plan for the 3% to 5%, I guess it's EBIT growth there. Importantly, what's that based on in terms of IDs? Is that still based on low 2% comp and then specific details on what you're expecting within pharmacy and wages? If there's any more incremental investments or margin pressure there? And then I guess with Ocado still a lot of questions and just curious how details of a map that has been in terms of how that profitability ramps and how it impacts as you roll those out in the first couple of years?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Well, I'll start on the first part, Gary you can start and then Yael on Ocado deeper. If you remember when we had our second quarter earnings call, one of the comments that I made on identical sales is they were tracking a little bit better than where the second quarter was that we would still be tracking a little bit better than where the

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second quarter was and that's what we meant when we included it in the press release and also when Joe talked about it earlier. In terms of some of the 3% to 5% and some of the other pieces, Gary I'll let you share.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.
A

Sure. Thanks, Rodney. Yeah, the way I would think about it is really take you back to the – you know we can't put the slides up again but the slide that I talked through around when you think about the sort of the business model that we're establishing for the company really the range that we shared is being built on the expectation that we want to drive continued improvement in ID sales, but building the model around if we're at the 2% to 2.5% range, how do we ensure that we have an economic model that supports that between the investments that we continue to make in delivering on the business performance at the same time as making sure we're taking cost out of the business where it doesn't add value for the customer or for the associate.

And then of course the alternative profit growth really accelerates the model. So I would think about it the more successful we are in accelerating our sales growth beyond where we provided the guidance, start to drive towards the higher-end of the earnings growth expectations or the range that we shared and as we continue to evolve the capital execution and allocation process that I shared earlier, obviously, if we're going to invest the level of capital that we are investing today, we'd expect that also to be successful in taking us both in sales and earnings towards the higher-end of the range so we're holding ourselves accountable to ensure that the investments that we're making are balanced with how you think about that 3% to 5% model longer term.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

Anything you want to add on it? Go ahead.

Yael Cosset
Chief Information & Digital Officer & Senior Vice President, The Kroger Co.
A

Yeah. And I think on your question regarding the impact of Ocado long-term on the economics for the Digital business if I followed you correctly. I think it really – there is not like one size answer. It really – we look at the design of the network by market, it's a function of the size of the demand, the maturity of that demand. And then, the balancing of small, medium and large scale facilities to really satisfy that demand in an optimal way – taking advantage of scale and aggregation where it makes sense and sticking to store or small facilities when it doesn't.

In overall – overall if you remember that curve I shared in a market like Cincinnati as Gary shared earlier where we have reached the level of maturity already from a demand perspective when we turn on a facility or the ability to improve the unit economics with an Ocado facility, medium, small, big facilities, it is going to improve the unit economics and performance of that market from a net operating profit perspective. So again, it's hard to kind of give a one size answer to the question. It's really based on where you are on that curve and that maturity, that point of indifference where we reach that point of indifference [ph] fulfilling (02:27:27) from store, the second we turn on additional facilities that are creating leverage from an economic perspective, it will have a positive impact on net operating profit.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

One other thing that might help – that probably a couple of people have. Tim, you might want to talk a little bit about people some of the changes in retention, some of the investments we've made and wages obviously, Gary

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outlined that that was a headwind and then Mary Ellen tie in, in terms of what does that mean operationally as well.

Mary Ellen Adcock
Senior Vice President-Retail Operations, The Kroger Co.

A

Absolutely.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

So, Tim.

Timothy A. Massa
Senior Vice President, Human Resources & Labor Relations, The Kroger Co.

A

Thanks, Rodney.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

You need, you need a mic?

Timothy A. Massa
Senior Vice President, Human Resources & Labor Relations, The Kroger Co.

A

Thank you. Yeah, so our talent strategy is all about developing talent at all levels to support the core business as well as the alternative profit business. As you recall on October 2017, we came out with a $500 million investment in wages and training. And as you look at the tight labor market, we've done – we have Mary Ellen talk about some of the internal customer metrics and retention results that we're seeing in our store. We also are seeing that we needed to increase that investment in wages than what we laid out in 2017. So Gary talked about an $800 million operating profit trajectory. About a third of that is in – the third that is going to be for wages and training. But that also includes we've planned out and forecasted all of our collective bargaining agreements for 2020, our build into that, into that forecast from a wage standpoint. But we are beginning to see the benefit of investing in our associates, training our associates and Mary Ellen can speak a little bit to what we're seeing in the store.

Mary Ellen Adcock
Senior Vice President-Retail Operations, The Kroger Co.

A

Absolutely. As Tim mentioned, that was part of the plan to invest in the associates and it is definitely benefited our associates in retention. We've seen double-digit improvement in our retention, which is especially in this labor market is incredible. And that also has been a key factor that's enhanced and enable us to make the progress that I shared on those customer internal metrics because the, that a retention we have and the associates then that helps us with those metrics. Also part of that was to get our associates closer to the customer and that's also been a benefit. And then, we will continue that investment with the higher wages because that's going to be important, but we've built that in with what we shared, which is also why the cost savings in areas that do not impact the customer are so important because just to give you a perspective if we save one second of labor, it's $38.5 million. So, this is an area where we can really leverage our size and scale to do things and take it out that don't impact that we can reinvest as part of that savings plan.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

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Is that second a day, a second per store per day?

Mary Ellen Adcock
Senior Vice President-Retail Operations, The Kroger Co.

A

That is one second per store per day.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Okay.

Mary Ellen Adcock
Senior Vice President-Retail Operations, The Kroger Co.

A

Yeah.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

[ph] Sam (02:30:10).

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Sorry, just maybe to close the loop on Mary Ellen slightly, but Kelly your question, so we have absolutely built in the assumption that we're going to continue to increase the average hourly rate for our associates, so taking the learnings from the last two years and how that builds into the plan as Mary Ellen mentioned is certainly on the one hand we expect some continued gross margin pressure on pharmacy. On the other hand, I alluded to in my slide, but we do see opportunity to find new revenue growth within the health and wellness space tying our data together with the health and wellness business plus the team has done a really good job of looking to improve the cost efficiency of our pharmacy business, so taking cost out of the cost of built, the business is part of the cost savings that Mary Ellen shared. So, certainly from an operating profit perspective, we are building in some expectation of a headwind, but not at the same level that we would have seen in 2019.

Kelly Bania
Analyst, BMO Capital Markets (United States)

A

Thanks.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Rupesh?

Rupesh D. Parikh
Analyst, Oppenheimer & Co. Inc.

Q

Rupesh Parikh, Oppenheimer. So first a question on your FY 2020 comp guidance, I was curious what you built in for inflation expectations?

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

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Yeah. So, we tend to stick to a fairly consistent path with that, so we've built in the assumption of between 0.5% and 1%. Obviously, if we saw something different from that, it would certainly have a potential impact on how we see the year, but we tend to every year try and build our model based on a relatively flat inflation outlook and then obviously adapt as we see the business change over time.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

And kind of what we're seeing right now.

Rupesh D. Parikh
Analyst, Oppenheimer & Co. Inc.

Q

Okay, great. And then on the delivery front, so one of your competitors recently announced they are going to free delivery – in quotes obviously, "free delivery." Just curious what opportunities you see to reduce delivery ease going for?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah I'll let you and Joe.

Yael Cosset
Chief Information & Digital Officer & Senior Vice President, The Kroger Co.

A

Sure. Yeah I mean I think I would start with the comment that Gary shared earlier which is we look at the overall economic value we bring to our customers. So some of it is above the line promotions free or waiving fees on specific services, but it's also below the line all the offers, all the other benefits and value that we provide our customers. So we've been and continue to test flex fees, waiving fees for delivery for pickup and we'll continue to optimize keep close tap on the customer and how that influences their pattern, their repeat rate and overall spend with us.

As it comes to improving or reducing the delivery fee, there is probably a number of variables we're going to continue to look into. One is the level of immediacy and what is the type of service, what is the perceived value added and what are the other benefits the customer gets with that service not just the executional fulfillment of that transaction. And also as we start we're getting demand away from the store that creates additional economic leverage for us to potentially be more aggressive on the fee in some markets or in specific campaigns.

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

Yeah and that's part of the thinking behind the program there we're – we kicked off this week was to learn from that experience with free pickup. We've tested it in smaller tests around the country. This is a broader example and one that we think is appropriate at the right time of the year when customers are more sensitive to time constraints and managing the time and pickup has a real opportunity for us here. So we think we'll learn from this experience and take some data away and really make some decisions going forward before we just turn it on for the entire enterprise and except that reduced fee component. So it'll be interesting to learn, we'll do that in a number of markets through New Year is our plan at this point.

Judah C. Frommer
Analyst, Credit Suisse Securities (USA) LLC

Q

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Thanks. Judah Frommer from Credit Suisse, just wanted to follow up a little bit on Ocado. I think Gary mentioned the cost of building out the facilities would be a little higher than anticipated. Can you give us some color on why that is? And then secondarily, the market since you announced the Ocado has certainly moved away or if you believe what you read in the press has moved away from overnight delivery and building baskets over long periods of time. So have your calculations in terms of similar returns on these Ocado sheds factor in potentially more home delivery, tighter delivery windows and lower fees overall like we just talked about?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Gary I'll let you answer the capital part and Yael on the cost part.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Yeah. So from the cost of the sheds or the facilities that we're building, it's really in two main categories that we've seen the higher cost in the first phase of selecting and starting to construct the sheds versus the cost of land has proven to be high. Now in some cases we've decided to take some optionality in buying more land in that situation as well. So it's not necessarily an apples-to-apples comparison, but certainly we've seen distribution centers become more attractive and the opportunities for where you can put them and who else is looking for a similar kind of space, I would say we've seen that become a slightly more expensive than we thought.

Combined with that we're obviously in the tight labor market we talked about earlier. So the cost of construction has been higher than we intended or would have originally built into the assumptions around the cost. So as I mentioned earlier really our focus is on – we're working with Ocado to [ph] monitor (02:35:36) ways we can actually flex and reengineer certain parts that can help defray some of that cost. The good news is like I mentioned in the earlier prepared remarks when we look at the model for the return that we expect to get on the value that Yael described earlier how this can change the economic model around a greater – a better experience with the customer and driving sales growth as part of our digital ecosystem.

How we can take cost out of the model and allow us to get towards the right-hand side of Yael's chart, where we've reached that point of indifference and now you can start to really take cost out of the model and make it more cost-effective.

Between those two, we were very comfortable with the return that we see and expect it still to be comfortably ahead of that hurdle rate of 11% that I shared earlier. Yael is probably going to talk about the demand. We look at it from the point of view of, very certainly when we look at our data, the sort of significant size of the market is when we look at how our customers today order and when we fill their orders, there's still a significant part of the market that would meet that next-day delivery or next-day pick-up at store. But actually the flexibility that Yael is working on with Ocado really takes the opportunity in our mind to really deliver on the whole ecosystem that we're talking about, not just delivering on the overnight delivery model, which is really where Ocado has been successful in the UK. But Yael, you probably want to...

Yael Cosset
Chief Information & Digital Officer & Senior Vice President, The Kroger Co.

A

Yeah. It's a complex matter, but actually relatively simple when you think through the math. So, first priority for us, as I mentioned earlier, is to not turn down business. We want to be where the customer is, whether they want immediate delivery or same-day or next-day or beyond that. And all the customers have different level of planning or kind of anticipation of that demand – of that basket. So, number one, they may want it further out in the future,

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which is a perfect fit for aggregation away from that customer, so you don't get penalized by the transportation time.

Number two is how do I build my basket. When we look at the demand today – and we have a pretty significant amount of data on our customers today and evolution of that behavior over time – there is clear separation, A, of people who plan and therefore project further out in the future, and B, people who may be planning a little bit and then kind of modifying their order closer to the point of fulfillment. And that's where we are optimizing our network. It is not going to be one size satisfies all the demand. If you go too far down the micro desegregated demand, you lose the economic advantage that you can gain by going into scaled aggregated demand.

If you go too far to the aggregated or only go down the aggregated path, then you lose the opportunity to fulfill that immediacy, that unplanned demand. So, really our solution and our focus is really to balance that [indiscernible] (02:38:29) leveraging all the way – the closest to the customer, which is our store, all the way to larger facilities and everything in between. And we're working with Ocado. I think part of the assumption in the industry is that Ocado is only one model, because they have optimized their model in a market like the UK, where the geography and the distribution of population is such that you can actually satisfy the demand as an eCommerce pure-play retailer.

That is not the approach we have been taking with Ocado in the US or definitely not the innovation they have brought to the table since day one. It's really designing the demand, the appropriate optimized network based on the demand we see, and also preparing for the future, because that demand – and you kind of hinted at that in your question. That demand evolves and also varies from one market to another. There is no kind of a blueprint that you can just take and apply to all of the markets. That maturity curve matters [ph] and get in play (02:39:28), and that's the kind of the opportunity we have with all the data we have, which is to optimize that network. I hope that answers your question.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

The other thing, Yael, is we know that Ocado is incredibly efficient at piece-pick as well. If you look at a store, there's a certain amount of things that are piece-pick within a store, and that's also a way to use some of the capacity of Ocado for low volume items both in existing network or possible smaller store type things as well.

Yael Cosset
Chief Information & Digital Officer & Senior Vice President, The Kroger Co.
A

Yeah. And since you reopened that one other thing you just reminded me of, which is I think it's important also to – when we model what that network is, whether it's small, medium or large facilities, to look at the demand not just from a delivery perspective, but also delivery and pick-up. Because the second you can predict and manage that demand over time, you can fulfill whatever the modality is. You could go as far as like fulfilling a ship modality, because it doesn't really matter where the goods come from a customer perspective. So, that creates that scale and that kind of flexibility creates a huge economic advantage long term.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

Okay. [ph] Sam (02:40:35)?

Spencer Hanus
Analyst, Citigroup Global Markets, Inc.
Q

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Spencer Hanus from Citi. I just had a question on your comp guidance for 2020. Can you just break down what your expectations are for price and volume? And then, the second question was just on the pharmacy business. It seems like there's a lot of pressure there just industry-wide. How are you going to turn around margins in that business going forward and do you expect any competitive exit from that business?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. Gary, I'll let you talk about the identicals, and Mike, you can talk about the pharmacy margins.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Okay. So, well, from an ID sales perspective, we are – we've built the plan, as you heard Joe and Mike talk about earlier, that we very much feel confident when you look at the layering of the initiatives that we've seen. We build in the tailwinds from the fact that we invested in price and some of the learnings from the work that we did on the initiatives that we're executing in the store and how we've now changed that model and feel a lot more comfortable with the momentum that we're building through identical sales execution. And when you think about the progress that we talked about with fresh and personalization and leading the digital growth that Yael talked about, really they are the main steppingstones as we look at how do we build from where we are today and how we continue to grow the business.

You obviously heard us mention that we're assuming inflation is in that range of 0.5% to 1%. We do expect to continue to invest in price of course. It's an important part of how customers value the shopping at Kroger, but it's really one component. And even price, when we think about our loyal customers, it's much more about what we define as value than it's what's the everyday price versus what's the incremental rewards that we're offering for fuel versus the personalized coupons that we provide to the customer. So, when we talk about investing in price, for us, it's about picking the right value equation that for the customer really allows them to connect more deeply with our value proposition and cause them to shop more at Kroger. So, we certainly expect a more balanced operating environment as we balance those investments and the savings, but we will continue to drive more value for customers that will allow us to continue to drive ID sales growth.

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

Yeah. I'll just jump in. To second what Gary is describing, I think from an investment standpoint, we see – we don't see an investment like we've had in previous years on price programs. We think that the level of investments that we would see in 2020 would certainly be around the investments we make against customers and in the loyalty programs and the personalization that we would offer to customers. And so, that would be the bigger driver of how we are going to drive sales going forward.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

And Mike, on the pharmacy, I'll let you and Gary tag team [ph] it (02:43:19).

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

Yeah. Well, actually I think Gary answered it earlier, I don't know. We do see a slight maybe headwind with the pharmacy gross margins, but it's nothing like what – obviously what we faced this year. But we do – to Mary Ellen's point earlier, we do continue to look at ways to fill scripts more efficiently...

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Mary Ellen Adcock
Senior Vice President-Retail Operations, The Kroger Co.

A

Yes.

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

And look at all those, so that when you think about the pharmacy profitability that Rodney was talking about, it obviously is a big part of our future.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

And then, cost of goods as well.

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

Right.

Mary Ellen Adcock
Senior Vice President-Retail Operations, The Kroger Co.

A

Yes.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

And if you look at some of the pressure this year, it was because of supply issues.

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

That's right, yeah.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Yeah. I think just to add a little bit more color to what Mike shared, we certainly think that the generic supply issues over time will correct themselves in the market. So, such should dissipate in terms of the impact on the business. We are assuming there will continue to be this PBM structure will create some level of gross margin pressure. But as Mike mentioned, when you look at the way in which the team is adapting through other elements of cost of goods that we can leverage and the fact that we're taking cost out of the model, when we look at the level of reduction in operating profit in 2020, significantly less than 2019.

When we look at the return on invested capital and the overall profit contribution it makes to the business, add that to the fact that the customer is significantly more loyal and we're starting to explore ways in which we believe we can tap into new revenue streams from health and wellness, so being able to connect the pharmacy relationship with the food and starting to build out new revenue streams, actually we're pretty excited about it. And we think five years out, we think there's potential for starting to see that trajectory change because of the value we can unlock in different ways.

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W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. On the last point – and at the break, there were a few people I was talking to about this. If you remember on Stuart and Cara's slides, on one of Stuart's slides, he had food as medicine. And food as medicine won't be something that creates income and revenue that helps us for 2020. It's not something that will help us probably for 2021 or 2022. But we are increasingly developing tests with healthcare companies and starting to learn food really is medicine. And if you look in the US, about half of healthcare costs could be eliminated if people ate differently. And helping people eat differently, one of the things that Stuart's team at 84.51° and Yael from a technology standpoint and Chris before him help support is what we call OptUP. And it's a way of using real data for each customer to help them eat healthier. So, as Gary mentioned and Stuart had on his slide, we see food as medicine as an opportunity to create some meaningful revenue, but not relative to the next couple of years.

Stuart W. Aitken
Senior Vice President, Alternative Business, The Kroger Co.

A

Just to build on that connection for you, if you think about the three biggest disease states in America today, diabetes, hypertension and heart health, 70% of the cost, here's the opportunity for us, how do we help customers eat in a way that's personalized to them, that helps change. So, for example – and I use this example all the time. I have a high sodium diet. I'm not going to stop eating salt, but I will eat low sodium bacon, low sodium butter, low sodium – and those small changes have a dramatic change in how can we help customers with those nudges. We've been doing that for years with our coupons, and now we're looking how can we help customers through the likes of an OptUP, change those behaviors, help customers live healthier lives in new innovative ways, and that's a big piece of alternative profit with [ph] Colleen (02:47:07) going forward.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah, [ph] Sean (02:47:09).

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

Hi, guys. Ed Kelly, Wells Fargo. So, a few questions for you. First on free pick-up and the test of free pick-up, if you were to roll that out across the chain, how material would the cost of that be and could you stomach that within 2020 guidance?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

I'll let Joe and Gary answer it, because the two of you have been partners.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Yeah. I think the way that we think about it, that is really from the point of view of is this the right value investment for our customers. So, it's kind of back to the – if we're trading off, what Kroger customers feel is the most important value to them when they're balancing, is it the everyday price, is it the fuel discount, is it the personalized promotions that we offer them. We have a lot of customers today that are enjoying the benefit of free ClickList because – or pick-up, I'm sorry, because they're downloading a coupon to say you've spent more than X-dollars on certain categories and therefore you get $5 back.

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So, we've been offering promotional opportunities for customers to test in that area over time and we've been learning where is that valuable, where is it not, and trying to figure out in our overall value equation for the customer what is the right way to give the value they expect. So, I would think about it that if we were making a decision that that was something that we felt was the right answer as we learned through the test, it would essentially be part of how we're thinking about investing in the value as part of our investment strategy for 2020. And so, I think if we found that the data was telling us it was compelling about driving sales growth and driving value, then for sure we would be thinking about how do we build that into the overall value equation that we're investing in for the customer.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

All right. And then, just to clarify around fuel, because I think there is a narrative out there that you're over-earning in fuel, that a decline in gallons would support that. But it sounds like what you're saying is that maybe there is a structural change in the way you're thinking about pricing fuel that your most loyal members get a discount [indiscernible] (02:49:17) spending in the store, you're not earning actually $0.35 a gallon on that customer and that you're willing to maybe sacrifice some volume, maybe someone who drives – drives up to the store, fills up at the pump and then leaves, which is a poor gas customer, I guess, for what is overall better profitability in a business in the way you're sort of dialing down into personalization of your customers. Is that all fair?

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Yeah. I think the only thing I would build on what you shared there is that we certainly think about it from the point of view of we want to be priced competitively on fuel. So, if the market is moving, we're going to be moving with the market and making sure that when the customer drives pass the fuel center, our price is right there with the competition on the pricing that we're offering. I would say there may have been times in the past where that price, we would have been the market leader. We would have been leading the market and thinking that driving some fuel sales in isolation is a more valuable activity. And I would say we're being more disciplined in, if the market moves, we're going to move with the market to make sure we're competitive. But we're giving, to your point, the majority of the value back to the customer in the fuel profitability that we're earning. We're giving that back in fuel rewards to our loyal customers.

So, we would rather be deepening the engagement with loyal customers where the total profitability look stronger than trying to be the first-mover on price in fuel and really driving a customer that has no loyalty to Kroger who isn't shopping in the store, because that really isn't driving our loyalty ecosystem. So, that doesn't mean we're going to get off track in not being priced right on fuel. But it certainly means we're being more deliberate in making sure that we're targeting our efforts with our most loyal customers, which is why the amount of discounts that we're giving on fuel is actually increasing, because we're actually providing that more to our – targeted to our customers as additional discounts versus trying to necessarily be the name on the high street that's the cheapest on fuel.

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

Just think about that description on fuel, very similar to how Joe thought about pricing in-store and who we're pricing for is very similar. So, the strategy spans all of our verticals within Kroger's world.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

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And last question just for...

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Sorry, one thing I would just clarify. Just as we cycle that, we'd expect that to slow down, which is why I mentioned in the answer to the guidance for 2020. So, as we kind of cycle through that sort of change, if you like, certainly we'd expect that to sort of ease out of the numbers, but that would be a fair characterization.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

And then, just for you, Rodney, I guess one of the things about Kroger that's changed over the years since I follow you guys is probably – I guess maybe most concerning for me is that you used to be a better comp story, a better ID growth story, where you go back 10-years-plus and you averaged about 3.5%, and that was under the old method. And the level of ID performance is materially below that now really. So, I guess the question is, what's changed? How much of this is really self-inflicted? I don't know if you can quantify that in terms of what we've seen. And can you get that back?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. The question – appreciate the question, and Mike, I'll let you add on. In terms of being able to quantify what's self-inflicted, that we haven't been able to do. There is no doubt, if you look at some of the earlier – if you look at 2018, there was no doubt there were things that were self-inflicted. And it was a double pain because what we thought was going to be a tailwind actually ended up being a headwind.

I think it's really important for us, as Mike and I both talked about in our prepared remarks, narrowing the focus and then getting to where we're using the data much more aggressively and proactively in terms of some of the examples that both Stuart and Gary just gave is using the data on where to price and how to price. We are seeing momentum both in terms of the things that Mary Ellen and Mike talked about in terms of basic execution and the things that Joe talked about in terms of momentum in terms of the deeper connection with the customer. Our loyal customers continue to grow as well, which is something that's incredibly important. Mike?

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

Yeah. The other thing – I would just add that – that's why you heard from us today about focus on the fundamentals. Here's the deal, in our business, the fundamentals are where we will get our sales. So, the distractions in 2018 and what we did in 2019 to pivot to say, no, we're going to focus back on the fundamentals, has given us the momentum that we see. Now, it may not have come at the same pace that it did five years ago, but we believe that the fundamentals plus the things we do for our customers, as Joe has talked about, and the focus we have on them is going to deliver better comps in the future.

Caroline Conway
Analyst, Sanford C. Bernstein & Co. LLC

Q

Hi. Caroline Conway from Bernstein. Really appreciated the color on merchandising and seamless that you guys gave today. And what I'm curious about is how that translates into the store format going forward. So, you're talking about very broad assortment, you're talking about adding this convenience, at least in terms of [ph] locking sales for (02:54:42) not necessarily the drive to the store, maintaining at least the price value. So, I'm just curious,

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if there's a format or a combination of formats that you're envisioning for the future, and does that differ dramatically from the remodels that you're doing today?

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

I'll let Mike and Joe answer that one.

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

Yeah. So, I would tell you that our prototype today is really the Marketplace store. And it's over 120,000 square foot store. And it's been a great producer for the company for a long period of time. We are in the midst right now of actually looking at that whole footprint and in design to figure out, okay, what does the future look like. And then you think about the customer and where the customer fulfillment might be an option for, what does that look like, along with the assortment in the store. So, a lot of work going on on that format. But don't – make no mistake, a 60,000 to 70,000 square foot store is still rock solid, and actually does produce very good for us.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Joe, I don't know if you have anything.

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

Yeah. No, I think that's right. I think the other piece that maybe add in, we talked about food halls and restaurants. We've got some stores. We've opened three stores in the last two months that were smaller footprints. So, I think we're open to urban locations that make some sense for us when we think about ready-to-eat and ready-to-heat, and we look for those opportunities where they make sense. And so, we've done that in Cincinnati, in Phoenix and Atlanta. But as Mike said, the workhorse for us going forward would be the Marketplace, and we continue to evolve that assortment and continue to get better and better. Listen to our customers ultimately.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Okay. [ph] Shawn (02:56:34)?

Scott Mushkin
Analyst, R5 Capital

Q

Thanks, guys. Scott Mushkin at R5 capital. So, I wanted to ask, Ed referenced it, I think Specialty when you guys made the change in comp was adding about 50 bps, Specialty Pharma. But I know that has accelerated the inflation rate there. I was wondering is that 50 bps – should we still think of it in that term? That's one.

Then, the second thing, and we touched on a little bit earlier about branded volumes, CPG branded volumes seem to be trailing the industry right now, and how do you – is that something you guys can maintain and expect alternative revenues to come in?

And then on the pickup thing, what if you had to make the change, what would that cost you rather than you kind of voluntarily did it, if the market kind of forces you to suspend fees on pickup and delivery. And I have more, but that's a good start.

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W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

Gary, I'll let you start the first part. And then, Mike, you can talk about the CPGs, even Joe. Yeah.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.
A

Sorry, just remind me what was the first question? There's a lot of you covered there, I was ready for the later one.

Scott Mushkin
Analyst, R5 Capital
Q

That the first one was around Specialty Pharma...

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

Specialty Pharma.

Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.
A

Yeah, Specialty Pharmacy. I'm not quite sure where the 50 basis point come from. It wouldn't be that dramatic; it would be maybe just over half that number in terms of the impact it has on IDs. There are some other pieces that impacted when we changed, things like when we added [ph] like the cost of (02:58:04) Home Chef and those things in there that become part of the ID number that the Kroger Specialty Pharmacy number wouldn't be as dramatic as that. And we would be assuming it would be a lower tailwind in 2020, because obviously at some point you start to reach a point where that ID number doesn't make – it's not as sustainable when you've been seeing that kind of growth. So, our assumption is it's about half of what you shared, maybe slightly above that and then they will be lower in 2020 than that as well.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.
A

And then, Joe and Mike on the CPGs.

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.
A

Yeah, the CPG brands were you're talking about the brands or the alternative?

Scott Mushkin
Analyst, R5 Capital
Q

The branded volume.

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.
A

Okay.

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W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Branded volume.

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

Yes.

Scott Mushkin
Analyst, R5 Capital

Q

[indiscernible] (02:58:42-02:58:48)?

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

Yeah. So I'd say that there's a bit of a mixed bag with the CPGs that we work with. We track our top 25 CPGs. And of those top 25, I would tell you 18 to 20 of those are growing with Kroger, and we're proud of our partnerships with those organizations. There are some that are trailing, and we continue to partner to balance both what we do with Our Brands and with our CPG partners. If you look at our top five CPG partners, I would tell you that those are leading in our organization and doing very, very well, and so we're proud of those relationships as well. So it's a real balance for us. We pay attention to it every day to make sure that we're thinking about both Our Brands and our CPG partners, and how do we grow the business together.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

So, I do want actually to comment on that, because I do think you hear a lot of the story around Our Brands and how proud we are, which we are. But we have learned over the course of the last couple, three years, that we can't win without them. So the CPGs, we have to pull them along and they have to be successful too. If we're focused on one side of the equation it does not work well. So just to Joe's point.

Rebekah Manis
Director-Investor Relations, The Kroger Co.

A

And we have time for one last question.

Michael Lasser
Analyst, UBS Securities LLC

Q

Good afternoon. It's Michael Lasser from UBS. Thanks for taking my question. If we consider the original goals that were part of the Restock Kroger program to be an optimistic case, the new goal to be more of a base case, how should we frame the potential downside case? Is it realistic to have maybe flat IDs and a sub 2% operating margin? If that were the scenario that were to play out, what levers would you push to maintain the balance and would you prioritize sales or profitability in that scenario? Thank you.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

I'll let Gary start, and I'll finish.

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Gary Millerchip
Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Okay. Yeah, I think to come back to the guidance that we shared, we feel very confident in the plan that we've laid out around how we expect to grow ID sales and build from where we are today. You heard us talk about a number of the data points that we look at and give us confidence that we absolutely see a path to how we continue to build out momentum, and we feel very confident in the cost saving plans. As Mary Ellen mentioned, we've had a track record now of 18 months of delivering on those plans and we have a very clear path in our mind around where those savings will be achieved in 2020. There's not aspirational numbers in those plans. They are very clear initiatives that we expect to deliver in 2020.

And as Stuart said, alternative profit is continuing to grow at a pace in the way which we expected. So from that perspective, we think about it more of, we've got a very clear plan and high level of confidence in that plan to deliver on the guidance that we've shared. Certainly, our goal obviously is to be pushing ourselves to the top end of that range and our ability to make sure that the capital investments that we make are driving those high return projects and our ability to make sure that we're executing at the high end of the plan is really what would be the drivers that would cause us to get more comfortable at the top end of the range. Obviously, if we're not seeing that kind of return from those initiatives, then we're going to be looking at the capital spend to make sure that we're being very disciplined, and only using capital where it's driving return for, first of all, the customer and then turning into a shareholder benefit.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah, identical sales are always incredibly important in our model. So if you look – we prioritize capital investments to do things that will support identicals both in terms of remodels and adding services in the store. So, identical sales will be something that's always a focus, but doing it in a way that's sustainable is the critical part. You can go out tomorrow and do milk at $0.99 and have a good identical number for a little period of time. But we would be doing it in ways of making sure that is sustainable. I don't know anything, Mike, you want to add to that?

Michael Joseph Donnelly
Chief Operating Officer & Executive Vice President, The Kroger Co.

A

No, I think that's good.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Okay. I'm going to cheat and let one other question on this side. So, [ph] Sam (03:03:00) I ended up more on this side than this side.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Thanks, Rodney. Andy Wolf from Loop Capital. Just wanted to come back to Ocado, and specifically to shed this plan for Florida. You can generally discuss, since it's new market versus I think the other three are in markets where you have a large store network, like how – what you can share with us about the payback, the length of time, maturity curve, ROI, all that kind of outlook generally to help us understand how you're thinking about that shed versus the others?

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The other thing I wanted to get back to, I think, Rodney, you brought it up and one of your other management folks brought it up, using some of the behavioral data you have on people's food purchases effects can affect their health and help them manage that. The products you're designing, standalone Kroger products, you're going to work sort of one-on-one with Kroger customers or it seems like it'd be more robust in a healthcare ecosystem where you may be working with other providers of healthcare or payers of healthcare. I'm just trying to get a sense of how that thinking is on that program.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah, on Ocado – for first, this last question, and Joe you can jump in. Joe talked about like a Simple Truth, where a lot of plant-based new items. If you look at food as medicine, there would be several healthcare companies that we're partnered with in terms of trying to scope what is that and what's the role for each partner, and the key thing is what can you do together that you can't do independently. I don't know, Stuart, you're in the middle of a lot of those conversations as well. And Joe I'll let you talk about our own brands relative to that.

Stuart W. Aitken
Senior Vice President, Alternative Business, The Kroger Co.

A

So, Rodney is exactly right. We're exploring a number of areas where we can help our customer first and foremost. And secondarily, can we generate profit from that. The other piece around something like OptUP from a brands perspective, brands are now coming to us asking us for the OptUP score itself. So, we see an opportunity for this to be a much broader scoring mechanism than just for Kroger products or our branded products, and see a huge opportunity there to help brands, help customers eat better across America.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Joe anything you want to add?

Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

Yeah, I would just comment on two things, one our fresh assortment really fits with the health concerns and the chronic disease states that we're addressing. That's a big opportunity. I talked about avocadoes today. I always joke with my wife that an avocado gets a 100 points. So, make sure we buy a couple of avocados, because those are really good for your OptUP score, they're really good for you in general for your health. But our fresh assortment really appeals to the customer in that regard.

We are doing – we have done some work and small tests with Home Chef as well. So, and we partnered with a small group where customers actually had a prescription for food and a Home Chef meal was given to – sent to that customer to say, this meal is actually what you need to be using for your healthcare situation. Everyone is different customers, want to know is this healthy. And then is this healthy for me. And to Stuart's example, sodium is one issue, cholesterol might be another. But customers really want to know is this important for my health situation, and Home Chef has been a small partner in that early on as well.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. A super good friend of mine just found out he has prostate cancer. And one of the things – one of the comments he made to me is, how can you help me eat the way I should eat, so...

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Joseph A. Grieshaber
Senior Vice President-Merchandising, The Kroger Co.

A

And I would just add in our pharmacists play a really important role there, because they are the most trusted healthcare professional in many customers' lives. And they'll talk to our pharmacists about their health situation and our pharmacist. And now we're starting to deploy nutritionists in stores, and they can help the customer make some choices that are really important to, just as Rodney had described.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

And on Ocado on Florida, Alex, I don't know if you want to say anything or yell. Obviously, the model there is a little different than in the core market.

Alessandro Tosolini
Senior Vice President-New Business Development, The Kroger Co.

A

Thanks, Andrew, and thanks, Rodney. Alex Tosolini. Florida is not comparable to Monroe or Cincinnati. It's a white space for us. The math still works the same as we talked for some of the other markets. Customers are there and are ready and, of course, our economies are going to be different than the economy slightness in Cincinnati and some of the other regions. And at the moment, I can talk about some potential other ideas in Florida that we have a lot of possible partnership that can help us create the right ecosystem for the Florida customers.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

A

We have budgeted the ramp up there to be slower than like in Monroe [indiscernible] (03:08:11). Go ahead.

Alessandro Tosolini
Senior Vice President-New Business Development, The Kroger Co.

A

So the other thing I would also add maybe to help things for the economic impact is the model and the operating setup, if you will, of an Ocado facility allows you to build up the utilization. So, you're not incurring all of the operating costs upfront. You're able to ramp that up as you ramp up the demand, so, there's a little bit of a [ph] variable in there (03:08:36). Building the building that's capital upfront and you don't really flex that, but how you incur the expenses to support the facility ramps up as the demand matures. So, as we go to that market, as we engage the customers in that market, taking advantage of a few levers which we'll remain silent about for now, we'll obviously manage the exposure as we ramp up the demand.

W. Rodney McMullen
Chairman & Chief Executive Officer, The Kroger Co.

Really appreciate all the questions and appreciate the management team for everything that they've answered. For everyone in the audience, thank you for joining us today and online. As you've heard, we're confident on our ability to deliver growth. We reconfirmed our identical sales and EPS guidance for 2019, and we outlined our expectations for 2020 and beyond. We're equally excited about the future after 2020 as well and hopefully you saw some of that. The steps that we took in 2018 and 2019 are making 2020 and beyond possible.

As we outlined – as you look at 2020 and beyond, we strive to deliver a minimum TSR of 8% per year and then more in some years. Our business model works because it's based on what the customer wants. And hopefully,

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you heard that time and time again that it really starts with the customer obsession, and we're obsessed about the customer, and we're focused on operational excellence in our core grocery business.

We have a plan to drive identical sales growth by leveraging the three advantages that Joe talked about today; the fresh experience, Our Brands and personalization. And digital ties it all together to make sure that we have a seamless experience for our customer. We're using the power of the stable and growing core supermarket business to create meaningful incremental profits through the alternative profit stream businesses, which adds up to a business built for long-term growth that generates a consistently attractive shareholder return.

Restock progress is the right framework to reposition our business to build our competitive moat and to create value for all of our stakeholders. It provides us with a clear purpose and our vision to serve America through food inspiration and uplift. It focuses us on redefining the customer experience. Identifying which partners will make sure that help us deliver more customer value today and the future and putting the right talent and the right teams in place to focus on growth, both in terms of our core supermarket business and our alternative profit businesses.

And through all this, we're making significant progress on transforming Kroger for the better. We have never been more confident in our future and excited about our future. We are committed to delivering a winning outcome for our shareholders, our customers and our associates.

And as I said before, thanks much for joining us today. And any follow-up questions, Rebekah can handle.

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