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The Kroger Co. (KR)

Q1 2024 Earnings Call

CORPORATE PARTICIPANTS

Rob Quast
Senior Director-Investor Relations, The Kroger Co.

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

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

OTHER PARTICIPANTS

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Robert F. Ohmes
Analyst, BofA Securities, Inc.

Zachary Abraham
Analyst, Morgan Stanley & Co. LLC

Ken Goldman
Analyst, JPMorgan Securities LLC

John Heinbockel
Analyst, Guggenheim Securities LLC

Michael Lasser
Analyst, UBS Securities LLC

Michael David Montani
Analyst, Evercore ISI

Edward Kelly
Analyst, Wells Fargo Securities LLC

Kelly Bania
Analyst, BMO Capital Markets Corp.

Krisztina Katai
Analyst, Deutsche Bank Securities, Inc.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Kroger Co First Quarter 2024 Earnings Conference Call. My name is Carla, and I will be coordinating the call today. [Operator Instructions] Please note that this event is being recorded.

I would like now to turn the conference call over to Rob Quast, Senior Director, Investor Relations, to begin. Please go ahead.

Rob Quast

Senior Director-Investor Relations, The Kroger Co.

Good morning. Thank you for joining us for Kroger's first quarter 2024 earnings call. I am joined today by Kroger's Chairman and Chief Executive Officer; Rodney McMullen and Interim Chief Financial Officer, Todd Foley.

Before we begin, I want to remind you that today's discussions 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.

The Kroger Company assumes no obligation to update that information. After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question and one follow-up question, if necessary.

I will now turn the call over to Rodney.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thank you, Rob. Good morning, everyone, and thank you for joining us today. Before we begin, I'd like to provide an outline of our discussion topics this morning. I will start by sharing a recap of our first quarter performance and highlight how we continue to advance our go-to-market strategy.

Which powers our value creation model and drives long-term sustainable growth for our shareholders. Then Todd will cover our financial results for the first quarter. Finally, I will provide a few comments on our proposed merger with Albertsons before we open it up for questions. We're off to a solid start in 2024, reflecting the strength and diversity of our model.

As better-than-expected performance from our grocery business helped us manage fuel and health and illness results that were behind expectations, Kroger is providing exceptional value and a unique omnichannel experience, which combined with strong store execution led to growth in households and an increase in customer visits.

As inflation moderates, we expect customer sentiment to continue improving. But near term, many customers are managing economic uncertainty. While we expect health and Modis profitability pressures to continue into the second quarter, our recent improvement on store execution metrics and strong customer trends give us confidence that we are building momentum for a strong back half of the year, and we are well positioned to deliver on our full year guidance.

As we've seen over recent quarters, customers continue to seek value and are shopping with us differently based on their financial situations. Spending from premium and mainstream customers continue to be strong. Mainstream households drove our overall household growth. And we improved our share of wallet with premium customers who are deepening their loyalty, spending more in our fresh departments and enjoying more premium products such as private selection. Within our most budget-conscious households, we are starting to see positive momentum.

And we grew households in this segment after experiencing declines last year. Historic multiyear inflation across the economy, high interest rates and reduced government benefits disproportionately affect these customers and are influencing their spending behaviors.

Kroger's long-standing commitment to low prices and personalized promotions creates real value for our customers at a time when many of them need it more than ever. Food at home continues to be the most affordable meal option for customers.

While food inflation has impacted every meal occasion, inflation and food away from home has been even higher than food at home inflation since 2019. We are committed to making sure our customers can enjoy a great meal experience with zero compromise on quality, selection, value and convenience.

We see a significant growth opportunity to deliver convenient restaurant-quality meals at an attractive value. And we are expanding our ready-to-heat and ready-to-eat offerings. For example, after we revamped our fried chicken recipe, we created a meal bundle, which feeds a family for $3.50 a person, a fraction of what it would cost to eat out at restaurants with quality that's difficult to be.

Every day, we strive to provide an outstanding customer experience and we are focused on sharpening our store execution to do just that. This year, we raised the bar on our full fresh and friendly customer experience metrics, and we are very proud of our store teams who are delivering an even better shopping experience with service metrics at record highs.

To continue the momentum in our grocery business, we are committed to keeping prices low for customers and delivering a consistent experience while growing our pillars of fresh, our brands, seamless and personalization, leading with fresh our store team's primary goal this year is to drive more consistent shopping experience, and that begins with fresh.

We are introducing new technology that's enabling our teams to better track...

[Technical Difficulty] (00:06:04-00:07:41)

Operator: We have lost connection with today's speaker. Please standby as we try to reconnect with them.

Thank you for your patience everyone, we now have the speaker back on the line, please continue.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

...our ongoing work to differentiate and elevate our brands is driving higher profitability. We are identifying new supply sources using more effective promotions and improving product mix, which is contributing to further margin improvements.

Now to seamless, delivery solutions led digital results again this quarter with an increase in both households and visits. Hiccup also had solid growth and focus on delivering best-in-class fulfillment led to strong improvements in key customer experience metrics. This quarter, our teams improved fill rates to a new record high.

Reduced wait time and delivered a significant improvement in perfect orders compared to last year. Through the power of machine learning and AI, we are developing new ways to elevate the pickup experience for customers and at the same time, reduce costs.

With dynamic batching of orders, these tools are providing associates the most effective pick routes which is enabling us to dramatically reduce pick lead time in our highest volume stores. Our customers love the Kroger delivery experience with refrigerated products delivered directly to their doorstep.

As a result, the Kroger delivery network has experienced remarkable growth with sales nearly doubling this quarter versus last year. As we focus on providing an incredible customer experience we are learning and adjusting the delivery network.

A good example of this is our decision in the first quarter to close three spoke locations to reallocate capacity closer to our automated fulfillment centers where we have higher customer density and better order level profitability.

This decision does not impact Kroger's automated FCs or other spoke locations. We remain confident that our Kroger delivery network provides a differentiated customer experience and will continue to be a key pillar of our digital growth strategy.

Turning to personalization, the combination of seamless and our personalization capabilities generated another quarter of digital engagement growth, up 9% compared to the same quarter last year. Personalization enables us to balance the depth and breadth of our promotions more effectively and encourages customers to engage more with us by focusing on promotions that matter most to them. This led to an 18% increase in digital coupon clips compared to last year.

Capturing more digital households is a key to our long-term growth model as these households are more loyal, spend nearly 3 times as much with us, and drive our alternative profit businesses.

By executing our go-to-market strategy, we create momentum in our grocery business. In turn, this creates the data and traffic to accelerate growth in areas like health & wellness and our alternative profit businesses.

Alternative profit businesses had a strong quarter, led by growth in Kroger Precision Marketing. KPM results were in line with what we expected and keep us on track to meet our full year expectations of more than 20% media growth.

Yesterday, KPM continued to broaden its reach by offering its custom audiences an ad measurement capabilities to advertisers on the Meta – social media platforms. This is another important step in KPM's growth, creating more opportunities for clients to reach relevant audiences in more places and providing better transparency to ad effectiveness.

Health & wellness grew its top line this quarter, however, profitability results were below expectations. We are optimistic about the potential of this area of our business. Our script adherence initiatives are on track and our teams are providing excellent care, which helps patients live healthier lives.

Additionally, our marketing plans and in-store activations, designed to raise awareness and attract new patients, are launching now to help drive growth in the back half of the year.

Turning now to associates. Our associates are doing an excellent job elevating the customer experience and improving our full fresh and friendly metrics this quarter. Team consistency leads to better execution and retention improved again this quarter. We are retaining more associates through a holistic approach, which includes wage and benefit investments and also a focus on associates' well-being.

And this work is being recognized. This quarter, Kroger received the 2024 Platinum Bell Seal for Workplace Mental Health. This is the third consecutive year that we've been recognized with the certification and for the first time, we received the top distinction.

This program recognizes Kroger as an employer who creates a mentally healthy workplace for our associates through culture, benefits, compliance, and wellness programs. We'll continue to invest in our associates. When our associates have a better experience, they provide a better experience to our customers.

With that, I'll turn it over to Todd to take you through our first quarter financial results. Todd?

Todd A. Foley

Interim Chief Financial Officer, The Kroger Co.

Thanks Rodney and good morning everyone. Kroger's first quarter performance reflects the resiliency of our model, which enables us to manage a variety of economic cycles. The strength of our model, combined with a momentum in our grocery business, gives us confidence to reaffirm our full year guidance, even as we continue to navigate an environment of economic uncertainty.

I'll now take you through our first quarter financial results. We achieved identical sales without fuel growth of 0.5%. As Rodney mentioned earlier, our identical sales were driven by several positive customer metric trends, including increases in total and loyal households and increased customer visits. We continue to see sequential unit improvement, and our teams remain focused on returning to positive units later this year.

Inflation continues to moderate, which is consistent with our expectations at the start of the year. And towards the end of the first quarter, we began cycling the headwinds from the reduction in SNAP benefits.

Digital sales grew by more than 8%, which was led by 17% growth in Delivery Solutions. Gross margin was 22.4% of sales, and our FIFO gross margin rate, excluding fuel, decreased seven basis points.

The decrease in rate was primarily attributable to lower pharmacy margins and increased price investments, partially offset by favorable product mix, reflecting our brand's margin performance.

The slight decline in our FIFO gross margin rate was in line with our expectations. We expect our FIFO gross margin rate to improve beyond our first quarter results, driven by the core components of our margin expansion initiatives.

During the first quarter, we recorded a LIFO charge of $41 million, compared to a charge of $99 million for the same quarter last year. The decreased charge for the quarter was due to lower inflation expectations for the current year, compared to last year.

The OG&A rate, excluding fuel and adjustment items, increased 22 basis points, driven by planned investments in associate wages and increased incentive plan costs. Partially offset by continued execution of cost savings initiatives.

In the second quarter, we expect the factors identified in the first quarter to continue, leading to a similar to slightly higher OG&A rate. We expect our OG&A rate to improve in the second half of 2024.

We continue to make progress on our digital profitability, delivering another quarter of improvement in our pickup cost to serve. It remains a long-term margin opportunity with runway to improve to increase volume and process enhancements.

Our store associates played a key role in the cost to serve improvements and as Rodney mentioned earlier, did so while they improved key customer experience metrics. Adjusted FIFO operating profit was $1.499 billion. Our adjusted EPS was $1.43 per diluted share, a decline of $0.05 compared to last year.

Fuel continues to be our strategy to build loyalty by providing compelling fewer rewards to customers. We continue to see more reward activity with 8% more redemptions contributing to gallon sales, which outpaced the industry this quarter.

However, our fuel profitability was below expectations this quarter, with our cents per gallon fuel margin down low-single digits, compared to last year. I'd now like to provide a brief update on associates and labor relations.

We continue to invest in our associates, as part of our long-term strategy, resulting in an average hourly rate of $19 an hour, at a rate of nearly $25 with comprehensive benefits factored in.

During the first quarter, we ratified new labor agreements for our Houston Clarks and Meat, Mid-Atlantic division stores in West Virginia, South Carolina stores in Colombia and Myrtle Beach and Portland distribution center and drivers covering more than 21,000 associates.

Turning to cash flow, Kroger continues to generate adjusted free cash flow, strong adjusted free cash flow through consistent operating results, which is enabling us to continue deleveraging in anticipation of our merger with Albertsons. At the end of the quarter, Kroger's net debt to adjusted EBITDA ratio was 1.25, compared to our target range of $2.3 million to $2.5 million.

Our strengthened balance sheet provides ample opportunities for Kroger to pursue growth and enhance shareholder value. We continue to take a disciplined approach to deploying capital, with a focus on projects which drive long-term sustainable net earnings growth.

While remaining committed to our investment-grade debt rating, increasing our dividend over time subject to Board approval and returning excess capital to shareholders when we are able to do so. As part of our capital investment plans for 2024, we shared last quarter our plans for approximately 30 major storing projects focused on higher growth geographies, where we have traditionally achieved a strong ROIC and operating profit growth.

We've made good progress on our projects so far and remain on track with our plans. While early, we're happy with the results from projects completed in the first quarter. We are confident these new storing projects will help advance our omnichannel strategy and be an important component to our sales growth and TSR model going forward.

During the first quarter, we announced we had entered an agreement for the sale of our Kroger Specialty Pharmacy business. As part of our regular and ongoing review of our portfolio, we determined that Specialty Pharmacy was not part of our core strategy going forward and the sale will enable us to focus on our health and wellness strategies that revolve around our retail pharmacies.

Due to the sale, a non-recurring held-for-sale tax adjustment of $31 million was recognized in the quarter, and it has been reflected as an adjustment item in our results. The sale of KSP is not expected to have an impact on our 2024 guidance.

I'd now like to provide some additional color on our outlook for the rest of the year. Today, we reaffirmed our annual guidance, reflecting both positive momentum we are seeing in our business, along with a more cautious customer environment in the near-term. In terms of quarterly cadence, we now expect a decline in adjusted EPS for the second quarter, similar to the rate we observed in the first quarter as we expect pharmacy business profitability pressures to carry over into the second quarter. This reaffirms where we expected to be through both the first half of the year as well as the full fiscal 2024.

In closing, our first quarter performance reflects the strength and resiliency of our model. We are strengthening our grocery business, which drives the data and traffic to accelerate growth in our alternative profit businesses and we remain confident in our ability to drive attractive and sustainable returns for our shareholders.

I'll now turn the call back to Rodney.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thanks, Todd. As you've heard from both of us, our grocery business is performing well, and we are building momentum across our business. Kroger is operating from a position of strength. We have the right strategy, which is resonating with customers, and we have the financial strength to pursue growth and enhance shareholder value.

As we continue to prepare for our merger with Albertsons, I'd like to thank our associates for their incredible commitment. Since we announced the proposed merger back in October of 2022, our associates have done an exceptional job preparing for the integration with Albertsons, while never once taking their eye off the ball of serving our customers, advancing our strategy, operating our business and driving results. Because of their efforts, we will be prepared to hit the ground running as a combined company, ready to serve more customers from day one.

As a more general merger update, in April, we announced an expanded divestiture plan with C&S, which directly responds to the concerns raised by federal and state antitrust regulators regarding the original agreement. We believe the package, which includes a modified and expanded store set and more non-store assets, bolsters Kroger's position and regulatory challenges to the proposed merger, including our upcoming court proceedings. It also positions C&S to be a strong and successful competitor. We are prepared to defend our merger because it will produce meaningful and measurable benefits for customers, for associates, and for communities across the country. Customers will benefit from lower prices and more choices following the merger close.

We have committed to investing $500 million to begin lowering prices day one following close, along with an additional $1.3 billion to improve Albertsons stores. Employees will benefit from Kroger's commitment to invest $1 billion to raise wages and comprehensive benefits, further building on our $2.4 billion in incremental investments since 2018. As union membership continues to decline nationwide, this merger will secure union jobs and communities will benefit from the strength and the ability of the combined company to accelerate Kroger's commitment to ending hunger. As a combined company, Kroger has committed to donating 10 billion meals to families across the US by 2030.

In closing, Kroger is off to a solid start to the year, positioning us well to deliver on our commitments. We continue to invest in associates and the associate experience. Because when they have a better experience, our customers do as well. Grocery results are off to a better-than-expected start, which provides the foundation for growth in alternative profit businesses. And our model is generating strong free cash flow, which has strengthened our balance sheet and positions us for future growth.

With that, Todd and I look forward to taking your questions. Because we are in litigation, we will not be taking questions on the merger this morning.

QUESTION AND ANSWER SECTION

Operator: [Operator instructions] And our first question comes from Rupesh Parikh from Oppenheimer.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Good morning, and thanks for taking my question. So I want to dig deeper into the gross margin line. If you can maybe walk us through the puts and takes as you guys see it for the balance of the year, including how you think about the pharmacy margins in the back half of the year?

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

Yeah. Thanks, Rupesh. Great question. We talked at the beginning of the year that our expectation was to have relatively flat year-over-year gross margin, and that is still the expectation. As mentioned in my comments, we do expect results for the balance of the year to improve beyond our Q1 results. And that's really reflective of some of the gross margin expansion efforts that we have going on. They're going actually really well. We alluded to our brands' performance. Our margins and our brands continue to do very well. And as that business continues to grow, particularly in today's environment, we talked about the budget-conscious consumer. And that continues to connect with them. So the growth in that business helps drive the margins, and we expect to see that as the year goes on.

Fresh is another category where we've had meaningful growth. Fresh is doing really well. We've talked a lot about produce, our end-to-end fresh and how that business is growing. And certainly, that comes with higher margins, which has a positive effect on our mix. And then when you look at alternative profits and in particular, retail media, that business continues to grow well. And especially the second half of the year, we expect retail media to continue its momentum to achieve our growth of in excess of 20% for the year. A lot going on in that space, and we went to a new platform a year ago. And as we went and ramped up the platform a year ago, we'll be cycling that period of time with some of the momentum we have in that business.

So all of those are where a lot of our confidence comes from, and we talk about reaffirming our guidance for the year. And we alluded to some of the pharmacy headwinds. Even though we expect some of those to carry over into the second quarter, I think all of the results that we're seeing from our margin expansion efforts are going to continue to drive us so that we hit our expectations to improve the result relative to Q1.

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

A

I want to just add a couple of points on Todd's last point. We continue to have good success with value-add product. And typically, that product is something that the customer can eat almost immediately in the car or at home and that's helping on margin and then our sourcing teams continue to have – making progress in cost of goods, which helps as well.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Great. And then maybe just one quick follow-up question. In light of some of the competitor announcements of reducing price on certain items. Just wondering how you guys feel about your price gaps today?

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

A

Yes. If you look at overall, as you know, for the last, I don't know, 15, 18 years, part of the Kroger strategy has always been to invest in pricing every year. And 2024 wouldn't have been any different than any of the previous years. And we continue to execute against that plan of helping the customer stretch their budget.

If you look at where we feel on a relative price position, we feel very good. And one of the things that we – even was glad to see is if you look at the customer that's on a budget for the first time in over a year, we actually had growth in count from that customer base. So overall, we feel good about where we are.

One of the things I always think it's important to remember too is, as a promotional merchant, people buy a lot more when things are promotion. We also have a very sophisticated rewards program that for personalized offers that publicly you wouldn't see and also our fuel rewards. So overall, we feel good about where we are, and we feel good about where we are relative to any of our competitors. Thanks, Rupesh.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Great. Thank you. I'll pass it on.

Operator: The next question comes from Robert Ohmes from Bank of America Merrill Lynch.

Robert F. Ohmes
Analyst, BofA Securities, Inc.

Q

Oh, hey, Rodney.

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

A

Hello.

Robert F. Ohmes
Analyst, BofA Securities, Inc.

Q

I had just two follow-ups on the first question. Just in terms of the price investments, and I know you guys always do them. But has anything changed with what your CPG partners are doing with Kroger to drive volumes because we know that they're looking to do that.

And then also, I would love to just get further perspective on what Kroger is seeing competitively either the same or different sort of there's kind of Walmart and Target, but what are the regionals and independents doing competitively? Are they changing at all what they're doing?

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

A

If you look at CPG partners, overall, we would be seeing more trade dollars than in the past. And I think some of that ties to the comment I made before on sourcing. The economists always say all short statements are incorrect. We – there are some CPG partners that aren't worried as much about tonnage and wouldn't be as aggressive. But we are seeing an increased trend where CPG – most CPG partners are starting to focus on tonnage again. And then trying to partner with us more aggressively to help tonnage. If you look at regional competitors, really wouldn't see much difference there than the national competitors. And overall, inflation is up slightly, you would see people raising slightly more prices than lowering, but nothing that's especially different there than what we would see. And as you know, there's a ton of great awesome regional competitors out there. Thanks, Robby.

Operator: The next question comes from Simeon Gutman from Morgan Stanley.

Zachary Abraham
Analyst, Morgan Stanley & Co. LLC

Q

Hi. This is Zach on for Simeon. Thanks for taking our questions. First, with respect to the Q1 performance, would you say that you set up the guidance with some conservatism? Or was it genuinely stronger than what you thought it would look like? And maybe as a follow-up, why shouldn't we extrapolate that level of upside for the full year? And was it driven primarily by price or units or some of both? Thank you.

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

A

Yeah. If you look at the first quarter performance, as Todd and I both mentioned, we felt very good about where were finished or were turned out. One of the things I always think it's – the first quarter is so early in the year. I never feel – it would be unusual for us to feel comfortable changing too much. If you look at things that we felt good about are the things that we outlined in the prepared comments, around our customer count growth, the growth that's broad-based across all of our customer types. Our store team is doing a very good job of continuing to improve the experience and the in-stock positions and all those things. The couple of headwinds that we do have is if you look at like incentive plans, especially in the second quarter, we'll have significantly higher incentive plan accruals in the second quarter than what we did a year ago, which is partially what's affecting the second quarter. But overall, for the year, we feel good about where we are. We feel good about where we are relative to where we thought we would be, but it's really too early in the year to make too many changes.

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

That's a good color, Rodney actually to go together. The strength we saw in the first half of the business is really time of your incentive plan comment, a big contributor to the strength we're seeing in our grocery business is around our teams delivering on store execution and the shopping experience. And improvement in those metrics is an important part of our incentive plan this year. So it's – those two thoughts are connected with one another.

Zachary Abraham
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

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

A

Thanks, Zack.

Operator: The next question comes from Kenneth Goldman from JPMorgan.

Ken Goldman
Analyst, JPMorgan Securities LLC

Q

Hi, thank you. I just wanted to clarify, are you still on track to see inflation increase as the year progresses? I think that was mentioned last quarter. I didn't hear any update on that rate of change. And then I don't think you provided – again, I may have missed it, gross profit dollars or pennies per gallon for fuel. Just trying to follow up on those two.

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

A

Yes. I'll let Todd answer the second part. On inflation for the year, the first quarter was pretty much where we expected it to be, where we – for the year, it's pretty consistent with where we thought it would be. So if – I'm going off of memory, but I think we said it was slightly over 1%, and we would continue to see it slightly over 1%. If you look at some of the commodity – the commodities themselves, obviously, that will bounce up and down. And as you get later in the year, we – that some of that balance will be driven by what kind of crop year is it, relative to corn and some of those things.

But really, overall, what we expect inflation to be similar to where we did last year, and it is starting to stabilize. We don't see deflation broad-based at all, but it is stabilizing around that little over 1%.

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

Yes, that's great. And on the fuel point, we did in my comments, we did see that cents per gallon margin was down low single digits.

Ken Goldman
Analyst, JPMorgan Securities LLC

Q

Okay.

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

A

Thanks Ken.

Operator: The next question comes from John Heinbockel from Guggenheim Partners.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Hey, Rodney, I wanted to start with when you think about delivery and pickup profitability, I mean, I know you're losing money in those areas. Do you have an idea in mind when you can begin to approach breakeven? I know it's going to take a while, but [ph] thought (00:36:08) on that. And then if you had to pick a couple of key drivers, right, that would get you there. What do you think they are?

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

A

Yes, if you look and John, we've talked about it a lot of times. I always say our job one is to make sure we don't lose the customer, and job two is we have the responsibility to figure out how to be profitable with each of those customers.

We do have some divisions that are now at breakeven or slightly profitable, and if you look at incrementally on a per order basis through almost all of our channels now incrementally, they're contributing. In terms of our expectation of ourself is that that customer will be just as profitable as a store customer over time.

I don't know that I would put a specific date on it yet, but that is the expectations we have for ourselves. And the key things on it will be continuing. For me, I think number one is making sure our NPS scores stay strong, because that's what causes that customer to continue to repeat.

Then making sure that each basket, we start getting where the customer adds items within a basket. And then always, from an operating cost standpoint, we'll continue to use our technology to be more efficient.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Okay. And then maybe as a follow-up on pharmacy. So what's your sense the pressure is coming from where? Is it solely reimbursement or something else? I mean, what's your take on reimbursement longer-term? And are we basically going to see less capacity, right? And drug stores right are closing a lot of locations.

But do you think between that, supermarkets getting out of the business, there will be a lot less capacity in pharmacy three or four or five years from now, that will help profitability?

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

John, I'll talk to the headwinds a little bit. What we're seeing there was really a couple of items in product mix. One was around GLP-1. We've talked about that before. It's a high retail ring, but at an extremely low margin. And so that puts pressure on our margins. And coming into the year, if you recall, the latter part of last year, we had supply constraints on GLP-1. And so some of those restraints were relieved in the first quarter.

And frankly, our team did a really nice job with suppliers getting out there to get product to meet demand in our stores. And so our sales exceeded what we expected to see in the first quarter, and that put a little bit of that unexpected pressure on margins.

And then the second, there's another category of drugs as well where we saw some regulatory restrictions that were unexpected that drove up the cost on those meds and put some pressure on the margins. So when we talked about some unexpected trends in pharmacy, it was really around product mix in those couple of areas. And wanted to make sure we called it out because we do see that carrying over into the second part of the year. It wasn't necessarily reimbursement period.

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

And as we look longer term, three or five years, we definitely think there'll be less capacity and as you noted, there's a significant number of closures by the other three players in that space. And there's a lot of work that's being done from a governmental standpoint around PBMs.

The thing that I get super excited about our pharmacies and our health & wellness teams they continue to do a great job of improving the experience. And I think it's amazing that a third of our customers don't even realize we have a pharmacy and we're obviously working incredibly hard to make sure that third of our customers that don't even realize we have a pharmacy to get them to convert and become a patient of our pharmacy, because our teams do an amazing job on service. We have incredibly quick lines and things like that, and it's one less trip that somebody has to make. So thanks, John, for the question.

Operator: Our next question comes from Michael Lasser from UBS.

Michael Lasser
Analyst, UBS Securities LLC
Q

Good morning. Thank you so much for taking my question.

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

Good morning.

Michael Lasser
Analyst, UBS Securities LLC
Q

Rodney, between some of the comments from other food – good morning. Between some of the comments from other food retailers as well as your own discussion around increased price investments, there is a perception that the industry is becoming more competitive, and that is going to disrupt the profitability of food retail in the back half of the year.

So could you compare where the overall promotional intensity that you're witnessing is today versus where it's been in the past, especially around disruptive time. And how much did your price investment contribute to the improvement that you saw in more price-sensitive customers, lower-income consumers in the quarter?

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

In terms of overall, I would say in terms of promotional activity looks very similar to pre-COVID and for the first time, it finally starts looking and feeling more like pre-COVID times. As I mentioned a second ago, overall, we saw more prices go up and go down. So when you look at the individual number of SKUs. I feel really good about where we are, and I feel good about our teams and their ability to continue taking care of customers.

In terms of the value customer, I think a lot of it is driven more from some of the things that we've done relative to our new brand in terms of smart way, helping that customer understand that they can come and shop with us, and you don't have to compromise relative to fresh and quality in some of those other aspects, the customer experience or associate experience that they give. So when you look at it overall, it's pretty consistent with where we thought it would be. And part of it, I think, is just the moderating inflation, but we still continue to expect a little bit of inflation.

Michael Lasser
Analyst, UBS Securities LLC

Q

My follow-up question is that progress financial formula works very well when its ID sales are above 3%. When is a realistic expectation that it could resume seeing ID sales back at that level?

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

I think you're right, our model is to drive 2% to 4% ID sales. And as you look at – we talked a lot last quarter around the dynamics of inflation and what we saw last year with the rapid disinflation throughout the year. And as we get back to this year, the more normal inflation environment that Rodney alluded to, and we start cycling those heavy disinflation – we talk about the – getting towards the high end of our guidance range relative to sales by the second half of the year. And I think that starts to get us back into that range that our long-term model is based on 2% to 4%.

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

A

And the other thing, it's a great question. It's hard to give a specific data other than I can assure you that our team is working really hard to get there. We're also – and this is something I would say we've always done, but you always try to get better. And if you look at capital investments, we would also be using capital investments to support that growth. And as you know, we're starting to increase the number of stores that we're opening. And the maturity of those stores and the remodel of those stores also help with identicals over time. And we would expect that obviously be the case now. And as Todd mentioned, it's early in the slightly higher capital spending for new stores and expansions and stuff, but we're pleased with the early results. Thanks, Michael.

Operator: And our next question comes from Michael Montani from Evercore.

Michael David Montani
Analyst, Evercore ISI

Q

Hey, thanks for taking the question. Wanted to ask if you could discuss the ID sales cadence through the quarter and then in the month of June. How should we think about ID sales for 2Q? And then I had a follow-up.

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

Yes. The first quarter was a little choppy because we had an Easter mismatch relative to the calendar. But the general trend throughout the quarter was that we saw IDs increase steadily as we went through the quarter on average. And then as we look to Q2 to-date so far, we're right on plan relative to our expectations for Q2 results and the guidance that we've given.

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

A

Yes. And as you know, we do expect IDs to improve throughout the year, and we continue – so far, we're continuing to see that and would expect that to continue.

Michael David Montani
Analyst, Evercore ISI

Q

Got it. That's helpful. And if I could, I just wanted to try to better get the arms around some of the pharmacy pressures. Is there anything that you could point to in the back half of the year, whether it be comparison based or otherwise that would help to alleviate some of those pressures or perhaps other sources of profit, whether it be media or fuel that could offset somewhat.

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

A

I'll make a couple of comments, and Todd, feel free to add. One of the things as you get to the third quarter and early in the fourth quarter is vaccines. And as you know, last year, our teams did an amazing job of increasing the number of vaccines we gave. And we have a ton of learnings that we think we'll be able to do that again this year. And so when you look at just the pharmacy business, part of that will be that. And also on some of the supply issues we would hope that and expect for those to get more normalized and like the one drug that Todd was talking about, the generics as they come out and stuff historically, that's always improved profitability, and we would expect at some point in this – the later part of the year for those things to happen. Relative to the other pieces, Todd I'll let you.

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

You're right. I was going to say on pharmacy, Rodney just overall with the business. I alluded to earlier the margin expansion efforts that we're seeing and those are all factored into the guidance for the rest of the year. And even given those pharmacy headwinds, we expect the pharmacy or the margin expansion, the gross margin expansion initiatives that we have blended with the pharmacy headwinds that we called out should enable us to achieve gross profit results beyond what we saw in the first quarter.

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

A

Thanks, Michael.

Operator: And our next question comes from Ed Kelly from Wells Fargo.

Edward Kelly
Analyst, Wells Fargo Securities LLC

Q

Hi, morning, everyone.

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

A

Good morning, Ed.

Edward Kelly
Analyst, Wells Fargo Securities LLC

Q

I wanted to start, two questions. The first question I had is just around the – good morning – it's just around the second quarter guidance. So in Q1, you beat on lower fuel margins and lower pharmacy Q2, the guidance is coming down. Is that just sole baseball pharmacy and incentive comp? Is there something else happening within here? I'm just trying to figure out the level of conservatism that is sitting in the second quarter guidance, given what you just did in Q2 against all of this?

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

Yeah. No, you're right. And it is primarily based on pharmacy and incentive. You are correct. From a fuel perspective, that's so volatile. It's really week to week. It's part of what we keep our eye on as we go forward. So far, it has been closer to our expectations for the quarter, but that's one that we truly monitor daily and weekly to understand the impact that's having on the business.

Edward Kelly
Analyst, Wells Fargo Securities LLC

Q

All right – and then I guess a quick follow-up is just on leverage. So you continue to reiterate your leverage target. You are well below that at this point. Taking a step back, are there any advantages that you see to the business to running below the target long term? Is this a metric that you think you would reassess post the Albertsons precision. Just curious as to how you're thinking about that.

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

I think long term, our target of $2.3 million to $2.5 million are in the right place. That is one of our key objectives is to maintain our investment-grade rating. And over time, it's – it's proven that, that is the range that enables us to be able to do that. So I think we long term continue to look to operate within that range with or without the merger, frankly. And the beauty with where we're at here, you're right. We do have a lot of capacity there. Obviously, we're firmly focused on closing the merger and being able to use that capacity relative to the merger. And come out the other end. But I think in any scenario, the capital allocation approach that we've taken over time, we've got a long track record on what that is and how we do it. And I would expect us to execute under that framework on a go-forward basis.

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

A

We really view our lowest cost of capital as a BBB rating. And if you look at it historically, it's like 80% of the time that would be the lowest cost of capital. And as you look at the markets going forward, we don't see anything that would cause that to change. So that gives you the financial flexibility to do things like merging with Albertsons and also that creates the lowest cost of capital. And the reason we always reiterate that $2.3 million to $2.5 million is that really is the point that we believe creates a solid BBB rating. And the thing that, as Todd and I both mentioned, the business continues to be incredibly strong from a free cash flow standpoint in the anticipation going forward. So, it gives us the opportunity to continue to invest in the business, continue to grow the business, and we can't wait to be able to merge with Albertsons, so we can do that even at scale a little bit bigger. So, thanks, Ed, for the questions.

Operator: And our next question comes from Kelly Bania from BMO.

Kelly Bania
Analyst, BMO Capital Markets Corp.

Q

Hi, good morning. This is Kelly Bania from BMO.

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

A

Good morning.

Kelly Bania
Analyst, BMO Capital Markets Corp.

Q

I just wanted to ask about the volume and the tonnage outlook. I think you mentioned some positive momentum with the budget consumers and maybe an increasing customer count there, but how are volumes and tonnage trending year-over-year within your different customer cohorts? And how is that impacting your outlook for the full year in terms of tonnage and volume overall?

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

A

If you look at the tonnage trends are all – think if there's any exception to this, they're all in the right direction and they're improving. If you look at historically, part of that, we believe, is because of the moderating inflation, part of it is because of doing a better job on in-stock and the customer experience and connecting better with each customer segment. So, we feel good about those trends for multiple of reasons. Was there a follow-up question or?

Kelly Bania
Analyst, BMO Capital Markets Corp.

Q

Oh, yeah. Thank you. I wasn't sure if you're done. Just wanted to ask maybe another question on the promotional and the competitive environment. It sounds like you'd characterize it may be back to normal. I guess what's different today about Kroger's kind of gross margin profile being more stable, and it sounds like maybe up a little bit in the next couple of quarters here relative to a few years ago?

How much of that just rest on the alternative profit and the magnitude of that and the continued growth there versus anything different that you see in the gross margin for the kind of the core business?

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

Yes, Kelly, I think it's – you hit on part of it. I don't think it's just alternative profit. I think we have today more levers maybe than we've had in the past to be able to drive that value through margin expansion. So, it's alternative profit in retail media. It's what our merchants do.

We've already talked a little bit today about our brands and the value that our brand brings and margin expansion there and same with fresh, I think it's all of those areas. And I think it's also the things that we continue to do with process improvement, whether it's in supply chain, whether it's continuing to drive down shrink, et cetera, et cetera.

So, I think it's the variety of margin improvement initiatives that we have is what's a little different than maybe what we saw several years ago because we have various sources of value to help fund those investments in our customers and in our associates frankly.

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

A

Yes. And if you look at some of the things that's in margin, like warehouse and transportation costs, our teams are making good progress there, reducing the number of empty miles, taking and managing more of the transportation.

So, there's a lot – one of the things, as you know, we've done a ton of work over the last 5 or 10 years on diversifying our business model, and how we create value. And part of it is the traffic that our base business creates being able to monetize that in ways that the customer actually views and finds of value. Thanks, Kelly.

Operator: And our next question comes from Krisztina Katai from Deutsche Bank.

Krisztina Katai
Analyst, Deutsche Bank Securities, Inc.

Q

Hi. Good morning. And thanks for taking the question. I wanted to ask about the store execution plan that you implemented with the daily scoring system. Now you're really addressing some of the underperforming stores relative to the chain average.

So one is what has been the biggest opportunity for some of the store level improvements you're seeing? Just how much are they contributing to the traffic gains that you are also seeing? And just help us to think about further upside with both your budget-conscious customers, but also the mainstream and the premium customers?

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

A

Yeah. When you look at upside, I think we – our whole team feels incredibly good. If you were in one of our meetings, you would hear us talk about all the things that we can get better at, and its things that matter to our associates and matter to our customers. So we're incredibly excited about the continued opportunity we have on getting better.

On the store execution, it's – obviously, they always say, retail is detail. And it literally is working with every single store. As we mentioned in our prepared remarks, turnover continue to improve, when turnover is lower when retention is better. It helps on the experience. It helps on the execution in the store on in-stocks and other things.

Our teams are doing a very good job on fresh, and that's everything from our supply chain to our folks ordering product to using AI, to make sure the right stores get the right product to the stores getting it out on the shelf and helping the customer have a couple more days of freshness at home.

So it's really all of those things together that we think it's what's driving the increase in traffic and increase in connection with our customers. So it's obviously super proud of the whole team and excited about the opportunities going in front of us.

Krisztina Katai
Analyst, Deutsche Bank Securities, Inc.

Q

Great. And just a quick follow-up, I hate to beat this, but just on the promo backdrop, just how should we think about your promotional basket? How much of that is proactive versus reactive that you are doing in the current environment.

And I think you said that it's pretty much back to pre-COVID levels. Is it fair to assume that your vendor funding is also in line with pre-COVID levels? Or do you anticipate that to continue to ramp as your vendors are focusing on driving volumes. Thank you.

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

A

Yeah. If you look at vendor funding, we would expect it to continue to increase because the CPGs are trying to move tonnage. If you look at overall, we would, I think, feel like its pretty much back to pre-cut but at a higher-level. Some CPGs have increased their margins without – so they're just making flat out more profit, so we think they actually have room to even further invest in trade dollars.

Todd A. Foley
Interim Chief Financial Officer, The Kroger Co.

A

And to your comment on reactive versus proactive, when we put our plan together for the year and our guidance for the [indiscernible] (00:58:07) we put together our pricing strategy for the year. And we're executing on the strategy that we've put in place. And we think clearly, customers are responding to that very favorably.

We're not deviating from the plan that we have – that we've put into place. We're executing our playbook, Rodney mentioned it earlier. It's what we've done for 15 or 20 years. And we just talk to our playbook. And we think that's what's resonating with our customers.

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

A

Yes. There isn't things that are going on out there that I would say that's causing us to be reactive. You always pay attention and I spend as much time getting to the competitor stores as I do our own stores. But when I look at overall, we're running our plan, and we're using our data and insights to make sure that we're taking care of our customers and associates. So I feel really good about where we are overall on that. So thanks for the questions.

Operator: The next question comes from Chuck Cerankosky from Northcoast Research.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Good morning, everyone.

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

A

Good morning, Chuck.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

I was cut-off for a while, but it sounded like you said, Rodney, that your delivery sales doubled year-over-year in the first quarter. What's driving that? Is it just your execution or the customer demand? And when you look at customer demand for delivered groceries, how does it break down between budget conscious customers and more affluent customers?

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

A

Yes. If you look – sorry that you got cut-off, but the delivery business almost doubled year-on-year. It's pretty broad-based on all customer segments. But I think one of the things that's important to remember is that our technology allows us to do a better job now accepting SNAP and some of those things than what it did a year ago. So it's really across all customers.

I think the thing that's driving it is our teams are doing a nice job on making sure the experience is good. I can tell you, in Florida, we will get ice cream that's still frozen and chocolate that's not melted because of our delivery – because of the delivery trucks. And it's really – it's one of those things where all the things you feel good about. We still have a lot of work to make sure that we're satisfied with the profitability.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

And are there any CPG promotions or monies made available to help get that customer to make the first delivery order?

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

A

Yes. The short answer is yes. And there's – as you know, online and with our data and personalization, there's all kinds of things that you're learning in terms of different customers find it attractive at different times. So the short answer is absolutely yes. The other thing is, obviously, online really supports the alternative profit business as well from a media standpoint. Thanks, Chuck.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Thanks, Rodney. Good luck for the rest of the year.

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

A

Thank you. Appreciate it.

Operator: The question-and-answer session is now finished. I will hand back over to Rodney for any final remarks.

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

Thank you for all the questions, as always. As you know, I always like to share a few comments with our associates listening in. Today, I'd like to take a moment to celebrate Alex Spurlock. Alex is a store leader at QFC Store 860 in Redmond, Washington and recently he was named the 2024 Food Industry Association Store Leader of the Year. Obviously, this is a huge honor, and we are so impressed by the amazing work that Alex does at our store. With more than a decade in the grocery business, Alex understands the industry. She has a gentle spirit and a fierce attention to detail that clearly earned her this recognition. What's most impressive is Alex's passion for her associates. She is always ready to coach her team and celebrate their success in meaningful ways. Thank you and congratulations, Alex, for everything you do for our customers and your fellow associates. And congratulations on this amazing honor. And thank you to all of our teams for all the work they do every day to take care of each other and our associates. And thank you for everyone for joining us today.

Operator: That does conclude today's conference call. Have a nice day. You may now disconnect your lines.