05-Dec-2024

# The Kroger Co. (KR)

## Q3 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

**Simeon Ari Gutman**
*Analyst, Morgan Stanley & Co. LLC*

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

**Leah Jordan**
*Analyst, Goldman Sachs & Co. LLC*

**Ken Goldman**
*Analyst, JPMorgan Securities LLC*

**Edward Kelly**
*Analyst, Wells Fargo Securities LLC*

**Michael Lasser**
*Analyst, UBS Securities LLC*

**John Heinbockel**
*Analyst, Guggenheim Securities LLC*

**Michael David Montani**
*Analyst, Evercore ISI*

**Rob Dickerson**
*Analyst, Jefferies LLC*

**Jacob Aiken-Phillips**
*Analyst, Melius Research LLC*

**Chuck Cerankosky**
*Analyst, Northcoast Research Partners LLC*

# MANAGEMENT DISCUSSION SECTION

**Operator**: Good morning, and welcome to The Kroger Co. Third Quarter 2024 Earnings Conference call. [Operator instructions] Please note this event is being recorded.

I'd now like to turn the conference over to Rob Quast, Senior Director, Investor Relations. Please go ahead.

## Rob Quast

*Senior Director-Investor Relations, The Kroger Co.*

Good morning. Thank you for joining us for Kroger's third 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 third 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 third quarter, and walk through updates to our full year guidance. And finally, I will close with some comments on our pending merger with Albertsons.

Turning first to our performance, we delivered strong third quarter sales results, led by our pharmacy and digital performance, which reflects the versatility of our model. Customer engagement remains strong. Our convenient, seamless shopping experience, along with incredible customer value through low prices, personalized offers and great quality Our Brand (sic) [Our Brands] products, drove growth in both total and loyal households.

As we entered the last quarter of 2024, we are focused on providing the quality, fresh and affordable products that make holiday celebration special. Customer spending habits continue adjusting to current macroeconomic factors. As inflation normalizes, our premium and mainstream households are feeling more confident and are returning to their pre-pandemic shopping patterns more quickly.

Mainstream households are the primary driver of our positive customer engagement trends. While overall consumer sentiment remains low, expectations are improving, which positions us well for the holidays and into next year. As we said, near term, some customers are managing macroeconomic uncertainty. Spending from budget-conscious households remain under pressure, as the effects of multi-year inflation and higher interest rates have had a larger impact on these households. Therefore, we expect it will take longer for these households to fill the benefits of economic improvement.

Kroger is delivering on its long-standing commitment to provide customers with the value they are seeking. We are helping customers save in multiple ways, including competitive shelf prices and loyalty discounts, personalized offers, fuel rewards and an expanded multi-tier Our Brands portfolio.

Digital offers are an important way we deliver savings to customers, and engagement continues to grow, with 5% more digital offer clips so far this year. And that has led to 14% more savings for Kroger customers.

We are always creating additional ways for our customers to save. This quarter, we celebrated and thanked our customers with a Customer Appreciation Week, offering new great deals. And to help our customers enjoy a memorable Thanksgiving, we lowered the price of Thanksgiving meals for the third consecutive year by creating a meal bundle that served a group of 10 people for less than $5 per person.

We are focused on executing our go-to-market strategy to deliver a differentiated customer experience through our focus areas of fresh, Our Brands, personalization and seamless. We appreciate our associates' continued efforts to elevate the customer experience and bringing the strategy to life by improving on our key priorities of full, fresh and friendly again this quarter.

I would now like to cover how we are enhancing our go-to-market strategy. We are seeing long runways for growth in many areas of our strategy, starting with fresh. Customers connect strongly to our Fresh for Everyone brand promise, which is a key differentiator for Kroger. Improvements across the supply chain as part of our End-to-End Fresh initiative are increasing days of freshness.

For example, bagged salads now offer customers more than seven days of freshness. Customers are noticing and it has led to identical sales and produce of more than 3% this quarter. In addition, we constantly evaluate new ways to apply data and technology to provide an even better fresh experience and deliver more days of freshness for our customers.

One of the ways we are doing this is through recent implementation of RFID-embedded labels on bakery items. These labels provide us with greater insights into our fresh inventory, resulting in consistently fresher items and higher in-stock levels. We have seen encouraging results, including higher sales in locations and categories where we have piloted the RFID labels, and we look forward to scaling this to more stores.

Turning to Our Brands, I would like to step back and talk about the significant investments we've made in Our Brands and how those investments are delivering value to both customers and shareholders.

For years, the grocery industry offered private label products, with the primary goal of creating products at lower price points. Several years ago, we recognized an untapped opportunity for growth in these products and envisioned a future where our private label products would match or exceed the innovation, quality and recognition of national brands, which is why we coined the phrase Our Brands.

Guided by that vision, our teams built distinct and recognizable brands that our customers want and love, providing more value and meeting unique product needs that national brands cannot fill.

Recently, we focused in on refining Our Brand (sic) [Our Brands] architecture to optimize the portfolio and ensure each brand plays a unique role on the shelf. The successful addition of Smart Way, our new opening price point brand, played an important role in rounding out our multi-tiered portfolio and offering an attractive alternative to national brands at every price point.

The next phase of the work involved refreshing designs and packaging, enhancing brand equity and reinforcing quality and improving the shopability. For example, to reinforce our long-standing guarantee of quality and freshness, we are placing guarantees on labels across our Kroger-branded products.

Innovation remains a driving force for Our Brands' growth. We utilize our data and insights to understand customer trends and meet increasing demands by consistently introducing new items to our portfolio with a focus on growth areas, including free-from, organic and multicultural. This innovation enables us to differentiate ourselves from both national brands and other private label brands, creating destination items that help build customer loyalty.

Our manufacturing capabilities will continue to be an important advantage for Our Brands. With oversight over the quality and the supply, we can develop unique and differentiated products while keeping costs low, allowing us to pass the savings to customers while preserving our ability to grow margins, a true win-win for customers and Kroger. This quarter, Our Brands continued to deliver strong financial results, which Todd will cover in more detail.

Next to personalization. Our Kroger Plus program provides our loyal customers access to savings and rewards that, in turn, drive traffic to our seamless experience. As customers become more engaged, we gain deeper insights into customer trends, while creating the data that enables us to grow Kroger Precision Marketing and deliver more effective promotions and relevant product recommendations.

We are working to grow Boost, the next level of our loyalty program through new benefits. And this quarter, we announced the addition of Disney+, Hulu or ESPN+ streaming benefits with Boost annual memberships.

Turning to seamless, digital sales grew 11%, driven by an increase in both households and traffic. Within digital, delivery sales grew at 18% and continues to outpace other channels. Boost is one of the important ways we are increasing e-commerce penetration, providing customers an affordable membership model for free delivery.

Increasing e-commerce penetration is important to our model as households who shop with us digitally and are in our stores are our most loyal customers, and increase retail media monetization opportunities as well.

As our digital business grows, particularly in our Delivery network, it continues to have a larger impact on our financial results. Improving profitability is a key priority and becoming even more important to our financial model.

Over nearly a decade, we made significant investments in our digital capabilities, building out our own properties, creating distribution channels in both Pickup and Delivery, investing in automation, enhancing personalization and introducing an industry-leading retail media network.

While each of these capabilities required significant investments, we now have a unique digital experience that our customers enjoy. Moving forward, we are committed to growing volumes, utilizing automation and introducing new technology that will create efficiency gains while helping us narrow the profitability gap between online and in-store. Narrowing that gap will generate meaningful operating margin benefits and help drive shareholder value over the next several years.

By executing our go-to-market strategy, we are building loyalty, increasing customer engagement and creating more growth opportunities. First, with alternative profit businesses, which had another solid quarter. Kroger Precision Marketing continued to deliver the most significant growth from our alternative profit businesses.

Next, in health and wellness, as the pharmacy industry continues to transform, Kroger has a unique opportunity to play a bigger role in helping patients live healthier lives, while growing our share of the industry. We are excited about this area of the business and its performance this quarter demonstrates we can grow this business profitably in a way that supports our customers to live healthier lives.

Sales and profitability this quarter were well ahead of last year, led by growth in both GLP-1s and vaccines. Our strong growth in vaccines reflect patient trust in Kroger to vaccinate them and their families during the start of the cold and flu season, the peak quarter of the year for vaccinations.

Our health and wellness teams did an excellent job this quarter in building awareness around our vaccine capabilities, growing share and administrating significantly more vaccines this year versus a year ago. These helped offset the product mix pressures from GLP-1s. Our vaccine efforts are leading to new patient scripts, which is important as these customers are more likely to become loyal households and spend more across the store.

We appreciate our associates for their continued efforts to elevate the customer experience by delivering on our key priorities of full, fresh and friendly. Team consistency leads to a better customer experience, and we are excited about another quarter of improvement in retention. Our focus on retention reflects a holistic strategy, including investments in wages and benefits as well as enhancing the associate experience through training, technology and career development opportunities.

With that, I will hand it over to Todd to take you through our third quarter financial results. Todd?

## Todd A. Foley

*Interim Chief Financial Officer, The Kroger Co.*

Thanks, Rodney, and good morning, everyone. Kroger's third quarter results reflect the durability of our model, with strong pharmacy results that helped offset lower fuel profitability as we cycled strong fuel results from a year ago. As we head into the final quarter of the year, we are narrowing the ranges on our identical sales without fuel, adjusted FIFO operating profit and adjusted EPS guidance. The strength of our model gives us confidence in our ability to deliver on this full year guidance.

Before I walk through our third quarter financial results, I would like to start off by covering a couple of items from the quarter that affected our financial results. First, during the third quarter, we finalized the sale of our Kroger Specialty Pharmacy business for $464 million. The sale reduced total company sales in the third quarter by approximately $340 million compared to the same period last year, and annualized sales will be approximately $3 billion lower going forward.

KSP was a low-margin business. As a result, the sale of the business increased both Kroger's gross margin and operating, general and administrative costs as a rate of sales. It had no material effect on operating profit.

Second, on a year-over-year basis, the combined hurricane season and port strike had approximately a 20-basis-point favorable impact on sales as customers stocked up in anticipation of these events. These events had an unfavorable impact on OG&A. Together, this did not have a material impact on total operating profit.

I'll now take you through our third quarter financial results. We achieved identical sales without fuel growth of 2.3%. As Rodney mentioned earlier, identical sales without fuel were led by strong pharmacy and digital sales. We're also encouraged by the continuation of positive customer metric trends, including increases in total and loyal households.

Our Brands had a strong quarter, with sales outpacing national brands again this quarter, led by mid-single-digit growth in our most premium brand, Private Selection. Customers continue to demand premium products, but at the same time, are looking for value. Our Private Selection brand is a perfect solution by offering our customers premium quality at an attractive price. These results demonstrate the breadth of Our Brands portfolio and the ability to meet customers' needs for quality and value.

Digital sales delivered another quarter of double-digit growth, led by 18% growth in delivery solutions, driven by our Customer Fulfillment Centers. The CFCs are offering customers a superior digital experience with excellent in-stocks, fresher items and a white glove on-time delivery. CFC growth was driven by a significant increase in households and trips as well as an increase in basket size.

Our third quarter identical sales without fuel results were affected by the Boar's Head recalls that began in the second quarter. We acted quickly with the safety of our customers in mind as soon as we became aware of the situation. Boar's Head is a strategic supplier with brand-loyal customers that are an important driver of our deli sales. As a result, some customers have temporarily migrated away from the category. It will take some time for those customers to resume their prior purchasing behavior, and we expect this to remain a headwind to sales in the near term. The unfavorable sales effect from Boar's Head this quarter was largely offset by the favorable sales impact from the hurricane and port strike.

Turning to margins, gross margin was 22.9% of sales and our FIFO gross margin rate, excluding fuel, increased 51 basis points compared to last year and was ahead of expectations. The increase in rate was primarily attributable to the sale of Kroger Specialty Pharmacy, Our Brands' performance and lower shrink, partially offset by lower pharmacy margins. The result reflected Kroger's ability to improve margin while being competitive on price and helping customers manage their budgets.

The OG&A rate, excluding fuel and adjustment items, increased 22 basis points, driven by the sale of Kroger Specialty Pharmacy and increased incentive plan costs, partially offset by the continued execution of cost savings initiatives. Excluding the sale of Kroger Specialty Pharmacy, fuel and adjustment items, our OG&A rate to sales would have been nearly flat year over year, demonstrating that our model can leverage expenses when we achieve our long-term ID sales without fuel goal of 2% to 4%.

This is made possible by our relentless focus on productivity and cost savings initiatives, which remain an essential part of our model. These initiatives are focused on simplification and utilizing technology to enhance the associate experience without impacting the customer experience. This quarter, we launched a new, internally developed generative AI-powered sell-through tool, which helps us better manage inventory in both fresh and center store departments through real-time insights tracking sales and shipments. This enables our teams to increase freshness on shelves and prioritize sell-through, optimizing both sales and margins. Looking ahead, we plan to further enhance the AI capabilities on this platform by extending into improved forecasting and end-to-end inventory management.

During the third quarter, we recorded a LIFO charge of $4 million compared to a charge of $29 million for the same period last year due to lower expected year-over-year inflation. Adjusted FIFO operating profit was $1.02 billion and adjusted EPS was $0.98 per diluted share, an increase of 3% compared to last year.

Fuel is an important part of our strategy. Fuel rewards through our Kroger Plus program helped build customer loyalty. Fuel sales were significantly lower this quarter compared to last year, attributable to lower average retail price per gallon. Fuel profitability was also meaningfully behind a year ago as a result of fewer gallons sold and lower cents per gallon margin.

I wanted to provide a brief update on inflation as it remains a topic of interest for many investors. Inflation was down slightly in the third quarter compared with the second quarter, but it remains around 1%. We expect inflation to remain consistent in the fourth quarter.

I would now like to provide a brief update on associates and labor relations. During the third quarter, we ratified new labor agreements for Dillons, Columbia, Missouri clerks; Central Division, Ottawa and [ph] Streeter (00:22:11) clerks; Northern Illinois, Meat clerks; Fred Meyer Portland retail stores, and the Foods Co. contract in Northern California, all covering nearly 13,000 associates.

We respect associates' right to collectively bargain. We're also communicating to local unions that coming to the table with proposals that do not balance investing in associates, with keeping groceries affordable for our customers and supporting a growing and profitable business model are untenable. These proposals stand in the way of operating our business in a way that ensures job security and advancement opportunities for associates.

Turning to cash flow, Kroger continues to generate strong adjusted free cash flow with consistent operating results. Free cash flow generation is an important part of our model and is enabling us to invest in our business for growth. At the end of the third quarter, Kroger's net total debt to adjusted EBITDA ratio was 1.21 compared to our target range of 2.3 to 2.5. Our strengthened balance sheet provides us flexibility to pursue growth and enhance shareholder value.

We continue to take a disciplined approach to deploying capital, prioritizing the highest growth opportunities that strengthen our business and deliver solid returns for our shareholders. We're committed to maintaining an 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.

I would now like to provide some additional color on our outlook for the rest of the year. After delivering solid third quarter results, we're narrowing the ranges of identical sales without fuel, adjusted FIFO operating profit and adjusted EPS guidance. Additionally, we've updated our guidance for adjusted effective tax rate and expect it to be 22.5%.

We now expect identical sales without fuel for the year to be in the range of 1.2% to 1.5%. With quarter-to-date trends signaling, we will be near the midpoint of this range. Identical sales without fuel results year-to-date have largely been in line with our expectations, with Q3 being slightly ahead of expectations due to the favorable effects from the hurricanes, the port strike and strong vaccine growth during the peak season for immunizations.

Our expectations for fourth quarter identical sales without fuel are consistent with our forecast at the beginning of the year. We expect Q4 identical sales to remain strong, but sequentially lower than third quarter, partially due to the cycling of weather benefits from the fourth quarter of 2023 that are not built into our current forecast for Q4 2024.

We now expect adjusted FIFO operating profit to be in the range of $4.6 billion to $4.7 billion, and adjusted net earnings per diluted share is expected to be in the range of $4.35 to $4.45. Looking to next year, we are in the process of finalizing our 2025 business plan. While we still have many unknowns, we do expect Kroger to deliver FIFO operating profit growth on a standalone basis. During our fourth quarter earnings call, we plan to share our full year 2025 outlook in more detail.

In closing, we are happy to deliver another quarter of strong results, which reflect the resilience of our value creation model. While macroeconomic conditions remain uncertain, our model has multiple levers, which enable us to navigate any environment, including grocery, health and wellness, fuel and alternative profit businesses. This gives us flexibility in the ways we create shareholder value and confidence in our ability to generate attractive and sustainable returns for shareholders.

I will now turn the call back to Rodney.

## W. Rodney McMullen

*Chairman & Chief Executive Officer, The Kroger Co.*

Thanks, Todd. Before I open it up to Q&A, I'd like to speak briefly about our pending merger with Albertsons. First, I would like to express my appreciation for our associates and their incredible commitment. It has been a long journey, and our associates have done an excellent job serving customers and running the day-to-day operations of our business, while also preparing for the merger.

I would like to extend a special thanks to those who supported the litigation in federal and state courts, both the associates who testified and the teams who prepared a compelling case about the meaningful and measurable benefits of the merger. Our teams are ready to ensure a seamless transition for our customers and associates from day one. It is exciting to see the complementary strengths of both Kroger and Albertsons organizations. And we look forward to combining these strengths to provide customers with an even better experience. As we await the court rulings and the regulatory challenges to the merger, we remain confident in the facts and the strengths of our position.

The retail industry continues to be more competitive and we know how our customers shop. Every day, they are making decisions on where to eat and where to buy their groceries. They shop at a wide range of competitors, from Costco to Amazon to Dollar Stores, and they eat at restaurants. They shop digitally and brick-and-mortar.

And as I've said before, we remain committed to closing the merger because it will provide meaningful and measurable benefits for customers, for associates and for communities across the country. And we look forward to bringing these commitments to life. Regardless of the outcome of the trials, Kroger is operating from a position of strength, and we are optimistic about our future.

Our business is more diverse than ever, and our value creation model provides us with multiple ways to drive sustainable growth. Our strong free cash flow and strengthened balance sheet provides us with the ability to invest in our business and enhance shareholder value.

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

# QUESTION AND ANSWER SECTION

**Operator**: Thank you. [Operator Instructions] Our first question for today comes from Simeon Gutman of Morgan Stanley. Your line is now open. Please go ahead.

**Simeon Ari Gutman**
*Analyst, Morgan Stanley & Co. LLC*

Q

Good morning, Rodney, Todd. My question is on the P&L for 2024. If you take out the extra week lap and then you pull out some of the merger-related costs, the big ones, it looks like the core business is growing pretty nicely on EBIT and really nicely, potentially mid-single, even high-single-digit percentage. And that's despite lower fuel profitability and the environment has been pretty tough. So, first, is that a fair characterization? And is it mixing the way you would have thought between the core business and the alternative? Thanks.

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

A

Great question, Simeon. Thanks for that. I think that's a fair read on how you've described it. We were, obviously, very happy with the results that we've seen coming from not only the core business, but inclusive of pharmacy. We're particularly pleased with the results we saw in pharmacy. You heard Rodney talk about today. So, despite that lever in fuel giving us a headwind this quarter, we were pleased with the core growth coming from the core business and see that continuing.

The mix relative to alternative and core business, I think the growth expectations that we have around the alternative profit business are relatively consistent to what we expected to see. And so, I think that those are – continue to be as balanced as we expected going into the quarter.

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

A

And longer term, as everyone knows, the alternative business – profit businesses, we continue to see a great opportunity. And the margins on that business is meaningfully higher than the supermarket business and the whole flywheel between our brick-and-mortar business and our seamless business, Pickup and Delivery, is the engine behind driving that continuation there, which we're very excited about.

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

A

That's a great call, Rodney. We saw the digital growth again at low-double-digit growth, which is an important part of the growth that you talked about, Simeon. And that, again, when you talked about mix in our business in our omnichannel, that low double-digit growth is right on what we expected and helps drive both the core business and the alternative profit, as Rodney described.

**Simeon Ari Gutman**
*Analyst, Morgan Stanley & Co. LLC*

Q

And the one follow-up, this is more towards a comment Rodney made. All year, we talked about the mainstream, the premium and the lower end. It felt like there may have been an inflection, where the mainstream has been resilient and the premium has been healthy. I thought your comments today on mainstream inflected a little more positively. I'm not sure if that's reading too much in. Lower income sounds about the same. Curious if that's fair.

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

Yeah. The mainstream customers certainly performed – are connected with us better in the third quarter than the second quarter. How much of that is driven because of the things we did and how much they're just feeling better, we don't know. Now, they're telling us they feel better. And certainly, customers that are on a budget continue to be under a lot of strain, and the cumulation of inflation and other aspects and higher interest rates have affected – continue to affect them more.

And I think the other thing that's always important to remember is that customer, in many cases, are starting out in careers and things and they don't have as many physical assets on a house or a little bit of savings and those things. And those – inflation obviously affects that person a little harder than others. Thanks, Simeon.

---

**Operator**: Thank you. Our next question comes from Rupesh Parikh of Oppenheimer. Rupesh, your line is now open. Please go ahead.

---

**Rupesh Parikh**
*Analyst, Oppenheimer & Co., Inc.*
Q

Good morning and thank you for taking my questions. So, just going back to your guidance, so you did narrow the operating profit range to the lower end of the range for the full year. So, just curious what's driving that?

---

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

Todd, I'll let you start and...

---

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

Yeah. With one quarter left, Rupesh, we wanted to try to narrow the range because there should be less variability in our expectations. When you look at the sales part of the guidance down at 1.2% to 1.5%, I think that's pretty consistent with what we've been thinking for the year. The midpoint on that range is a tick higher than I think what we had been thinking before.

And frankly, when you look at where we expect to be in Q4, I think that's right on how we've been thinking about it all year relative to all of that. Q3 actually is the one that was really strong. And we talked about – Rodney talked about the pharmacy and the digital growth there, particularly in the vaccine space, we're really pleased. We've been working hard to grow our vaccine business, and we saw that throughout the quarters early in this year.

But with Q3 being that key vaccine – Super Bowl season for vaccines, we were really pleased to see that that growth continue and then it paid off at that point in time. So, that's where we saw Q3 being really strong and that Q4 guidance being really what we expected.

When you look at it on the EPS side of our guidance, Rupesh, again, narrow the range there. We took $0.05 off the top side and the bottom side, and really that midpoint of the range is pretty consistent with where we've been thinking about it for the year.

As we think about that range and some of the key factors for that range in the fourth quarter, a couple of key things that we're keeping an eye on. One is weather. We alluded to it in our prepared comments. There were several meaningful weather events a year ago that drove some benefits and we just don't forecast weather on a forward-looking basis. So, if we see the number and magnitude of weather events in the fourth quarter this year, I think that would be something that could push us towards the higher end of that range.

And then the other one is fuel. And certainly, we – fuel tends to be pretty volatile, and we've seen that this year. And really, we have fuel expectations to be pretty in line with where they were last year. And frankly, from a gallon trend and from a cents per gallon trend in the fourth quarter, we're pretty consistent sequentially from where we've been performing over the last few periods. So, if we have variance in the fuel profitability, either positive or negative, I think that could lean us towards the top or the bottom end of that range, respectively.

---

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

A

Todd said this, but I think it's important to just highlight it. If you look at the range for the year, fuel in the third quarter was a tougher quarter than what we expected it to be. And that really, relative to the top side and the other thing that Todd mentioned, we don't budget weather because we just don't know.

Obviously, there's been some major storms, but those storms haven't been in places where we operate stores. So, it really hasn't affected us so far. And generally, that's a positive when we have weather because people eat at home as opposed to going to restaurants.

---

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

Q

And then my very quick follow-up question. Just on the Boost membership, you added the Disney perk as well. Just overall, are you guys happy with the signups you're seeing and the retention with that program?

---

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

A

I would say we're very happy, but the thing that, I guess, I get more excited about is the potential because it's a incredible value for customers and customers love it. And they – we have a high renewal rate and a high NPS score. So, our job is to continue to educate more customers on it. So, really more excited about the opportunity going forward and the overall deeper connection with customers. So, great question. Thanks, Rupesh.

---

**Operator**: Thank you. Our next question comes from Leah Jordan of Goldman Sachs. Your line is now open. Please go ahead.

---

**Leah Jordan**
*Analyst, Goldman Sachs & Co. LLC*

Q

Good morning. Thank you for taking my question and thanks for the commentary on inflation this morning and how you're thinking about it in the fourth quarter. But as you plan with your vendors and seeing if you can add more color on how you're thinking about inflation into next year, what are you seeing across categories and hearing from those partners?

---

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

A

Yeah. No, a great question. Maybe still a little early to think about next year. But you think about where we were this year, obviously, coming into the year, we were coming out of that crazy disinflation that we had a year ago.

And inflation has played out more or less the way we expected. It's maybe a little bit less than what we expected, but it's been relatively stable at just under 1%. Maybe even saw, I think, a slight step back in Q3 relative to Q2, which as we said, we expect to see for next year.

As we look the next year at this point, looking at both some of the macro and governmental studies as well as conversations with vendors, again, it's still early to tell. And we might see a slight expansion to inflation next year, but really don't expect to see anything meaningfully different or inconsistent with what we're kind of seeing right now with inflation.

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

Yeah. We are continuing to see CPGs be a little more aggressive on trade dollars and over time, that obviously affects inflation a little bit as well.

**Leah Jordan**
*Analyst, Goldman Sachs & Co. LLC*
Q

Great. Thank you. And I just wanted to follow up on some of your fresh initiatives. I know you've been working on improving days of freshness in produce for a while, so great to see some improvement there. But it seemed like the RFID tags within bakery is new to me. Just wanted more color there. What degree of lift are you seeing when you add that to the category? How many of your stores have it today? And how should we think about the rollout over time?

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

Well, we are – as I mentioned, we're testing it. We're happy with the initial result. The benefits are as much helping our associates be able to do their job a little bit easier. And it's too early – it's early enough to be excited about the potential. It's too early to say this much we can budget in terms of what we would do. But the thing that we're excited about for our customers, it's helping us make sure we have fresher product for the customer and stay in stock better. And it's super exciting. We will look at other areas of the store to see what kind of opportunity it is. The cost per tag is still higher than we would like, so we still need to continue to work on focusing on to get the cost per tag down. But positive early results, really early in the process and excited about the potential. Thanks, Leah.

**Operator**: Thank you. Our next question comes from Kenneth Goldman of JPMorgan. Your line is now open. Please go ahead.

**Ken Goldman**
*Analyst, JPMorgan Securities LLC*
Q

Hi. Thank you. I wanted to follow up on the topic of next year. I appreciate it's too early for specifics, and I'm not asking for any numbers. But to Simeon's question, you agree that it's a fair read that the core underlying business is doing very well, I think those were the words, despite when you ex out the merger cost and the digital mix and fuel and so forth. And you talked a little bit about inflation being sort of steady and predictable and consistent in that low-single-digit range.

Are there any other unusual tailwinds or headwinds that we should consider, just directionally as we think about next year? I'm just trying to get a sense for what would kind of throw you off from having another reasonably good year. You did say that operating profit will be up, but you didn't kind of tell us how much, and your longer-term algo is 3% to 5%, of course?

---

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

A

Yeah. And it would be way too early to tell you specifics. And obviously, we're awaiting for the ruling on the merger, which will affect guidance as well. The other thing that – I guess, from a positive standpoint, that I'm excited about, in the third quarter, we opened or expanded the most number of stores that we've done. I think it's actually in a quarter in seven years. And as you know, last year, we talked about it that we will open more stores this year than we have in several years. And we would expect to continue to open more stores.

And so far, the stores that we've opened, we're happy with the way they're connecting with customers and we're happy in terms of the volumes they're creating and the early read on the profitability of the stores as well. So, over time, we would hope that that would continue to be a tailwind. And obviously, on seamless, we continue to see that as really critical to our 5 or 10-year future to be awesome there. And we still have a lot of work to do to make where we're indifferent whether somebody shops with us online or in store, and we'll continue to put a lot of effort there. In terms of headwind, Todd, I'll let you – anything that you can think of that's...

---

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

A

Yeah. I can't think of anything unusual headwinds or tailwinds as we sit here today, frankly, Ken. But going into next year, part of what has us optimistic and feeling good about the strength of our value creation model is a lot of the momentum we have in the things that are in our growth areas today. We've talked about a lot of them already. It's pharmacy, it's our digital business, it's our alternative profit. And we have good momentum in those spaces and are executing on those.

And from a headwind standpoint, we're going to continue to invest in the business. We're going to invest in price. You've heard Rodney say it before, we assume every year is going to be more competitive than the last and that view hasn't changed. And so, we'll continue to engaging customers, make sure we're delivering value to them by investing in price and investing in their shopping experience. And we're committed to continue to invest in wages.

So, some of those are headwinds, they're just the parts of our model that as we deliver the value in our model through all our different value propositions, we're able to use that to invest in the business to keep the flywheel moving.

---

**Ken Goldman**
*Analyst, JPMorgan Securities LLC*

Q

Okay. Thank you for that. And then speaking about price investments, Rodney, you mentioned that CPGs continue to be a little bit more aggressive on trade dollars. Your largest competitor in food retail, we'll see if the judiciary – that the judges agree that it's a competitor or not, but your largest competitor in food retail had more kind of commentary last week or this week about how they would like to see more of those price investments from key vendors.

Rodney, your tone, since I've known you, has always been more sort of agnostic about that. If investor – if your vendors don't invest with that, you'll be happy to sell customers more private label. I'm just curious where you stand in terms of, are you content with the level of price investment? Or are you more just sort of agnostic and saying, look, whatever our vendors want, it will play out, either way, beneficially for you?

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

A

Yeah. I guess a little bit of both. The – if you look at tonnage growth in CPGs, there is a lot of CPGs that cannot be satisfied with their tonnage growth. And I believe the trade dollars and being more aggressive on partnering with us to make sure the right customer gets access to those benefits is good long term for the customer, long-term benefit for both of us on tonnage. If they're not willing to do that, it really gets back to the comment that we talked about.

Our Brands, and Todd and I both mentioned it, had a strong quarter. The profitability of Our Brands is several hundred basis points higher than national brand. And if the CPGs are willing to continue to give up share to Our Brands, we're okay with that. Because what we find is once a customer tries Our Brand (sic) [Our Brands], their repeat rate of customers coming back is incredibly high.

Because what they find is they have – there's no compromise on quality and they have a great value for the money. So, at the end of the day, the customer wins when they buy Our Brands. But it really is we try to run a business where the customer decides what they want to buy as opposed to forcing them to buy something. Thanks, Ken.

**Operator**: Thank you. Our next question comes from Ed Kelly of Wells Fargo. Your line is now open. Please go ahead.

**Edward Kelly**
*Analyst, Wells Fargo Securities LLC*

Q

Hi. Good morning, everyone.

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

A

Good morning.

**Edward Kelly**
*Analyst, Wells Fargo Securities LLC*

Q

I'm curious about the gross margin. You've had a couple good quarters on the gross margin front. I think you admit this quarter was better than expected. How are you thinking about gross margin in Q4? And then, even like into – I don't know, you're not going to give next year, but sort of like the outlook for the gross margin. And I'm talking like ex Spec Pharma divestiture. And maybe just talk about the puts and takes around that?

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

A

Yeah. No, great question, Ed. And I think you hit on a key part thinking about it, excluding KSP. We talked about it was a strong quarter in gross margin. And about half of that year-over-year benefit was a result of the divestiture. But the other piece of it really came – we highlighted both of them, Rodney – layers them out what Rodney was just talking about was our growth in Our Brands.

We continue to have Our Brands sales growth outpacing national brands, and that is always going to drive solid margin expansion. And so, that's certainly what we saw again in the third quarter, very similar to what we saw in the second. And then, shrink had another nice quarter. So, we've got – cautiously optimistic on the progress we're making there, but we are making progress in the shrink space that really helped us in the third.

As we look to the fourth, I think excluding KSP, I think overall, we'll probably be slightly favorable in the fourth. Reflecting KSP, when you pull that out, I think we'll probably be relatively flat on that relative to some of the puts and takes. Again, if we over-index in things like Our Brands and whatnot, but we may be a little bit favorable. But overall, I think we'll be relatively consistent, relatively flat year over year on the margins in Q4.

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

A

I totally agree with everything Todd said, and Todd said the big pieces. I would also add a couple of smaller pieces that's helping on gross margin that should continue is if you look at our warehouse and transportation costs, we continue to make some progress there. And the customer continue to buy more value-added product and fresh continues to grow as well. So, those are things that help on mix in addition to things that Todd talked about.

**Edward Kelly**
*Analyst, Wells Fargo Securities LLC*

Q

And just, Rodney, a quick follow-up. This one is for you. And you kind of hinted at it or talked about it, but Albertsons would be a transformational deal. How do you feel about Kroger's position if the deal is rejected? And do you need to hunt for something else more transformational? Or is it just simply more prudent to double down on what you have and reward shareholders for their patience with return of capital?

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

A

Yeah, Ed, it's a great question. If you look at the balance sheet capacity that we have, there's probably nothing else that would be transformational that would use the balance sheet capacity that we would have. So, I don't know that we would be out there trying to find what's the next Albertsons. As you know, and you just said it, we've always made sure that we don't need to do mergers to make our business successful. And that was one of the reasons that we've always been proud of what Kroger has done.

We're super excited about Albertsons and the potential, and we believe we will be able to add a ton of value for giving customers better value, the people there, we'll be able to provide security and grow our business and create additional career opportunities and support communities. But if it doesn't happen, we'll continue to go on.

As you know, we always will continue to look at how – ways to grow the business. Mergers is always one of those ways of growing the business, but we try to make sure that we only do a merger when it makes sense, and we're not chasing something, and we won't get in a position where we are having to chase something. So, great question, and thanks, Ed.

**Operator**: Thank you. Our next question comes from Michael Lasser of UBS. Your line is now open. Please go ahead.

**Michael Lasser**
*Analyst, UBS Securities LLC*

Q

Good morning. Thank you so much for taking my question. As of the second quarter, Kroger had made a point in its presentation that it was on track to deliver more than 20% media growth this year, and that line was removed this quarter. So, is it right to interpret that the media growth, which is an important driver of the alternative revenue stream, is starting to slow perhaps as there are more platforms for advertisers to choose and direct its advertising dollars? And if that's the case, how does Kroger accelerate that element of its algorithm in order to support the long-term outlook for the business?

---

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

A

Yes. Let me start there, Michael. Thanks for the question. It's a good call. We do still expect to see our retail media growth be in that 20% range for the year. It's still a fast-growing part of our business, and the outcomes that we're seeing continue to demonstrate that we're well positioned for that growth.

As we look at those CPGs that are advertising with us, we see the outsized return on ad spend that they're generating. And so, that's why I say we're able to demonstrate and we're seeing those results. And not coincidentally, the sales for those CPGs at Kroger are strong. And so, I think the proof points continue to be there. But as you say, there's a proliferation of options as everybody has kind of got their own flavor of what this is. So, I think we just need to continue to demonstrate that to CPGs, because I think the proof will be in the results.

---

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

A

Todd's last point to me and if CPGs are listening in and that's the only reason why I'm adding on top, the CPGs that increased spending the most had the highest tonnage growth with us on – which to me is it shows you the power of our platform. And Todd said it, I just wanted to double down on it.

---

**Michael Lasser**
*Analyst, UBS Securities LLC*

Q

Okay. And my follow-up question is what do you need to drive – what do you need to happen in order to drive the – that – Kroger to achieve the sales piece of its long-term algorithm in 2025? This year, there's been a contribution from the GLP-1 drug, some storm-related spending, perhaps those won't be as meaningful contributors next year. So, is it that you would be banking on, A, market share stabilizing? And is that realistic? And B, some acceleration in inflation to offset what have been driving some of the comp this year?

---

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

A

Yes, we would not be dependent on inflation and it's really we continue to double down on the customer experience. And when we find that we improve the customer experience, our business follows that or the customer rewards us for that. And it's – it really gets back to, you've heard us say it a million times, full, fresh and friendly.

The other thing that we're increasingly supporting is allocating capital to growth areas, and that would be storing, obviously, continuation of seamless, our online business continues to have outside growth. And then specific projects that support cost reductions and sales opportunities.

---

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

A

Yeah. I agree everything you said, Rodney, especially the storing that you hit on earlier as well. You mentioned GLP-1, and that certainly has been part of this year but as we sit here today, I think we continue to expect to see growth in that area as more manufacturers get in the mix and the supply continues to become more available, and more and more patients continue to utilize that drug. So, I think we'll still see – expect to see growth in the GLP-1 space as well for the, at least, near future, foreseeable future.

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

Thanks, Michael.

**Operator**: Thank you. Our next question comes from John Heinbockel of Guggenheim Partners. Your line is now open. Please go ahead.

**John Heinbockel**
*Analyst, Guggenheim Securities LLC* Q

Hey, Rodney, can you talk about the – you referenced in your release, the initiatives, productivity initiatives on in-store order selection? How broadly is that rolled out? When I think about how much you can take the cost per order down, can you take that down double-digit from where we are today?

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

Over time, we would certainly expect to take it down double-digit from where we are today. And when I talk about over time, I'm talking about over the next two or three years. And it's – we still have a reasonable amount to roll it out. Now, as you followed Kroger long enough to know that we will start – whenever we roll something out, we start with the biggest opportunity places first. So, it's the highest volume locations and those kind of things.

The thing that I think is fascinating and exciting is, if you look at the fundamental things behind the software, we're learning that we can actually use that same technology in other areas of the business. And I would hope that we'll continue to find those kind of opportunities. So, I feel confident and comfortable that, certainly, double-digit type stuff of improvement. But our team is not going to be satisfied until they get to where it's indifferent, how somebody shops with us.

**Operator**: Thank you. Our next question comes from Michael Montani of Evercore ISI. Your line is now open. Please go ahead.

**Michael David Montani**
*Analyst, Evercore ISI* Q

Yes. Good morning. Thanks for taking the question. I just wanted to ask first, did I miss the fuel CPG contribution for this quarter? Wondering if you could give some added color there. And then just had a follow-up.

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

Yeah. Thanks, Michael. We don't typically – we stopped a few quarters ago giving details around CPG. You did catch on to the point that I think that Rodney brought out that both gallons and CPG were down in the third quarter, again, some of the volatility in fuel. But as we look to the fourth quarter relative to our expectations versus a year ago, we think fuel will be a little bit – our expectation is that fuel will be a little bit more stable year over year in Q4, and that's supported by some of the trends that we've seen over the last few periods in both gallons and margins.

**Operator**: Thank you. Our next question comes from Robert Dickerson of Jefferies. Your line is now open. Please go ahead. .

**Rob Dickerson**
*Analyst, Jefferies LLC*
Q

Yeah. Great. Thanks so much. Rodney, I know you said upfront, it seems like consumer sentiment is still low, but maybe there are some green shoots, maybe it's improving a little bit. So, I'm just wondering kind of as you got through the Thanksgiving holiday and then as we're kind of real-time in the current holiday season, like have you seen any incremental, almost like sequential traffic improvement in the actual retail store?

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

We feel good about where we are. The thing, I guess, I would say that we still don't quite – it will take time is there's five less shopping days between Thanksgiving and Christmas. So, we feel good about where we are. We're tracking a little bit better than where we thought we would be, but we still are cautious because of the five less shopping days and how does that play out. And as you mentioned, we are seeing the customer – most of the customers are starting to feel a little bit more relaxed and comfortable in terms of where they stand and what's coming – how things look going forward.

**Operator**: Thank you. Our next question comes from Jacob Aiken-Phillips of Melius Research. Your line is now open. Please go ahead.

**Jacob Aiken-Phillips**
*Analyst, Melius Research LLC*
Q

Good morning, everyone. Thanks for the question. I just wanted to go back to inflation a little bit. So, you showed that you were able to kind of leverage SG&A given like flat comps, excluding KSP. So, how do we think about that relationship going forward in terms of wage inflation and wage investment? And then also with tariffs, we're of the view that it could be a self-fulfilling prophecy in terms of like people buying stuff and causing inflation even if there aren't actually tariffs happening. I just wanted your thoughts on there.

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

Yes. I'll start with the wage investments. It's a great question. We've talked a lot about how important it is for us to invest in our associates, because they're so critical delivering our customer experience. But we will continue to balance those wage investments with the other profitability enhancement items that we say. So, in any inflationary environment and in any sales leverage environment, we've demonstrated that our model enables us to pull the levers to be able to balance those wage increases accordingly over time.

So, given the comments that we said with fairly balanced inflation, we think we'll be able to leverage our SG&A, including wage investments. Rodney, I don't know if you want to comment on the tariffs.

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

Yeah. Tariffs for us, first of all, the effect on us is probably a little less than most companies. And we buy product internationally, but it's pretty modest. If you look in the fresh departments, it's less than 20% of the stuff, if you look in the center store, it's a fraction of that. So, we would see the tariffs affecting others generally more than us and we feel like we'll be able to manage whatever is done because our competitors will have to deal with the same thing. Thanks, Jacob.

**Operator**: Thank you. Our next question comes from Chuck Cerankosky of Northcoast Research. Your line is now open. Please go ahead.

**Chuck Cerankosky**
*Analyst, Northcoast Research Partners LLC*

Q

Good morning, everyone. Rodney, you mentioned that the mainstream and premium customers were pretty close to spending how they had been before COVID, but they're also, from what I could observe, the groups that are more likely to be going to restaurants, which seem to be doing fairly well right now. How do you sort of offset that with Kroger's prepared food offerings and maybe what changes are you making in those categories?

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

A

Well, first of all, we believe that that's a huge opportunity. Our market share – half of meals bought at a restaurant is consumed in a car or at home. Actually, I think it's a little over half. So, we see that as a huge opportunity. I would say we're trying a lot of different things. We've – we're working with a couple of outside companies trying to help us there. But to me, it's more of a – in the future, we have a bigger opportunity than we've been able to unlock so far. And we believe it's a huge opportunity because what we have found is that customer can buy a meal from us and it's usually – the cost is one-third to one-fourth versus going out to a restaurant. So, it's – for us, it's a great opportunity, but we're just scratching the surface.

**Operator**: Thank you. At this time, I'll take no further questions. So, I'll hand back to Rodney for any further remarks.

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

Thank you for all the questions. And as always, we have a lot of our associates listening in. First, I would like to send our thoughts and prayers to those impacted by the recent hurricanes. I would also like to take a moment to express my gratitude and appreciation for our dedicated team of associates, especially during this time. They just did amazing things on supporting communities.

And as you know, our stores are vital to each community we serve. And during these types of times, our customers rely on us to provide them with food and other essential items. And I am so proud of our associates who have stepped up to be there for our customers, communities and each other. Thank you for everything that you do for Kroger and our customers. And thank you for everyone joining us today. We wish you a very happy holiday season. Merry Christmas and Happy New Year.

**Operator**: Thank you all for joining today's call. You may now disconnect your lines.