Third Quarter 2010

Investor Conference Call Prepared Remarks
December 2, 2010

Carin Fike, Director of Investor Relations:
Good morning and thank you for joining us. First, I'd like to take a moment to express our thanks to those who came to our Investor Conference in Cincinnati. It was great to see you there, and we hope you enjoyed our meetings, including a presentation by Clive Humby. If you weren't there, you missed a lot.

Before we begin today, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions, and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings, but Kroger assumes no obligation to update that information.

Both our third quarter press release and our prepared remarks from this conference call will be available on our website at www.kroger.com.

After our prepared remarks, we look forward to taking your questions. Just as a reminder – 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 topic with one question, and one follow-up question, if necessary. Thank you.

Now, I will turn the call over to David Dillon, Kroger's Chairman and Chief Executive Officer.

Comments by Dave Dillon:
Thank you, Carin. Good morning everyone and thank you for joining us today. With me to review Kroger's third quarter 2010 results are Rodney McMullen, Kroger's President and Chief Operating Officer, and Mike Schlotman, Senior Vice President and Chief Financial Officer.

<u>Third Quarter Performance</u>
We are pleased with Kroger's third quarter results and believe they demonstrate the continued success of our Customer 1st strategy. Increases in identical sales, tonnage, and loyal household count show our core grocery business is strong and resilient. We also met our commitment to strike an appropriate balance between sales growth and margin investment, and we achieved operating margin leverage through sales growth and ongoing operating efficiencies. I'm very pleased that Kroger increased both earnings and earnings per share for our investors in the third quarter. These results reflect our progress toward building a flexible customer-focused business model that can create shareholder value through sustainable earnings growth and strong cash flow.

Kroger's identical supermarket sales for the quarter increased 2.4%, excluding fuel. Our associates produced these positive results in an environment that continues to be challenging for both retailers and customers. Some say that the "Great Recession" is technically over. For Kroger, it's not over until our customers say it is, and many of our customers continue to be cautious in their spending.

At a time when many retailers are struggling to turn around negative identical sales trends, Kroger continues its exceptional identical-sales record – now 28 consecutive quarters of positive identical supermarket sales growth, excluding fuel. By listening closely to our customers, Kroger has created a variety of competitive advantages that collectively are very difficult for other retailers to replicate. The strength of Kroger's identical sales results relative to many of our competitors' trends strongly suggests we continue to gain market share.

Our positive identical sales growth continues to be broad-based across the store and nearly all markets. All departments experienced positive identical sales growth in the third quarter, with the strongest increases in our Nutrition, Produce, and Deli/Bakery departments. Sixteen of our 18 supermarket divisions produced positive identical sales growth, excluding fuel, during the quarter. Of the two remaining divisions, one was essentially flat and the other experienced a slight decline.

In a few minutes, Rodney will share some additional sales insights with you, including loyal household trends, tonnage growth, and the performance of our exclusive store brands.

Influencing Factors

First, I'd like to update you on the four major factors we told you at the beginning of the year would influence Kroger's fiscal 2010 financial results. These factors are the economy and its effect on customer spending, food costs, competition, and fluctuating fuel margins. Mike will talk about the performance of our retail fuel operations in a few minutes. I will briefly discuss the trends we have seen in the other three areas.

Economic Environment & Customer Spending

Overall, the economic recovery is slower and weaker than we anticipated it would be at this point in the year. Job growth remains elusive, and fuel prices have risen. These factors affect consumers' confidence and grocery budgets, and many of our customers remain cautious in their discretionary spending. We continue to manage our business with the expectation that this economic environment will persist through the end of the fiscal year and throughout next year.

Food Costs

Although the economy is sluggish, some food costs are rising. We have seen inflation in our Meat, Dairy, and Produce departments; however, our Grocery department continues to experience deflation. Rodney will address this further in his remarks.

Competitive Environment

The competitive environment remains challenging. Our unique competitive advantages – including our Customer 1st strategy – position Kroger to compete and win in this environment. While price is important, it is not the only factor that determines where customers spend their grocery dollars. They tell us the entire customer experience matters. That's why we continue to invest in all four areas of our strategy to strengthen their loyalty to Kroger and our family of stores.

Fiscal Year 2010 Guidance

This morning Kroger narrowed its identical sales guidance to a range of 2.5% to 3.0% for the year, excluding fuel. The previous range was 2.0% to 3.0%. Three weeks into the fourth quarter, our identical sales are tracking a little above the upper end of this guidance, but it's still early.

For earnings, we've narrowed our guidance range to $1.65 to $1.78 per diluted share. We are striving for a result in the upper half of this range. This guidance reflects the fact that our customers remain cautious. We are off to a good start in the fourth quarter, but volatility from week to week remains high, which makes predicting a narrower range difficult. While the competitive environment hasn't worsened, competition remains intense.

As always, the holidays are Kroger's time to shine, and our associates are focused on having our stores stocked and ready with many holiday temptations and treats to meet the needs of every shopper – no matter how modest their budget.

Rodney will now offer more insight regarding our business trends during the third quarter. Rodney?

Comments by Rodney McMullen:

Thank you, Dave. Good morning everyone.

We are very pleased with the results our Kroger team has achieved in a very challenging retail environment. I will provide some additional color behind our solid third quarter sales results, specifically on tonnage growth, food costs, customer shopping behavior and labor relations.

Tonnage Growth – National Brands and Corporate Brands

As Dave mentioned, Kroger's third quarter identical sales rose 2.4%, excluding fuel. This result was primarily driven by solid unit growth – without much help from retail price inflation. Our stores sold more product units compared to the same period last year – a low single-digit increase. Keep in mind that is on top of very strong tonnage growth in the third quarter last year – in the high single digits.

In the Grocery department, the increase was driven by positive growth in national brands. Corporate Brand units in the Grocery department declined slightly compared to very strong tonnage growth in the same time period last year. We remain very confident in the outlook for strong future growth in this important part of our business. Corporate Brands represented approximately 34% of Grocery department units sold in the third quarter, compared to roughly 35% in the same period last year. Corporate Brands represented approximately 26% of grocery department sales, about flat versus third quarter 2009.

Kroger's Corporate Brands portfolio is best-in-class among U.S. retailers, and we believe this is a unique competitive advantage. Our goal is to continue building this portfolio and increase sales of national brands. We do not view these objectives as mutually exclusive. Kroger's unique portfolio of more than 20,000 Corporate Brand items – combined with our strong partnership with national consumer goods companies – helps us offer the variety and value our diverse customer base seeks.

In the third quarter, we launched our new branding campaign for Banner Brand products with fresh packaging to appeal to shoppers. We added new items to our store-brand lineup, including Kroger Wholesome@Home meals for busy families. We also continued to reinvent our exclusive Private Selection® line of premium foods. Just in time for the holidays, we added new seasonal ice cream flavors, like New York Style Pumpkin Cheesecake and Strawberry Peppercorn. Yes, Strawberry Peppercorn – it's a wonderful, unexpected flavor, and I strongly recommend that you try it.

It's not just our customers who have noticed the enhancements we've made. Store Brands Decisions recently named Kroger as "Retail Innovator of the Year" for winning entries in all four award categories – product development, packaging design, consumer marketing and in-store merchandising. Congratulations to our Corporate Brands team for this honor.

Food Costs

Next I will move on to food costs. We are seeing inflation in some of our perishable departments – particularly Meat and Produce. Deflation is persisting in our Grocery department, largely due to increased promotional spending by national brand suppliers. This promotional spending masks some of the list price increases we have received. The level of deflation is about 50 basis points if you exclude milk. Grocery represents about half of our supermarket business, so this level of deflation has a meaningful impact on our total company results. Inflation in Grocery has been slow to develop, but we still believe it is coming.

Many of you ask us about Kroger's ability to pass along product cost increases to customers, particularly at a time when shoppers are spending cautiously. We believe it depends on the product. We are passing on product cost increases from national brand suppliers in the Grocery department today, and we will continue to do so.

Inflation in perishable departments affects our business differently. In these areas, product costs are typically driven by short-term factors such as seasonality and product supply, so product costs can vary from quarter to quarter.

Customer Shopping Behavior

I would like to give you an update on our customer shopping behavior trends. In the third quarter, the total number of households we serve continued to grow. In fact, more customers across all segments – from value to upscale – visited our stores compared to a year ago. This tells us that Kroger's shopping experience and value proposition is striking a chord across a broad spectrum of shoppers.

While total household growth is important, we focus more attention and energy on increasing our number of loyal households. Kroger has been steadily increasing its number of loyal households for several years. In the third quarter, Kroger added loyal households at a faster rate than total households. The number of visits per loyal household remained about the same as a year ago, but the amount our loyal customers spend with us on a monthly basis continues to increase. This drives the solid identical sales results that Dave shared with you.

Kroger's partnership with dunnhumby continues to help us make sense of our huge amount of customer data. We use this information to offer more compelling ads and weekly specials, and to offer the right product selection in our stores. Kroger has more insight into our customers' behavior than most retailers today, and we use this data to reward them for shopping with us – with special offers, coupon mailers and recall alerts, for example.

Customer Tracker

Listening to our customers' feedback and acting on what they tell us is a big part of our strategy. Every quarter, we survey more than 50,000 households to find out what they like and don't like. Once again, we made steady progress in each of our four key areas in the third quarter – our people, our prices, the products and services that we offer, and the overall shopping experience in our stores.

Labor

We also have good progress to report in labor relations. We successfully achieved agreements that offer shared solutions for associates and the company while managing rising health care costs and stabilizing pensions.

Most recently, our associates have ratified new agreements in Houston, Toledo, Cincinnati and New Mexico. Logistics associates in Southern California and non-food clerks in Portland also ratified new contracts. Finally, we reached an agreement with unions in Seattle, and associates there are expected to ratify that agreement this week.

Now, Mike will offer more detail on the quarter and Kroger's financial strategy. Mike?

Comments by Mike Schlotman:

Thanks, Rodney. Good morning everyone.

Third Quarter 2010 Results

Earlier today, Kroger reported solid third quarter financial results that are consistent with the fiscal 2010 forecast we shared with investors in March. We believe these results demonstrate that we are managing our business well in an economic environment that hasn't improved as we had expected.

Kroger's third quarter net earnings were $202.2 million, or $0.32 per diluted share. This compares with $176.7 million, or $0.27 per diluted share. In making that comparison, I am adjusting last year's third quarter results for the non-cash asset impairment charges totaling $1.05 billion, after-tax, that primarily resulted from a goodwill write-down.

FIFO Gross Margin

Turning now to some of the details behind our third quarter earnings, FIFO gross margin, excluding our retail fuel operations, decreased 10 basis points.

Supermarket selling gross margin, excluding fuel, declined 13 basis points. Recall that Kroger's third quarter supermarket selling gross margin, excluding fuel, declined 109 basis points last year. An average of the two-year decline reflects a more normalized investment level for our business model. Delivering value to our customers through lower prices is an ongoing part of Kroger's strategy. We are committed to improving Kroger's price position relative to our competitive set. We believe this approach helps us grow market share and brings incremental profitable business to our enterprise. At the same time, we remain mindful of striking an appropriate balance between investments in all 4 Keys of our Customer 1st strategy and near-term financial results.

OG&A

Excluding the impairment charges in fiscal 2009, Kroger's third quarter non-fuel OG&A rate was 14 basis points lower than the same period last year, even as we continue to face the challenge of rising credit card fees, health care and pension costs. Positive identical sales growth, good cost control, and our ongoing implementation of operating efficiencies produced this result. Identifying and executing sustainable operating cost reductions remains a critical element of our Customer 1st strategy. We will use these savings to improve our customers' shopping experience and further grow our business.

Operating Margin

Kroger's third quarter operating margin rose 6 basis points as a rate of sales, excluding our retail fuel operations and adjusting for the 2009 impairment charges. This reflects the gross margin and OG&A performance that I just described, plus approximately 4 basis points of additional sales leverage over rent and depreciation expense. Kroger's non-fuel operating margin performance is consistent with the expectations we shared with you last quarter. It reflects sequential improvement in this measure as we transition back to a more normalized operating environment than we faced in the back half of fiscal 2009.

Tax Rate

Kroger's third quarter tax rate was 31.7% this year compared to 35.9% for the same period last year when you adjust for the impairment charges in our prior year results. Our tax rate was lower this year primarily due to the resolution of certain tax issues during the quarter. This benefit added about a penny and a half to third quarter earnings per diluted share.

We now anticipate a full-year effective tax rate slightly below 35%. This rate includes the second and third quarter tax benefits.

Retail Fuel Operations

Dave has already commented on three of the four factors that are affecting our 2010 financial results. Fuel margins are the fourth factor, and so far these have been slightly stronger than we anticipated for the year.

In the third quarter, our retail fuel operations benefited our total company results by about a penny per share on a year-over-year basis. The cents per gallon fuel margin for the quarter was approximately 12.7¢ compared to 11.9¢ for the same period last year. On a rolling four-quarters basis, the cents per gallon fuel margin was 12.1¢ compared with 10.7¢ in the comparable prior period.

Our decades of experience in this business have taught us that fuel prices and margins are unpredictable, so we manage this business by focusing on gas gallons sold. On this measure, our retail fuel operations had another outstanding quarter. Both our supermarket fuel centers and c-stores produced solid identical gallon growth as customers continue to engage strongly in this component of Kroger's overall value proposition.

Financial Strategy

Moving on now to the Company's financial strategy. Kroger's operations generate substantial cash flow, and we believe it is important to allocate that cash flow among various priorities in a balanced manner to benefit our shareholders.

Capital Investment

Capital investment is one of those priorities. We firmly believe it is critical to invest in our business – through new technology as well as other store improvements – to ensure that we are the grocery retailer of choice. We now anticipate investing $1.8 to $2.0 billion in capital projects during the current fiscal year. This compares to our previous guidance of $1.9 to $2.1 billion.

Debt

Our free cash flow allocation remains balanced across debt management, share repurchase, and dividends. We are firmly committed to Kroger's investment grade credit rating and manage the Company's debt levels accordingly. At the end of the third quarter, we had reduced Kroger's net total debt by almost $490 million compared to one year ago. On a rolling four-quarters basis, Kroger's net total debt to EBITDA ratio, adjusted for the impairment charges in fiscal 2009, was 1.93, which is consistent with the same period last year.

Just after our third quarter ended, we closed on a new $2.0 billion 3.5-year revolving credit facility. This speaks to the strength of our balance sheet and the success of Kroger's business strategy.

Share Repurchase

While we believe our debt management strategy creates long-term shareholder value, we remain committed to delivering near-term value to shareholders through our share buyback program. During the third quarter, we invested $64.0 million of free cash flow to buy back 2.9 million shares at an average price of $21.72 per share. Kroger began its regular program of share buyback activity in January 2000. Since then, we have invested $6.2 billion to repurchase 285 million shares of stock at an average price of $21.65 per share – that represents over 30% of the company. I believe this track record demonstrates our commitment to the buyback.

Dividend

Kroger's quarterly dividend is also an important part of our stock's value proposition for investors, adding about 1.5% to 2.0% to total shareholder return. Since Kroger's dividend program was initiated in March 2006 – a little over four years ago – our board has increased the dividend amount four times. Our most recent increase was reflected in the dividend payment made to shareholders yesterday. It remains the board's objective to further increase the dividend over time, with consideration given to the needs of the business, the interests of our shareholders, cash flow trends, and other factors.

Now Dave would like to make a few remarks before we take your questions. Dave?

Comments by Dave Dillon:
Kroger's third quarter results demonstrate that our team continues to perform well in a tough environment. If we step back and look at our results in the broader context of our Customer 1st strategy and our journey to create sustainable value for shareholders, I think we've accomplished a great deal. Our associates have weathered significant changes in economic conditions and delivered steady results throughout.

We firmly believe that taking care of our customers is the best way to create value for our shareholders. Whenever we delight our customers and exceed their expectations – with lower prices, a fast and friendly checkout, or an amazing floral arrangement for a special occasion – we are building loyalty and investing in the future growth of our business.

At the same time, we are focused on creating a sustainable business model that rewards shareholders through solid near-term and future earnings growth, share repurchases, debt reduction and dividends. Kroger continues to deliver value today while investing thoughtfully in our future. This is how we can ensure long-term success for our Company and our shareholders.

Now we look forward to your questions.

Closing Comments by Dave Dillon:
Before we end the call, I have a special message for our associates listening in today.

First, I'd like to recognize Paul Scutt, senior vice president of Retail Operations, for his leadership and his contributions to Kroger. Paul recently announced his plans to retire in February after a distinguished 45-year career with our company. He has been a driving force behind Kroger's safety, productivity and cost control improvements through the years, and we are grateful for his influence on our business. We wish Paul and his wife, Carol, all the best. We will miss seeing him on a daily basis.

I also want to thank all of our associates for delivering on our Customer 1st strategy once again. Each of you plays a unique part in achieving the positive results we announced today. The changing economy has affected each of us in some way, and it has affected some of our customers more than others. We remain committed to serving all of our customers – those who continue to shop on a tight budget, those who are feeling more confident in their spending, and everyone in between. Thank you for your special efforts every day to give each customer a warm welcome and a fantastic shopping experience.

With two months remaining in our fiscal year, we need all of your individual efforts to finish strong in the fourth quarter. No matter where you work – in our supermarkets, manufacturing plants, warehouses, convenience stores, jewelry stores, fuel centers and offices – you help make the holidays special for our customers.

I hope each of you has a wonderful holiday season with family and friends. Merry Christmas and Happy Holidays!

That completes our call today. Thank you for joining us.

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factors identified above that will affect our supermarket sales. Our ability to manage our debt levels to maintain an investment grade rating will be affected primarily by our continued generation of free cash flow from our operations. Any change in tax laws, the regulations related thereto, the applicable accounting rules or standards, or the interpretation thereof by federal, state or local authorities could affect our expected effective tax rate. Please refer to Kroger’s reports and filings with the Securities and Exchange Commission for a further discussion of these risks and uncertainties.

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