



**Second Quarter 2018
Investor Conference Call Prepared Remarks
September 13, 2018**

Rebekah Manis, Director of Investor Relations:

Good morning and thank you for joining us.

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

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

After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one question, and one follow-up question, if necessary. Thank you.

Please save the date for our 2018 Investor Conference, which we will hold in Cincinnati on October 29th and 30th. Details will be coming soon and we hope you can join us.

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

Comments by Rodney McMullen:

Thank you, Rebekah. Good morning everyone and thank you for joining us. With me to review Kroger's second quarter 2018 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

Restock Kroger Vision

Restock Kroger is designed to reposition our core business by 2020 so we can achieve our long-term vision, to serve America through food inspiration and uplift.

We outlined the four main drivers of our plan last October:

- **Redefine the Grocery Customer Experience,**
- **Partner for Customer Value,**
- **Develop Talent,** and

- **Live Our Purpose.**

Delivering on our objectives under each of these areas between now and 2020 will generate incremental operating margin dollars and free cash flow to **Create Shareholder Value**. And while we are only two quarters into our three-year plan, we are making solid progress.

More importantly, I want to help you understand how all the steps we take today – and in the future – are set in motion with a clear strategic intent, in line with our vision.

Everything we are doing is intended to create a truly seamless shopping experience, so we can serve customers anything, anytime and anywhere. As we create a seamless experience, we'll use our data to provide convenient and personalized food inspiration to help customers be a hero to their families at mealtime, every time.

You can see this in our exclusive agreement to bring Ocado's Smart Platform to the U.S. And in our recent launch of Ship – Kroger's new, direct-to-customer shipping platform. And in our continued expansion of home delivery, including our driverless delivery test with Nuro.

You can also see this in our merger with Home Chef. Part of what makes our merger so exciting is their data-driven and customer-centered approach to menu creation and meal solution development. Home Chef is accelerating our ability to deliver convenience, simplicity and a personalized food experience.

We are also building an expansive network of innovative partnerships to create new customer value. Alternative revenue streams will expand and enhance our strong core business and increase profitability.

Partnering with innovators like Ocado will both accelerate our core business and serve as the foundational platforms for new opportunities.

Our decision to launch *Our Brands* in international markets through Alibaba's Tmall Global platform is another example of our willingness to develop alternative revenue streams.

And, our people, generosity, and passion for Zero Hunger | Zero Waste will make the world a better place. We were incredibly excited to see that our Zero Hunger | Zero Waste commitment earned Kroger a place among the top 10 companies on *Fortune Magazine's* Change the World list.

You can see our vision coming into focus in several of the exciting announcements we've made over the last couple of months. And ... we're not done. As we share more of these very intentional puzzle pieces with you in the months and years ahead, a very clear picture will emerge.

Every one of these announcements is both a culmination and a new beginning. They are the culmination of long, focused, strategic work by our teams ... and they are the new beginning of exciting innovations and growth platforms for the future.

Digital Progress

Kroger's digital sales grew over 50% in the second quarter. We are executing our digital strategy and growing our seamless coverage area, which now reaches more than 80% of our customers, up from 75% in the first quarter. This includes our network of ClickList pickup locations, stores offering home delivery through Instacart and other partners, and ship to home capabilities, such as our new Kroger Ship platform.

Introducing Kroger Ship

Kroger Ship launched in four markets in August: Cincinnati, Houston, Louisville, and Nashville. We have since launched in Atlanta and anticipate rolling out the service to additional markets over the next few months.

During this first phase of Ship, customers can shop from a curated selection of 4,500 *Our Brands* products, which are not available anywhere else online, and more than 50,000 groceries and household essentials that matter the most to our customers, a list informed by 84.51° data and insights.

Digital Talent

Executing our strategy and innovating in our core business requires tremendous digital and technology talent. I'm pleased to share that, this summer, Kroger Technology was named one of the best places to work in IT by *Computerworld* magazine. Also this summer, we announced Kroger is establishing a new, Digital HQ in downtown Cincinnati. In the city alone, we expect to grow the digital team from about 600 today to over 1,000 people by 2020.

Then in August, we signed an agreement with the University of Cincinnati to operate an innovation lab within the school's new innovation hub, creating another talent pipeline to support our business.

All the changes we are making to build digital platforms will also create opportunities to grow our business and improve margins in the future. We are aggressively investing in these transformational opportunities. And while we are investing for the future, we are delivering for our customers and shareholders today.

Our Brands

Our Brands continue to resonate with customers, both in stores and online. Since our August launch of Kroger Ship, 41 of the top 50 items sold are *Our Brands*, and four of the top five items on ClickList are *Our Brands*. In the center of the store, premium *Our Brands* including Private Selection, HemisFares and Abound grew double digits during the second quarter as well.

In the second quarter, *Our Brands* made up 28.2% of unit sales and 26.5% of sales dollars – both of which are record results for the second quarter.

Our Brands continue to outpace Kroger's ID sales growth, led by more than 15% growth in our popular Simple Truth and Simple Truth Organic lines during the second quarter.

Simple Truth has quickly become the second-largest brand sold in our stores since launching five years ago. In 2018, Simple Truth reached more than \$2 billion in annual sales, making it the largest natural and organic brand in America. Simple Truth's popularity and explosive growth is a major reason why we are starting with the brand in our first international pilot with Alibaba Group's Tmall Global platform.

Create Shareholder Value

Restock Kroger is just getting started. We like what we're seeing so far and we're working to keep that trend going.

The outcome of our key *Restock Kroger* drivers is the creation of shareholder value, which we remain committed to delivering over the long term.

In June, we announced that Kroger's Board approved a dividend increase for the 12th consecutive year. Our dividend has grown at a double-digit compound annual growth rate since it was reinstated in 2006, and we continue to expect an increasing dividend over time.

We are on track to generate the free cash flow and incremental FIFO operating profit that we committed to in *Restock Kroger* through 2020, and to deliver on our long-term vision to serve America through food inspiration and uplift.

Now, here is Mike to share more details on our second quarter results and to update you on our guidance for the remainder of 2018. Mike...

Comments by Mike Schlotman:

Thanks, Rodney. Good morning everyone.

Our second quarter results demonstrate our ability to deliver for shareholders while we reposition the company for the future through *Restock Kroger*.

As noted in our press release this morning, for the first half of 2018, Kroger's adjusted net earnings per diluted share result was slightly ahead of our internal expectations due to the solid early execution of *Restock Kroger*, including process changes that led to sustainable cost controls and higher-margin alternative revenue streams. This performance will allow us to continue making incremental investments while delivering on our guidance range for the year.

We also noted that the second quarter adjustment items relate primarily to the change in the market value of Kroger's investment in Ocado securities. Since our investment and partnership announcement in the second quarter, the share price has doubled.

Q2 Price Investments

As you know, we accelerated several planned *Restock Kroger* investments starting in the first quarter and continuing during the second quarter. These included investments in price, especially in support of *Our Brands*, and in space optimization.

Our pricing strategy isn't "new." Since 2000, we have invested more than \$4.2 billion in lower prices for our customers, while also striving to provide the best full-service grocery experience in America. Even as we pursue our long-term strategy we always look for ways to bank savings before we make significant investments – as we did in the first half of the year.

We noted in June that pull forward investments in *Restock Kroger* that began the last four weeks of the first quarter, and continued space optimization rollout, would be headwinds to ID sales in the second quarter. So, this effect is not a surprise to us. We expect the headwinds from space optimization during the first half of 2018 to become a tailwind late in the third quarter.

ID Sales

Looking at our ID sales in the second quarter, twenty of our supermarket divisions had positive IDs, demonstrating *Restock Kroger* is resonating with customers across the company. Several departments outperformed our total ID sales in the second quarter, most notably Natural Foods, Seafood, and Pharmacy. We also continued to see growth in households during the quarter.

Gross Margin

Looking at gross margin, we were pleased to see that our shrink rate continued to improve during the second quarter. The gross margin rate reflects the company's price investments, some rising transportation costs, and growth of the specialty pharmacy business.

Part of our price investments was to support *Our Brands*, especially to reduce starting price points. The improvement in unit movement in the quarter demonstrates these investments are resonating with customers.

We intend to continue investing in price to drive unit growth while also delivering on the bottom line for our shareholders.

OG&A

OG&A costs increased as a rate of sales, driven entirely by higher expense for incentive plans as compared to last year.

We continue to face rising credit card fees, especially as more customers shift to using credit cards with higher interchange rates. This is a growing problem and we are taking steps to address it. You likely saw the news this summer that our Foods Co Supermarkets division announced that it would no longer accept VISA credit cards as a form of payment. This is because VISA's rates and fees are among the highest of any credit card brand.

We stopped accepting VISA credit cards to save on the high costs associated with the credit card company's interchange rates and network fees. The savings will be passed along to Foods Co customers in the form of low everyday prices on the items shoppers purchase most.

Foods Co stopped accepting the cards in mid-August. We are currently assessing next steps, and we are prepared to expand non-acceptance to other banners if that is what it takes to get to a level playing field for negotiated interchange rates.

It is also worth noting that we recently changed our Kroger Rewards credit card from Visa to MasterCard.

We will continue to aggressively manage OG&A costs and implement new programs to reduce our cost of goods sold. A big focus continues to be on store productivity and waste.

We manage our business every day to drive shareholder value. Our investments in *Restock Kroger* – in redefining the grocery customer experience, partnering for customer value, and developing talent – will be paid for by cost of goods savings, strong ID sales, and productivity gains. This is how we will generate \$400 million in incremental FIFO operating profit by the end of 2020.

Retail Fuel

Now for an update on retail fuel performance during the second quarter. Our cents per gallon fuel margin was approximately 26.3¢ compared to 21.7¢ in last year's second quarter. The average retail price of fuel was \$2.85 versus \$2.28 in the same quarter last year.

Taxes

We expect our 2018 tax rate to be approximately 22%. Excluding the 2018 first and second quarter adjustment items, we expect the 2018 tax rate to be approximately 20%. Favorable tax resolutions with certain states during the quarter benefitted adjusted second quarter net earnings by \$0.01 per diluted share.

Exploring Strategic Options for Turkey Hill Dairy Business

As previously announced, we are actively exploring strategic alternatives for our Turkey Hill Dairy business, including a potential sale. We want to ensure Turkey Hill has every opportunity to meet its full potential for growth.

Turkey Hill is a unique CPG food business within Kroger as it is a strong, nationally-known brand. Much like our convenience store business, Turkey Hill is such a beloved brand thanks to the 800 dedicated associates who have contributed to its success.

Free Cash Flow

We remain committed to generating the \$6.5 billion of free cash flow by 2020 as part of *Restock Kroger*. The original amount was \$6.0 billion, and we increased it to \$6.5 billion after the passage of the federal Tax Act. We expect the Tax Act to reduce cash taxes by \$1.2 billion

over the next three years. We used \$700 million of those savings to fund our investment in Ocado and our merger with Home Chef.

One other note to this is we have working capital improvements built into this guidance and we are off to a great start with a \$300 million improvement in net operating working capital so far this year.

Kroger's net total debt to adjusted EBITDA ratio, on a 52-week basis, is 2.59. Our net total debt to adjusted EBITDA ratio target range is 2.30 to 2.50. For the remainder of fiscal 2018, we expect our leverage ratio to remain slightly above the target range, primarily due to increased borrowings to fund the company's merger with Home Chef and investments in Ocado. Kroger remains committed to bringing the leverage ratio back into the target range.

Financial Strategy

Our financial strategy is to use our free cash flow to drive growth while also maintaining our current investment grade debt rating and returning capital to shareholders. We continually balance the use of cash flow to achieve these goals.

Over the last four quarters, we used cash to:

- Contribute an incremental \$1.1 billion pre-tax to company-sponsored pension plans and \$467 million pre-tax to satisfy withdrawal obligations to the Central States Pension Fund,
- Repurchase 103 million common shares for \$2.6 billion, which includes \$1.2 billion repurchased with after-tax proceeds from the sale of Kroger's convenience store business unit under a previously-announced accelerated stock repurchase plan,
- Pay \$435 million in dividends, and
- Invest \$2.9 billion in capital.

As of the end of the second quarter, we had approximately \$546 million remaining under the current share repurchase authorization.

Labor Update

We are investing an incremental \$500 million in our associates – in wages, training and development – over the next three years through *Restock Kroger*. This will be in addition to our continued efforts to rebalance pay and benefits while also focusing on certifications and performance incentives, career opportunities, and training. In March, we also announced investing a portion of our tax savings in our education assistance program, Feed Your Future, and an increased 401k match for our nonunion associates.

We recently ratified a contract with the UFCW covering Kroger associates in Ft. Wayne and in Richmond and Hampton Roads.

We are currently negotiating with the UFCW for contracts covering store associates at Smith's in Albuquerque and Fred Meyer in Portland.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide solid wages, good quality, affordable health care, and retirement benefits for our associates. We continue to strive to make our overall benefit package relevant to today's associates. Our financial results continue to be pressured by inefficient health care and pension costs, which some of our competitors do not face. We continue to communicate with our local unions and the international unions, which represent many of our associates, on the importance of growing our business and profitability, which will help us create more jobs and career opportunities and enhance job security for our associates.

2018 Guidance

Turning now to guidance for 2018:

We continue to expect identical sales growth, excluding fuel, to range from 2.0% to 2.5% in 2018.

We updated our GAAP net earnings guidance range to \$3.88 to \$4.03 per diluted share for 2018, from the previous range of \$3.64 to \$3.79. The increase in guidance is due to the unrealized gain in Ocado shares, recorded in the second quarter, and does not reflect any ongoing changes in the market value of Ocado shares because those cannot be predicted.

On an adjusted basis, our net earnings guidance range remains \$2.00 to \$2.15 per diluted share for 2018.

We continue to expect capital investments excluding mergers, acquisitions and purchases of leased facilities, to be approximately \$3.0 billion for 2018.

And now I'll turn it back to Rodney...

Comments by Rodney McMullen:

Thanks, Mike.

Everything we are doing supports our *Restock Kroger* vision to serve America through food inspiration and uplift.

- We are building a truly seamless shopping experience so we can serve customers anything, anytime and anywhere.
- We're using our data to provide convenient and personalized food inspiration to help customers be a hero to their families at mealtime, every time.
- We are identifying the partners who will help us deliver customer value today and the future.
- We are laying a foundation for more profitable alternative revenue streams that will also accelerate core business growth.
- And, we are serious about living our purpose – to Feed the Human Spirit – because associates, customers and stakeholders are increasingly deciding where to work, where to shop, where to invest, and who to support based on a company's commitment to making the world a better place.

It's no surprise, then, that we are very proud Kroger was recognized in Fortune magazine's *2018 Change the World* list for Zero Hunger | Zero Waste, our plan to end hunger in the places we call home and eliminate waste in across our company by 2025.

It is exciting to see our vision taking shape – especially because we know that by delivering on our vision, we will create value for our customers, associates and shareholders.

Now, we look forward to your questions.

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Comments by Rodney McMullen:

We are incredibly confident about the future of Kroger, especially with *Restock Kroger*.

One of the exciting things about our earnings call is that many of our associates listen in to better understand and gain insights on our business. And of course, many of our associates are shareholders as well. So, before we end today's call, I'd like to share a few final comments directed toward them.

First, I'd like to acknowledge that many of our customers and associates are bracing for Hurricane Florence. I know our store and logistics teams on the east coast have been working tirelessly for the past week to help our customers and each other be prepared for the storm. For those of you in the hurricane's path, please stay safe and look out for each other.

Second – and as I mentioned earlier on the call – we are thrilled that Kroger was included in *Fortune* magazine's *2018 Change the World* list for Zero Hunger | Zero Waste. This is such an awesome recognition of the work each one of you are doing to help us achieve our goal!

The same week we received the news from *Fortune*, Kroger was making news of our own. We added a bold, new pledge to our existing Zero Hunger | Zero Waste commitments by 2025: we are also phasing out single-use plastic checkout bags! The feedback on that announcement has been enormous and overwhelmingly positive.

Thank you for all you do!

That completes our call today. Thanks for joining.

The remarks contain certain forward-looking statements about the future performance of the Company. These statements are based on management's assumptions and beliefs in light of the information currently available to it. Such statements are indicated by words or phrases such as "expect," "intend," "committed," "planned," "objective," "will," "would," "approach," "guidance," "continue," "believe," "plan," "vision," "target," "range," "future," "strategy," "confident," "could," "can," "expectation," and "goal." Various uncertainties and other factors could cause actual results to differ materially from those contained in the forward-looking statements. These include the specific risk factors identified in "Risk Factors" and "Outlook" in our annual report on Form 10-K for our last fiscal year and any subsequent filings, as well as the following:

- Our ability to achieve sales, earnings, incremental FIFO operating margin, and free cash flow goals may be affected by: labor negotiations or disputes; changes in the types and numbers of businesses that compete with us; pricing and promotional activities of existing and new competitors, including non-traditional competitors, and the aggressiveness

of that competition; our response to these actions; the state of the economy, including interest rates, the inflationary and deflationary trends in certain commodities, and the unemployment rate; the effect that fuel costs have on consumer spending; volatility of fuel margins; changes in government-funded benefit programs; manufacturing commodity costs; diesel fuel costs related to our logistics operations; trends in consumer spending; the extent to which our customers exercise caution in their purchasing in response to economic conditions; the uncertain pace of economic growth; changes in inflation or deflation in product and operating costs; stock repurchases; our ability to retain pharmacy sales from third party payors; consolidation in the healthcare industry, including pharmacy benefit managers; our ability to negotiate modifications to multi-employer pension plans; natural disasters or adverse weather conditions; the potential costs and risks associated with potential cyber-attacks or data security breaches; the success of our future growth plans; the ability to execute on Restock Kroger; and the successful integration of merged companies and new partnerships. Our ability to achieve these goals may also be affected by our ability to manage the factors identified above. Our ability to execute our financial strategy may be affected by our ability to generate cash flow.

- Our effective tax rate may differ from the expected rate due to changes in laws, the status of pending items with various taxing authorities, and the deductibility of certain expenses.

Kroger assumes no obligation to update the information contained herein. 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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