



**Third Quarter 2018
Investor Conference Call Prepared Remarks
December 6, 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 third 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.

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 third quarter 2018 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

Transforming the Growth Model through *Restock Kroger*

At our investor conference at the end of October, we shared several big ideas. The defining idea is that we are transforming our business model through *Restock Kroger*...and then beyond.

We will grow market share by BOTH redefining the Kroger customer experience AND alternative profit streams through complementary businesses and partnerships.

Redefining the customer experience means offering customers incredible physical and digital experiences, a fantastic offering, and friendly & caring associates. Delivering an exceptional customer experience through the Kroger ecosystem creates incremental new profit streams, which in turn drives the economic model that makes the seamless experience possible. In this way, our new growth model will be a virtuous cycle.

This all means that Kroger is also reinventing our financial model.

We're moving from a traditional grocer to a growth company with both a strong customer ecosystem that offers anything, anytime, anywhere, and asset-light, high-margin alternative partnerships and services.

I will break it down a bit with more detail. Successful long-term businesses constantly explore new directions and adjacencies to grow their top line.

At our investor conference, we highlighted one of our most successful to date - Kroger Personal Finance - as well as several businesses under our 84.51° portfolio, including our *Kroger Precision Marketing* media offering.

Kroger Personal Finance delivered record year-to-date profit and is on track for their most profitable year ever.

Our high-margin media business is strong and growing.

Revenue for *Kroger Precision Marketing powered by 84.51°* is up more than 150% year to date. One service line, our *Boosted Products in Search* business where advertisers can influence how their product shows up on our sites, benefitted advertisers with more than 700 million product impressions in the third quarter alone, personalized to Kroger shoppers, with click-to-conversion rates that are two or three times the industry standard.

We see tremendous potential in these asset-light, margin-rich businesses built off a robust grocery supermarket experience, which is being redefined every day at Kroger.

Digital Progress

Nowhere is this more obvious than digital. Our digital sales grew over 60% in the third quarter. Our seamless coverage area now reaches more than 90 percent of Kroger households. This includes Kroger Pickup and Delivery.

Kroger Ship is now available in all supermarket divisions. Ship customers can shop from a curated selection informed by 84.51° data and insights of more than 50,000 groceries and household essentials that matter the most to our customers. Plus, there are 4,500 *Our Brands* products, available only from Kroger.

We are aggressively investing to build digital platforms because they will give our customers the ability to have anything, anytime, anywhere from Kroger, and because they are catalysts to grow our business and improve margins in the future. As we stated at our Investor Day, we expect to be able to cover not only 100 percent of our customers but also the entire U.S. population by the end of next year.

Our Brands

Our Brands continues to perform exceptionally well with customers and is one of the most profitable parts of our core business.

Our Brands made up 28.7% of unit sales and 26.6% of sales dollars – both of which are record third quarter results.

Our Private Selection and Simple Truth brands saw strong sales, unit and gross margin gains in the third quarter. Simple Truth and Simple Truth Organic is our fastest-growing brand, with sales up double digits again in the third quarter.

As we've shared previously, *Our Brands* accounts for 4 of the top 5 items sold through Kroger Pickup and 41 of the top 50 items sold on Kroger Ship.

Create Shareholder Value

We have now been executing for three quarters our *Restock Kroger* plan to create shareholder value by redefining the grocery customer experience, partnering for customer value, developing talent and living our purpose.

We feel good about our progress and how everything is coming together. We are proactively investing for the future – in stores and online, and in our customers and associates. We are using our assets – especially our love of people and of

our love of food – to transform our business in ways that drive sustainable competitive advantage.

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

Comments by Mike Schlotman:

Thanks, Rodney. Good morning everyone.

We are pleased with our net adjusted operating earnings per diluted share result of \$0.48 for the third quarter. Strong fuel margins and continued execution of *Restock Kroger* contributed to this result.

Investments & Space Optimization

We continued to make several *Restock Kroger* investments in the third quarter. These included investments in price, especially in support of *Our Brands*, and in space optimization, store remodels and technology enhancements. Part of these investments will allow customers to buy anything, anytime, anywhere from Kroger.

As we discussed at our investor conference, space optimization is a massive undertaking. We continue to expect to end the year with 600 stores completed.

ID Sales

Our ID sales for the third quarter were in line with our expectations. ID sales were led by the Natural Foods, Pharmacy, Seafood, Produce, and Deli departments.

Gross Margin

Looking at gross margin, we were pleased to see that our shrink rate continued to improve during the third quarter compared to the previous year. The gross margin rate reflects the timing and size of company's price investments compared to a year ago, rising transportation costs, and growth of the specialty pharmacy business, which is a high sales, low-margin-rate business that generates strong gross profit dollars.

Keep in mind that last year in the third quarter, our gross margin rate was higher than our typical run rate. For the third quarter in 2018, gross margin, excluding fuel, was actually higher than the second quarter of 2018. These fluctuations illustrate how our results in any given quarter can vary based on the cadence of the investments we make in the business.

Part of our investments this year support the *Our Brands* strategy, where we continue to offer high quality products at a great value. 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

We're pleased that OG&A costs decreased by 20 basis points as a rate of sales.

The significant improvements we are seeing from our focus on reducing store associate turnover is contributing to this positive movement. We continue to focus on productivity and waste. Improvements in our cost to fill prescriptions and increased adoption of self-scan contributed to this improvement.

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 will contribute to generating \$400 million in incremental FIFO operating profit through 2020.

Retail Fuel

Now for an update on retail fuel performance during the third quarter. Our cents per gallon fuel margin was approximately 26.1¢ compared to 24.9¢ in last year's third quarter. The average retail price of fuel was \$2.81 versus \$2.46 in the same quarter last year.

Taxes

We expect our 2018 tax rate to be approximately 23%. Excluding the 2018 adjustment items, Kroger expects its 2018 tax rate to be approximately 21%. These rates reflect a third quarter adjustment related to a regular IRS audit. The IRS audit resulted in a reduction of prior year tax deductions at pre-Tax Reform rates and future tax deductions at post-Tax Reform rates.

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:

- Invest a combined \$589 million in Ocado securities and Home Chef,
- Contribute an incremental \$185 million pre-tax to company-sponsored pension plans and \$467 million pre-tax to satisfy withdrawal obligations to the Central States Pension Fund,
- Repurchase 91 million common shares for \$2.3 billion, which includes \$1.2 billion repurchased with after-tax proceeds from the sale of Kroger's convenience store business unit under an accelerated stock repurchase plan,
- Pay \$435 million in dividends, and
- Invest \$3.0 billion in capital, excluding mergers, acquisitions, and purchases of leased facilities.

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

Restock Free Cash Flow

We remain committed to generating the \$6.5 billion of Restock free cash flow by 2020 as part of *Restock Kroger*.

We have working capital improvements built into this guidance, and are off to a great start with a \$100 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 2.72. Our net total debt to adjusted EBITDA ratio target range is 2.30 to 2.50 times. We remain committed to bringing the leverage ratio back into the target range.

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 nonunion associates.

The average hourly rate for our store associates is more than \$18 per hour when you factor in our comprehensive benefits that many competitors don't offer.

We recently ratified a new labor agreement with the UFCW covering more than 13,000 Kroger associates in Columbus, Ohio. The agreement raises starting wages and accelerates wage progressions after one year of service.

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 in a profitable way, which will help us create more jobs and career opportunities and enhance job security for our associates.

2018 Guidance

Turning now to guidance for the remainder of 2018:

We continue to expect identical sales growth, excluding fuel, in the second half of the year to be similar to first half results.

We updated our GAAP net earnings guidance range to \$3.80 to \$3.95 per diluted share for 2018, from the previous range of \$3.88 to \$4.03. The change in GAAP guidance is due to the third quarter market value adjustment of \$0.09 per diluted share for Kroger's investment in Ocado shares and does not reflect any future changes in the market value of those shares because those cannot be predicted.

On an adjusted basis, we maintained our net operating earnings guidance range to \$2.00 to \$2.15 per diluted share for 2018. Keep in mind that fiscal 2017 included an extra week.

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.

We're not quite through our first year of executing *Restock Kroger* and we feel great about where we are. We are laser focused on our customers and fulfilling their needs. We are clear on our vision, to serve America through food inspiration and uplift. Our 2018 accomplishments and investments set us up well for 2019, and we are committed to delivering on our *Restock Kroger* financial targets by the end of 2020. We have a clear path through both redefining the customer experience and growing alternative profit streams.

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 as always before we end today's call, I'd like to share a few final comments directed toward them.

Last week we celebrated Giving Tuesday. In conjunction with our partner Feeding America, we set a goal to raise enough money to provide 4 million meals to those in need during the holiday season. Together with our customers we raised enough to serve almost 6 million meals – helping us move closer to our Zero Hunger | Zero Waste goal of eliminating hunger in our communities.

Last Friday, a major earthquake rattled Alaska. We operate seven Fred Meyer stores that were affected, and thankfully all associates and customers inside our stores were safe. I'm so proud of our awesome Fred Meyer and Kroger team who worked together to reopen all stores within one day.

Each holiday season I am reminded of our privilege to serve more than nine million customers who shop with us every day. Every celebration or tradition is as unique as the customer who walks through our door. Among the hustle and bustle of the season, you welcome our customers and help to make their celebration brighter. We lift our customers' spirits and they uplift our spirits as well.

These are just a few examples of what it means to live Our Purpose: to Feed the Human Spirit. It's amazing what we can do, together.

Thank you for all you do for our customers, communities and each other. Merry Christmas, Happy Holidays and Happy New Year to you and your family!

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 "achieve," "believe," "can," "commitment," "committed," "confident," "continue," "could," "expect," "expectation," "future," "goal," "growing," "growth," "guidance," "intend," "may," "objective," "plan," "potential," "predicted," "range," "strategy," "target," "vision," and "will." 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 Restock 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, changes in tariffs, 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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