The Kroger Co.

Second Quarter 2013
Investor Conference Call Prepared Remarks
September 12, 2013

Cindy Holmes, 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.

We are hopeful that you can join us for our 2013 Investor Conference in New York on October 30. We look forward to seeing many of you then.

I will now turn the call over to Dave Dillon, Chairman and Chief Executive Officer of Kroger.

Comments by Dave Dillon:
Thank you, Cindy. Good morning everyone and thank you for joining us today. With me to review Kroger's second quarter 2013 results are Rodney McMullen, Kroger's President and Chief Operating Officer, and Mike Schlotman, Senior Vice President and Chief Financial Officer.

I am very pleased with our strong second quarter results, which put us on target to deliver the identical supermarket sales and earnings per share growth we promised for the year.

Kroger's second quarter operating performance and financial results show that the common thread in our story is consistency.

- We achieved our 39^{th} consecutive quarter of positive identical supermarket sales, maintained ROIC, and expanded FIFO operating margin, without fuel, on a rolling four quarter basis.
- Every supermarket division and every department had positive ID sales.
- We controlled costs throughout the business.

- As you know, we announced a merger agreement with Harris Teeter, a company we have admired for a long time, which will expand Kroger's footprint into new, exciting growth markets.
- And customers continue to tell us our associates are improving their shopping experience.

As we have shown quarter after quarter, our consistent execution of the Customer 1st Strategy deepens customer loyalty, increases sales and creates sustainable shareholder value.

As you know, the list that I have just covered was prepared in advance so that we could formally review the quarter we have just finished. I am not sure it does the quarter justice so let me depart from our normal script and describe our results this way.

- We have just completed what is nearly ten years of positive identical sales growth.
- We have invested in price for each of those ten years when compared to the year before.
- At the same time, we have focused on lowering our costs. We have actually lowered our costs now for over eight consecutive years.
- Last year in our investor meeting we raised the guidance for our long-term earnings performance expectations. In fact, for the past two years – and our guidance suggests this, 2013, would be the third year – we have been performing within this new, higher earnings per share growth range already. Plus, don't forget the dividend.
- Also in October, we offered a number of other keys to our successful growth plan for future years.
- Everything you are hearing today in our quarter suggests we are on the path to successfully achieve all of those goals that we set out for you last year in October. Maybe even more important, the progress we have achieved these past 10 years sets a wonderful foundation on which to build for an even brighter future.
- And the most important part of all, is that the team at Kroger is large, broad-based, with dedicated associates – Team Kroger – who have collectively come together to achieve these results -- and it is that combination that I think is unmatched in the industry today. The results achieved by our team – Team Kroger – make me most proud.

I don't use the words lightly, this quarter especially, when I say: We are very proud of the quarter we have just delivered.

Now, I'd like Rodney to cover some more details about the second quarter. Rodney?

Comments by Rodney McMullen:
Thank you, Dave, and good morning everyone.

Improving Customer Perception

As you know, we regularly seek customer feedback on how well we are executing in each of the Four Key areas of our Customer 1st strategy. We continue to improve our performance in each area, and our efforts are being noticed.

Customers are telling us that our associates continue to connect with them by showing that our people are great, our product selection and quality is improving, we are making the shopping experience faster and easier, and we continue to give our customers better value for their money. Doing the Four Keys together is what separates us from our competitors – competitors of both the past and the future – because the hard part is doing all four, and doing them reliably.

We are also more agile in balancing our investments in the Four Keys with the savings we realize, and we are consistently improving the efficiency of those investments on a rolling four quarter basis. Our lower gross profit today means customers are saving nearly $3 billion a year compared to when we started this journey.

I want to echo Dave's appreciation and also thank our associates for keeping their focus on our customers and delivering shareholder value. We are very proud of reaching a merger agreement with Harris Teeter, and we are especially pleased it has not diverted our associates' efforts to achieve a good quarter and to continue driving the business.

Customer Shopping Behavior and Tonnage Growth

One of the most important measures of our business is loyal household growth. It lets us know how well we are connecting with our best customers. And our loyal customers on average spend about half of every dollar with Kroger, which means we have a tremendous opportunity to increase their spending across our family of stores.

During the second quarter, we grew the number of loyal households. Our loyal household count grew at a much faster rate than total household growth, which was also up for the quarter.

Overall, customers continue to visit our stores more frequently, purchase fewer items per trip and buy more on a monthly basis. Total units sold were up compared to last year. We estimate the rate of product cost inflation at 1.6%, excluding fuel and pharmacy.

As we have discussed throughout the year, in fact for the last several years, consumer confidence continues to improve at a slow but steady pace. Factors that affect consumer confidence at any given time include fluctuating gas prices, payroll taxes and government policy uncertainty along with the overall state of the economy. We continue to monitor these factors closely. Overall, we would characterize the economy as continuing to improve, but fragile.

Operating Leverage

Kroger leveraged operating expenses in the second quarter as associates did a good job controlling costs and driving positive identical sales. Our OG&A costs plus rent and depreciation, without fuel, were down 17 basis points as a percent of sales. On this basis and excluding one-time items (as Dave mentioned before), we have improved this metric for eight consecutive years, and our year-to-date results set us up to achieve our ninth consecutive year.

Corporate Brands

Now I'd like to update you on our Corporate Brands offering, which is one of our key differentiators for Kroger versus our competition. Our focus is on new products, which are continually evolving as customer tastes change. We have modeled our team to facilitate a culture of innovation. This year alone we will have introduced more than 650 new items by the end of the year.

In the second quarter, Corporate Brands represented approximately 25.4% of total units sold and sales dollars were 23.8%, excluding fuel and pharmacy.

Labor

Finally, an update on labor relations. Our store associates ratified new labor agreements covering stores in Indianapolis, Roanoke and Little Rock.

We have several contracts that have expired or will expire soon, including contracts in Seattle, Cincinnati and Dallas.

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. Kroger's financial results continue to be pressured by rising health care and pension costs, which some of our competitors do not face. Kroger and the local unions, which represent many of our associates, have a shared objective – growing Kroger's business and profitability will help us create more jobs and career opportunities, and enhance job security, for our associates. In fact, over the last five years we've added 33,000 jobs.

Now Mike will offer more detail on Kroger's second quarter financial results and our guidance for the year. Mike?

Comments by Mike Schlotman:
Thanks, Rodney. Good morning everyone.

Second Quarter 2013 Results

Total Sales

Total sales increased 4.6% to $22.7 billion in the second quarter compared with $21.7 billion for the same period last year. Total sales, excluding fuel, increased 3.9% in the second quarter over the same period last year.

Net Earnings

Net earnings for the second quarter totaled $317 million, or $0.60 per diluted share. Net earnings for the second quarter last year were $279 million, or $0.51 per diluted share.

FIFO Gross Margin

FIFO gross margin, including fuel, was 20.46% of sales for the second quarter. Excluding retail fuel operations, FIFO gross margin decreased 11 basis points from the same period last year.

LIFO Charge

The company recorded a $13 million LIFO charge during the quarter compared to a $35 million LIFO charge in the same quarter last year. This is consistent with our original expectations.

FIFO Operating Margin

FIFO operating margin, excluding fuel and the extra week in fiscal 2012, on a rolling four quarter basis, increased 9 basis points.

Retail Fuel Operations

Turning now to retail fuel operations. We disclose many items with and without fuel due to its effect on operating costs and gross rates, but we view fuel as a core department that over time is expected to contribute to earnings per share growth. About half of our supermarkets have fuel centers today. In the second quarter, our supermarket fuel centers' rolling four quarter margin per gallon was approximately 14 cents compared to 13.6 cents a year ago, excluding the effect of the 53rd week last year. Total gallons sold showed solid growth.

Return on Invested Capital

On a rolling four quarter 52-week basis, ROIC grew slightly to 13.49% compared to 13.44% during the same period last year. As we increase capital, it will be more difficult to grow ROIC in the near term; however, as these investments mature, we expect them to be accretive to ROIC.

Financial Strategy

Our planned uses of cash remain unchanged:

1. Maintain our current investment grade debt rating,
2. Repurchase shares,
3. Pay dividends to shareholders, and
4. Fund capital investments.

You will see on our balance sheet that our current portion of long term debt has decreased because of our recent financings, and our net total debt to adjusted EBITDA ratio has declined to 1.77. We have not been repurchasing as many shares as we originally expected at the beginning of the year. This is purely because of our work to prepare for the Harris Teeter merger. The lower ratio gives us the flexibility to finance the Harris Teeter transaction and we are well-positioned to re-establish and maintain our targeted 2.00 – 2.20 net debt to EBITDA ratio, in line with our long-term financial strategy, within 18-24 months after the Harris Teeter transaction closes. In fact, this puts us in a better position than we originally expected from a debt standpoint. We are committed to executing our financial strategy, including maintaining our current investment grade credit rating and repurchasing shares.

Share Repurchase & Dividends

During the second quarter, Kroger repurchased 2.4 million common shares for a total investment of $90 million.

Kroger's strong financial position has allowed the company to return more than $920 million to shareholders through share buybacks and dividends over the last four quarters.

Capital Investment

Capital investment, excluding acquisitions and purchases of leased property, totaled $507 million for the second quarter, compared to $444 million for the same period last year. Year to date, we have spent $1.1 billion.

We continue to expect full-year capital investments to be in the $2.1 to $2.4 billion range.

Updated Guidance for Fiscal 2013

Now I'll update our growth objectives for fiscal 2013.

We are maintaining our net earnings guidance to a range of $2.73 to $2.80 per diluted share for the year. This is consistent with our long term growth rate guidance of 8 – 11%, based on our FY2012 adjusted earnings per share of $2.52. Shareholder return will be further enhanced by a dividend that we expect to grow over time. Keep in mind our long-term growth rate assumes no effect from year over year LIFO swings. A higher LIFO charge in any given quarter or year will lower the growth, and a *lower* LIFO charge will increase the growth.

As you look at our guidance for the year, please note that we expect an EPS growth rate in the third quarter similar to what we reported today for the second quarter. We still expect this year's fourth quarter to be behind the fourth quarter last year on a 12-week basis. This is because we currently assume a $13 million LIFO charge in the fourth quarter this year compared to a credit of $41 million in the fourth quarter last year. Bottom line, we think current estimates for the third quarter are a little low, and for the fourth quarter they are a little high, by offsetting amounts. We continue to be comfortable at the $2.73 to $2.80 level for the year.

We are increasing our identical supermarket sales growth expectations, excluding fuel, to approximately 3.0% to 3.5% for fiscal 2013. The original guidance was 2.5% to 3.5%.

Now, I will turn it back to Dave.

Comments by Dave Dillon:
Thanks, Mike.

We are really proud of what we are accomplishing. We are growing in such a consistent way that it may seem deceptively simple. But the truth is that our hard work over the past 10 years – since we began our Customer 1st journey – has created a platform for sustainable growth. We are improving our connection with customers and associates, creating new jobs and strengthening job security, and rewarding shareholders with consistent earnings per share and dividend growth.

Now, we are happy to take your questions.

Comments by Dave Dillon:

Before we end the call, I'd like to share some additional thoughts with our associates listening in today.

October is Breast Cancer Awareness Month. Across our company, associates in our offices, supermarket and convenience stores, manufacturing plants and distribution centers participate in many activities to honor and pay tribute to those who are fighting this disease, including many local Susan G. Komen Race for the Cure and Making Strides Against Breast Cancer events. I am always moved by the outpouring of support and generosity that I see from our associates at events like these.

In the next few weeks, we will also begin our annual Giving Hope a Hand campaign to support the fight against breast cancer in our stores. This year we will be featuring associates like Laurie, an apparel manager at one of our Fred Meyer stores in Oregon, who says "losing [this battle] is never an option." Laurie and 20 other courageous associates will share their stories of hope and courage on specially-marked packages of our Corporate Brand and national brand products. These items will be sold exclusively in our stores from September 22 through October 5. I encourage you to read our co-workers' inspiring stories at sharingcourage.com.

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," "objective," "will," "guidance," "continue," "believe," "committed," and "plan." 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 our annual report on Form 10-K for our last fiscal year and any subsequent filings, as well as the following:

- The extent to which our sources of liquidity are sufficient to meet our requirements may be affected by the state of the financial markets and the effect that such condition has on our ability to issue commercial paper at acceptable rates. Our ability to borrow under our committed lines of credit, including our bank credit facilities, could be impaired if one or more of our lenders under those lines is unwilling or unable to honor its contractual obligation to lend to us, or in the event that natural disasters or weather conditions interfere with the ability of our lenders to lend to us. Our ability to refinance maturing debt may be affected by the state of the financial markets.

- Our ability to use free cash flow to continue to maintain our debt coverage and to reward our shareholders could be affected by unanticipated increases in net total debt, our inability to generate free cash flow at the levels anticipated, and our failure to generate expected earnings.

- Our ability to achieve sales, earnings and 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; 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 inconsistent pace of the economic recovery; changes in inflation or deflation in product and operating costs; stock repurchases; the effect of brand prescription drugs going off patent; our ability to retain additional pharmacy sales from third party payors; natural disasters or adverse weather conditions; and the success of our future growth plans. The extent to which the adjustments we are making to our strategy create value for our shareholders will depend primarily on the reaction of our customers and our competitors to these adjustments, as well as operating conditions, including inflation or deflation, increased competitive activity, and cautious spending behavior of our customers. Our ability to achieve sales and earnings goals may also be affected by our ability to manage the factors identified above.

- Our capital investments could differ from our estimate if we are unsuccessful in acquiring suitable sites for new stores, if development costs vary from those budgeted, if our logistics and technology or store projects are not completed on budget or within the time frame projected, or if economic conditions fail to improve, or worsen.

- During the first three quarters of the year, our LIFO charge and the recognition of LIFO expense will be affected primarily by estimated year-end changes in product costs. Our LIFO charge for the year will be affected primarily by changes in product costs at year-end.

- If actual results differ significantly from anticipated future results for certain reporting units including variable interest entities, an impairment loss for any excess of the carrying value of the reporting units' goodwill over the implied fair value would have to be recognized.

- 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.

- The actual amount of automatic and matching cash contributions to our 401(k) Retirement Savings Account Plan will depend on the number of participants, savings rate, compensation as defined by the plan, and length of service of participants.

- Changes in our product mix may negatively affect certain financial indicators. For example, we continue to add supermarket fuel centers to our store base. Since gasoline generates low profit margins, we expect to see our FIFO gross profit margins decline as gasoline sales increase.

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