Second Quarter 2014
Investor Conference Call Prepared Remarks
September 11, 2014

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 2014 Investor Conference in Cincinnati the evening of October 28 through early afternoon on October 29. Details will be coming soon and we look forward to seeing many of you then.

I will now turn the call over to Rodney McMullen, Chief Executive Officer of Kroger.

Comments by Rodney McMullen:
Thank you, Cindy. Good morning everyone and thank you for joining us today. With me to review Kroger's second quarter 2014 results are Mike Ellis, Kroger's President and Chief Operating Officer and Mike Schlotman, Senior Vice President and Chief Financial Officer.

Accelerating Growth

Kroger achieved a strong and balanced second quarter. As we improve our connection with customers, we are also executing our growth plan and delivering on our key performance indicators – all of which is fueling strong financial results for our shareholders.

Our second quarter performance highlights Kroger's continued growth momentum. We continue to deliver on the performance targets we outlined at our October 2012 investor conference, including positive identical sales growth; slightly expanding rolling four quarters FIFO operating margin, excluding fuel; and improving return on invested capital. For the period we:

- Achieved our 43rd consecutive quarter of positive identical supermarket sales growth;
- Exceeded our goal to slightly expand FIFO operating margin, without fuel, on a rolling four quarters basis;
- And increased return on invested capital while also increasing capital investment.

Based on our strong quarter results, we are raising our net earnings per diluted share guidance and our identical supermarket sales growth guidance for the year. We expect to deliver a net-earnings-per-diluted-share growth rate of 13-15% for fiscal 2014. As you know this is partly due to the benefit of Harris Teeter. We expect to return to our long-term growth rate of 8-11%, plus the dividend, in fiscal 2015.

And, we are not done growing and differentiating to better serve our customers. We are proud to welcome the incredible Vitacost.com team to the Kroger family. We are excited about the opportunity the merger creates to transform the customer experience and move Kroger directly into the e-Commerce space much faster than we could have done on our own. The merger closed last month and our teams are hard at work developing our combined business plan. Mike Ellis will have more to say about Vitacost in a few minutes.

Our merger with Harris Teeter is going very well – we are learning a lot from each other and we can't say enough about our Harris Teeter associates.

Economy and Customer Shopping Behavior

We continue to see positive indicators in customer shopping behavior – both what our customers tell us and what their actual shopping behavior says. Kroger's data suggests some greater confidence in the economy and less caution in spending, consistent with what we saw in the first quarter.

Even so, confidence in the economy and the economic recovery is not pervasive across the board. Many of our customers are still struggling, and we continue to pursue our strategy of connecting meaningfully with <u>all</u> customers, wherever they are on the economic spectrum.

It is worth noting that our definition of a *loyal customer* is based on a combination of how often a customer shops with us and the amount of products that they purchase from Kroger. We have loyal customers in every segment of the customer spectrum, from value customers to upscale shoppers and everywhere in between. We continue to see our loyal households grow at a faster rate than total households.

As you know, we developed the four keys of our Customer 1st Strategy more than 10 years ago because we recognized that customers wanted a grocery retailer that would deliver not just one or two key advantages, but a total combination including a great overall shopping experience, excellent customer service, a full assortment of both national and corporate brand products, and everyday low prices and promotional offerings. Today, our customer research tells us that this is even more important. Our customers don't want to compromise by choosing retailers who do well in only one or two areas.

In short, customers are looking for a food retailer that can offer it all.

And that is Kroger's sweet spot. That is exactly where we have positioned ourselves to win, it is where we *are* winning, and it is where we intend to continue to win.

Now, I'll turn it over to Mike Ellis to outline our operational performance. Mike?

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

First, I'd like to thank our associates for their solid performance. Strong and consistent execution is what allows us to continue making investments in all Four Keys of our Customer 1st strategy, including investments in our associates and ongoing price investments.

Loyal Customer Growth

As Rodney said, loyal households grew at a faster rate than total households, which also grew for the quarter. This is important because it tells us that we are connecting with our customers across the entire spectrum, and that we are connecting in the right areas – people, products, the shopping experience and price.

As expected, inflation continued to increase during the quarter, especially in meat, dairy, and in pharmacy, which continued to produce solid growth in both script count and ID sales. We estimate inflation excluding fuel and pharmacy was 2.4% in the second quarter, and 2.8% with pharmacy. Even with higher inflation, we saw strong tonnage growth during the second quarter.

Corporate Brands

Our Corporate Brands portfolio continues to resonate with our customers. During the second quarter, Corporate Brands represented approximately 26.3% of total units sold, and 25.2% of sales dollars, excluding fuel and pharmacy. We saw strong double digit unit and sales growth in Simple Truth and Simple Truth Organics. Our new entry-level price point brands and premium-tier Private Selection brand all had strong positive sales and unit gains in the second quarter as well.

Customer 1st Innovation

Another driver of sustainable growth is Customer 1st Innovation. For the past few quarters we have been highlighting innovations that are improving our connection with customers and growing our market share. This quarter, I would like to focus on our merger with Vitacost.com.

First, I'd like to echo's Rodney's welcome to the team at Vitacost. You are now a part of Team Kroger and we couldn't be more excited.

This is a compelling transaction because of the incredible potential for transformation and growth. We believe Kroger is uniquely positioned to blend the art of retailing and deep customer insights with a superb online experience. Vitacost's people and extensive e-Commerce platform, coupled with Kroger's customer insights and loyal customer base, will be a powerful combination that we can leverage to create new levels of personalization and convenience for our customers. We intend to build on Vitacost's robust technology platform and integrate it with our existing digital footprint to do just that.

This is one of the reasons we recently asked Kevin Dougherty, who has been serving as Kroger's group vice president and chief supply chain officer, to lead this effort in a new role: as group vice president of digital and Vitacost. Kevin has been a leader on the Vitacost merger team from the start, and for the past several years he has been increasingly focused on building our digital organization here at Kroger.

We look forward to combining our teams to do great things for our customers together.

Labor Update

Now, I will provide a brief update on labor relations.

We recently completed several successful contract negotiations covering Food4Less associates in Southern California, and Kroger associates in Cincinnati and Dayton.

We are currently negotiating contracts with the UFCW for store associates in New Mexico, Toledo, and agreements with the Teamsters covering several distribution and manufacturing facilities.

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, should have a shared objective – growing Kroger's business and profitability, which will help us create more jobs and career opportunities, and enhance job security, for our associates.

Now Mike will offer more detail on Kroger's financial results and update our guidance for 2014. Mike?

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

Second Quarter Growth Metrics

When we outlined our accelerated growth strategy at our October 2012 investor conference, we also identified the key performance targets for shareholders to measure our progress. I'd like to spend a few minutes discussing the results in each metric.

<u>ID Sales</u>

Our first metric is identical supermarket sales without fuel. We are very pleased with our second quarter ID sales growth of 4.8%.

This strong performance was supported by ID sales growth in every department and every supermarket division. Our Natural Foods department continues to grow in the double-digits, accelerated by significant household gains.

<u>FIFO Operating Margin</u>

Rolling four quarters FIFO operating margin, excluding fuel and adjustment items, expanded by 7 basis points. Over time, we expect our FIFO operating margin growth rate, excluding fuel, to return to slightly expanding on a rolling four quarters basis.

<u>Return on Invested Capital</u>

The third target metric is return on invested capital. We reported a return on invested capital, on a rolling four quarters basis and excluding adjustment items, of 13.6%, which was an increase from 13.5% in the same period last year. Increased capital investments will make it more difficult to grow ROIC in the near term, however we expect these investments to be accretive to ROIC as they mature. We expect our year-end ROIC, which will factor in a full year of increased capital investments and fully reflect Harris Teeter in our calculation, to show a slight decline compared to the end of fiscal 2013.

Second Quarter 2014 Results

Now, I'll share our second quarter 2014 results in more detail.

Please note that this quarter includes Harris Teeter in Kroger's statement of operations. Year-over-year percentage comparisons are affected as a result.

Second Quarter Net Earnings

In the second quarter, our net earnings totaled $347 million, or $0.70 per diluted share.

Net earnings in the same period last year were $317 million, or $0.60 per diluted share.

Second Quarter LIFO

As Mike said, we are seeing higher inflation than originally anticipated. We recorded a $26 million LIFO charge during the quarter compared to a $13 million LIFO charge in the same quarter last year.

We began fiscal 2014 estimating LIFO for the year at $55 million, and at the end of the first quarter we increased our LIFO guidance to a charge of $90 million. As reported this morning, we are increasing our LIFO estimate for the year to $100 million, which is an incremental one penny charge to net earnings per diluted share in the second quarter and five to six cents for the full year.

As we have mentioned in the past, we manage the company without regard to our LIFO charge, and many of the items we discuss are on a FIFO basis. So when we develop our expectations for any given year we estimate LIFO last. The reason for this is LIFO is merely an accounting convention. Typically a higher LIFO charge would be a headwind to results, but our strong sales helped us to overcome the higher than expected charge.

Second Quarter FIFO Gross Margin

FIFO gross margin decreased 12 basis points from the same period last year, excluding retail fuel operations.

Second Quarter OG&A Expenses

Operating, general and administrative costs plus rent and depreciation, excluding retail fuel operations, were essentially flat as a percent of sales compared to the prior year. Increases in workers compensation and general liability reserves negatively affected this comparison by 8 basis points.

Retail Fuel Operations

Now for retail fuel operations. About half of our supermarkets have fuel centers today. In the second quarter, our cents per gallon fuel margin was approximately 18.0¢ compared to 16.5¢ in the same quarter last year.

Financial Strategy

Our long term financial strategy continues to be to:

1. Maintain our current investment grade debt rating,
2. Repurchase shares,
3. Have an increasing dividend, and
4. Fund increasing capital investments.

Maintain Current Investment Grade Debt Rating

Achieving a 2.00 – 2.20 net total debt to adjusted EBITDA ratio by mid-to-late 2015 remains a key objective. Kroger took on debt to finance the Harris Teeter merger, and has not yet realized a full year of Harris Teeter EBITDA. This has caused a significant increase in the company's net total debt to adjusted EBITDA ratio, which is 2.33 as of the close of the second quarter, compared to 1.77 during the same period last year. This is, however, an improvement from the 2.42 reported last quarter.

Kroger's net total debt is $11.2 billion, an increase of $3.5 billion from a year ago, including debt related to the Harris Teeter transaction and Kroger's share repurchase activity.

Share Repurchases

Kroger's strong financial position allowed the company to return more than $1.9 billion to shareholders through share buybacks and dividends over the last four quarters. During the second quarter, Kroger repurchased 1.6 million common shares for a total investment of $78 million. All $500 million of the buyback authorization granted in June is still available.

Capital investments

Capital investments, excluding mergers, acquisitions and purchases of leased facilities, totaled $672 million for the second quarter, compared to $507 million for the same period last year.

We continue to expect capital investments to be in the $2.8 to $3.0 billion range, including Harris Teeter, for fiscal 2014.

Updated Fiscal 2014 Guidance

Now I'd like to update our growth objectives for fiscal 2014.

Based on our strong second quarter results, we raised and narrowed our adjusted net earnings per diluted share guidance to a range of $3.22 to $3.28 for fiscal 2014. The previous guidance was $3.19 to $3.27 per diluted share.

The company's long-term net earnings per diluted share growth rate guidance remains 8 – 11%. Shareholder return will be further enhanced by a dividend expected to increase over time.

We raised our identical supermarket sales growth guidance, excluding fuel, to 3.5% to 4.25% for fiscal 2014. The previous guidance was 3.0% to 4.0%. We are optimistic as we look forward to the remainder of the year, but keep in mind that we had a very strong fourth quarter last year to compare to.

Now, I will turn it back to Rodney.

Comments by Rodney McMullen:
Thanks, Mike.

I've said this before – this is an exciting time to be at Kroger. We are accelerating growth in our core business and investing in unique competitive positioning for today and the future. Integration with Harris Teeter is going exactly the way we would hope and we continue to learn from each other in ways that improve our customers' experiences. We see transformational potential in Vitacost's e-Commerce platform. We are currently hiring to fill an estimated 20,000 positions in our supermarket stores. Next week, we will open our 2,000th fuel center location. And we are well on our way to exceeding our long-term earnings per share growth rate for fiscal 2014.

Now, we look forward to your questions.

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Comments by Rodney McMullen:

Before we end today's call, I'd like to take a moment to acknowledge that this morning is the anniversary of the attacks of September 11. We all continue to mourn the loss of the brave men and women who perished in that tragic day; and I know that many on the call today were personally affected by those events. We continue to honor the memory of the fallen through our support for police, firefighters, the military and their families. On behalf of all of us here at Kroger we want to say a heartfelt thank you to the everyday heroes who work to keep us all safe.

Finally, I'd like to share some additional thoughts with our associates listening in today.

September is Hunger Action month, and I'd like to take this opportunity to thank our associates across the company who help support our customers and neighbors in need. According to our partners at Feeding America, the nation's largest hunger agency, there are 46.5 million Americans who don't know where their next meal will come from.

Together we are working to combat poverty in partnership with 106 local Feeding America food banks.

Last year alone Kroger contributed the equivalent of 200 million meals – nearly 4 million meals every week – to feed hungry families in our communities.

Of that, our *Perishable Donations Partnership* program provided more than 50 million pounds of fresh meat, produce, dairy and bakery items directly to local food banks in 2013. Our associates play a vital role in helping us get this fresh, healthy food to those who need it most. Without your help and support, our *Perishable Donations Partnership* would not be possible. Thank you!

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 "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:

- 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 investment grade debt rating and repurchase shares, pay dividends, and fund capital investments, 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 identical 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; 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 inconsistent pace of the economic recovery; changes in inflation or deflation in product and operating costs; stock repurchases; our ability to retain additional pharmacy sales from third party payors; consolidation in the healthcare industry, including pharmacy benefit managers; natural disasters or adverse weather conditions; the potential costs and risks associated with potential cyber-attacks and data security breaches; the success of our future growth plans; and the successful integration of Harris Teeter. 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, and increased competitive activity. 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.

- 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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