Fourth Quarter 2016

Investor Conference Call Prepared Remarks

March 2, 2017

Kate Ward, 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 fourth 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, Kate. Good morning everyone and thank you for joining us. With me to review Kroger's fourth quarter and fiscal 2016 results is Executive Vice President and Chief Financial Officer, Mike Schlotman.

As we all know, some times are just more challenging than others, and last year certainly did not end the way we expected at the start.

But 2016 still had its bright spots.

Of course, our associates and our customers are always a bright spot. I am so proud of this team for continuing to focus on taking care of our customers each and every time they interact in our stores. Despite the challenging operating environment, our team pulled together to deliver some results we should take stock of.

Over the past year, the Kroger team delivered:

- our 12th consecutive year of market share growth;
- overall tonnage growth;
- record high unit share in our Corporate Brands portfolio, which was led by another blockbuster $1.7 billion dollar year for Simple Truth;
- a strategic merger with specialty pharmacy leader ModernHEALTH and reached an agreement to merge with the world's greatest purveyor of specialty cheese, Murray's Cheese; and
- we created more than 12,000 new American jobs in our stores and hired more than 9,000 veterans and military family members.

That's a lot to be proud of.

We are obviously disappointed with our identical supermarket sales number in the fourth quarter and our performance on several other KPIs, including FIFO operating margin and return on invested capital, which were driven by the deflationary environment.

Kroger has always focused on executing against our long term strategy. We are lowering costs to invest those savings in our people, our business, and the technologies to position Kroger to deliver the value proposition customers are seeking today and in the future.

One example of our efforts to control administrative costs is making the difficult decision to extend a voluntary retirement offer for certain non-store associates that we announced in December. Approximately 2,000 non-store associates were eligible for the offer, and at this point we estimate approximately 1,300 will accept it.

Investing for Today and the Future

As our customers change and evolve, we are taking steps to meet them where they are and – more importantly – where they are going.

We're making meaningful investments in digital. We feel great about these investments because customers tell us they are important to them. We've aggressively added more than 420 *ClickList* and *ExpressLane* locations in 2016, bringing our total online ordering locations to more than 640. This effort was based on learnings from our merger with Harris Teeter. We are also experimenting with ways to solve the last mile equation. We're testing with Uber delivery in several locations with plans to expand in 2017 – where our customers can order through *ClickList* and choose to have their groceries delivered by a local Uber driver – and we have a couple of other home delivery tests as well.

We are building digital experiences today so that customers can engage and shop for anything, anytime, anywhere with us in the future. The excellent service they get from our associates in the store will carry over seamlessly to the digital platforms. Whether shopping online, finding great promotions and recipes that are personalized and relevant to them, or downloading one of the more than one billion digital offers loaded to shopper cards each year, more and more customers are connecting digitally with Kroger.

We are leveraging refined customer insights from 84.51° as well as years of online shopping experience from both Vitacost.com and Harris Teeter to develop a sophisticated understanding of our customers' behavior when shopping with us online, in-store, and both. We're utilizing this rich data set to make decisions about where are the right locations to offer ClickList, what are the right assortments and promotions to engage customers online, and how we can offer the quality and convenience online that customers have come to expect from a Kroger brick and mortar location.

We are also keenly aware of growing consumer trends, like health and wellness and high quality fresh and prepared foods. Our initiatives in these areas are designed to deliver convenience to our time-starved customers, and will continue to be a big focus of both capital and Customer 1st investments.

Now, we could stop all of these investments, given the headwinds our industry is facing. That might make our results look better today, but we are playing the long game. And that requires being deliberate and determined. There are a lot of companies out there right now investing in digital and ecommerce in opportunistic ways that will likely never create value for their shareholders. A core strength of Kroger is our ability to both create shareholder value today and make meaningful, strategic investments for the future. We remain determined to execute on our strategy and we are deliberately investing to grow and create long-term value for our shareholders.

Corporate Brands

Our Corporate Brands business was another real bright spot in 2016. Our brands are in more homes than ever before. In fact, our customers fill their carts with more than 1.25 million Corporate Brand items every hour.

We are incredibly proud of the quality of our Corporate Brand products. Our quality is only getting better, and that showed clearly in Corporate Brands performance last year – when we sold a record number of units – and in the fourth quarter – when Corporate Brands hit an all-time high unit share of 29.2%.

Simple Truth grew at an impressive rate again in 2016, reaching total sales of $1.7 billion. Simple Truth Organic accounted for more than a billion of that figure last year!

And we still see more growth ahead in our Simple Truth and Simple Truth Organic lines. In fact we’ve begun offering Simple Truth to even more customers throughout the U.S. by making it available on Vitacost.com. Today you can find online and conveniently ship to home many of our Simple Truth food, snacks and supplements, as well as household and personal care products. Interestingly, New York City is already the #2 market for Simple Truth online sales, even though we don't have a store presence there.

Core Strengths

As you know we always build our business plan assuming the environment is going to get more competitive the next year and not less. We also don't run a business model that relies on inflation returning. Rather we proactively make the changes we need to remain competitive well into the future.

Kroger's core strengths remain our most valuable assets:

- On the people front: we have great associates, an effective and experienced management team, and a deep bench of future leaders;
- On the financial front: a strong balance sheet and the flexibility to create sustainable shareholder value;
- And on the customer front: deep customer insights through our data analytics experts at 84.51° and – above all – an unwavering commitment to putting our customers first.

What also remains unchanged is our commitment to long-term growth that investors can count on. Over the last five years, Kroger's annual net earnings per diluted share growth rate was 16.3%, excluding one-time items. Over the last three it was 14.2%, excluding one-time items.

We remain committed to delivering our long-term net earnings per diluted share growth rate target of 8 – 11%, plus a growing dividend.

And here is Mike to go into more detail on our fourth quarter and fiscal 2016 results. Mike…

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

2016 Market Share

Kroger's market share grew for the 12th year in a row. Our consistent market share gains drive both top and bottom line growth and generate lasting shareholder value.

We report on market share annually, and look at it the way customers would look at it – where they spend their money.

According to Nielsen POS+ data, Kroger's overall market share of the products we sell in the markets where we operate grew approximately 20 basis points in 2016, with 14 of 22 markets up, two flat and six markets down.

Starting in 2017, we plan to begin using IRI point of sale data to measure market share. While we expect there to be some differences in share reporting between Nielsen and IRI, we expect those differences to be minimal.

Regardless of the source, we use market share data as a directional measure, and not a specific one. It is also worth noting that market share is calculated based on total sales and not ID sales.

ID Sales, Deflation & Tonnage

Looking at ID sales, deflation was the primary driver of our negative results for the quarter. Inflation-adjusted ID sales were positive in the fourth quarter.

Deflation excluding fuel persisted at 1.3% compared to 1.1% in the third quarter. During the quarter, we saw a decline in pharmacy inflation, an acceleration in produce deflation, and a slowing in grocery deflation.

Another headwind to ID sales was our capital program. Over the last four quarters we relocated or expanded 35 strong-performing stores, taking them out of our identical supermarket sales calculation. This caused a 70 basis point headwind to ID sales for the fourth quarter.

Tonnage was positive during the fourth quarter. We continue to focus on the areas of highest growth like natural and organic products – which hit nearly $16 billion in sales in 2016 – and areas where we are saving customers' time, such as ready-to-eat and ready-to-heat meal solutions.

We've always given a little insight into our ID sales data. Visits per household and price per unit were down in the fourth quarter, but those were slightly offset by basket size and household growth. Loyal households continue to grow at a faster rate than total households, which was true for both the quarter and the year. It is interesting to note that loyal households had slightly positive ID growth.

Operating Cost Savings

Operating, General & Administrative costs as a rate of sales – excluding fuel, recent mergers, and a $30 million contribution to the UFCW Consolidated Pension Plan in the fourth quarter of 2015 – declined by 11 basis points; rent and depreciation with the same exclusions increased by 24 basis points.

While this result was better than the third quarter, we can and will do better. We are working diligently to pull costs out of the business and improve processes to lower costs as a rate of sales and deliver value to our customers.

Retail Fuel

Now for an update on retail fuel. In the fourth quarter, our cents per gallon fuel margin was approximately 17.2¢ compared to 16.9¢ in the same quarter last year. The average retail price of fuel was $2.18 versus $1.92 in the same quarter last year.

For 2016, we were at 17.1¢ for the year compared to 17.4¢ in 2015.

Financial Strategy

Our net total debt to adjusted EBITDA ratio increased to 2.31, compared to 2.08 during the same period last year. This result is due to the merger with ModernHEALTH and increases in working capital.

The increase in working capital is driven by higher inventory in three locations where we opened new distribution centers. When doing this, we duplicate inventory for a period of time to ensure a smooth transition. Also, accrued liabilities are lower due to lower incentive plan payout accruals. This will reverse itself in the first quarter when incentive plan cash payments will be lower.

It is worth noting that over a longer time horizon, we do expect our net total debt to EBITDA ratio to grow. This is because we continue to work with unions to modify pension plans. We continue to negotiate restructuring of troubled multi-employer pension plan obligations to help stabilize associates' future benefits, as we did in the second quarter. These restructurings do not change the total obligations of the company because the debt we add is offset by a reduction in the amount of our off-balance-sheet multi-employer pension plan obligations.

In 2016, Kroger used cash to:

- Repurchase $1.8 billion in common shares,
- Pay $429 million in dividends,
- Invest $3.6 billion in capital, and to
- Merge with ModernHEALTH for approximately $390 million.

Capital investments, excluding mergers, acquisitions and purchases of leased facilities, totaled $3.6 billion for the year, compared to $3.3 billion in 2015.

The flexibility to return value to shareholders is a core strength of our financial strategy.

Return on invested capital for 2016 was 13.09%. This result was affected by current year results and recently-merged companies. We are committed to growing return on invested capital over the long term.

Labor Update

I will now provide a brief update on labor relations.

We recently agreed to a new contract with the Teamsters for our Roundy's Distribution Center, and with the UFCW for our North Carolina Clerks & Meat associates.

We are currently negotiating contracts covering store associates in Atlanta and Michigan.

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 continues to communicate with our local unions, which represent many of our associates, the importance of growing Kroger's business and profitability, which will help us create more jobs and career opportunities, and enhance job security, for our associates.

2017 Guidance

Turning now to our guidance for fiscal 2017.

We anticipate identical supermarket sales, excluding fuel, to range from flat to 1% growth for 2017.

We expect net earnings to range from $2.21 to $2.25 per diluted share, including an estimated $.09 for the 53rd week.

We anticipate the operating environment in the first half of 2017 to be similar to the second half of 2016. Our results in the second half of 2017 should show improvement as we cycle the previous year.

We recognize that this is an unusual year, and that's why we are going to provide a quarterly cadence relative to last year rather than compared to our long-term guidance rate as we've done in the past. In fact, for the first quarter we are going to give you an earnings-per-share range – which is not something we plan to do over the long term but we think it is important to be very clear how we think the year is going to progress.

For net earnings per diluted share, we expect:

- the first quarter to be in the $0.55 to $0.59 range;
- the second quarter to be up slightly compared to last year;
- the third quarter to be up strongly compared to last year; and
- the fourth quarter to be up high single-digits compared to last year, without the benefit of the 53rd week.

Our guidance for the year excludes the estimated cost of the Voluntary Retirement Offer but does include the anticipated expense savings, which we will reinvest in the business.

Over the long term, we are committed to achieving a net earnings per diluted share growth rate of 8 – 11%, plus a growing dividend.

We expect a LIFO charge of $25 million for the year.

We expect capital investments, excluding mergers, acquisitions and purchases of leased facilities, to be in the $3.2 to $3.5 billion range for 2017. Capital expenditures in 2017 will be focused on sales-generating initiatives, remodels, upgrades to our logistics network and merchandising systems, and digital and technology initiatives. As we invest more in these areas our investment in stores will be reduced.

And we anticipate Kroger's full-year FIFO operating margin in 2017, excluding fuel, to decline approximately 10 basis points compared to 2016 results.

Now, I will turn it back to Rodney.

Comments by Rodney McMullen:
Thanks, Mike.

We've never been more determined about our future. We continue to focus on gaining a larger share of the $1.5 trillion U.S. food market. We are working on process changes to lower costs, and using those savings to invest in our people, our business, and the technologies that will enhance Kroger's competitiveness in the future. We will continue to deliver for our customers today while also setting the company up for our next phase of growth and Customer 1st innovation. We know that when we deliver for our customers, we create long-term value for our shareholders.

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 share some additional thoughts with our associates listening in today.

Thank you for continuing to connect with our customers every day. They are rewarding us with their business. With your help, we gained more of the market and improved our customer satisfaction scores in 2016. Thank you for your hard work!

For those associates who are choosing to accept the voluntary retirement offer, thank you for your contributions to our family of companies. I know for some, the decision to retire was not an easy one. Kroger would not be the company it is today without your years of dedicated service. Each of you has made a difference in the lives of our customers, our communities and each other, and we are grateful for your contributions.

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," "anticipate," "should," "goal," "target," 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 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; 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 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; and the successful integration of Harris Teeter and Roundy's. Our ability to achieve sales and earnings 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.

- During the first three quarters of each fiscal year, our LIFO charge and the recognition of LIFO expense is affected primarily by estimated year-end changes in product costs. Our fiscal year LIFO charge is 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.

- 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 fuel generates lower profit margins than our supermarket sales, we expect to see our FIFO gross margins decline as fuel sales increase.

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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