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The Kroger Co. (KR)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to The Kroger Company First Quarter 2020 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Rebekah Manis, Director of Investor Relations. Please go ahead.

Rebekah Manis

Director-Investor Relations, The Kroger Co.

Thank you, Gary. Good morning and thank you for joining us. I'm joined by Rodney McMullen, Chairman and Chief Executive Officer; and Gary Millerchip, Chief Financial Officer; and they will be providing an update on the business and discussing first quarter results. This is, obviously, an unprecedented time and we are taking the additional step of providing more details on current business trends this quarter, so our prepared remarks may run a little longer than normal.

But 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 could 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. So Kroger assumes no obligation to update that information.

Both our first 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.

I will now turn the call over to Rodney McMullen.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thank you, Rebekah, and good morning, everyone. A lot has happened in our world since the last earnings call. We've had to adapt quickly to a new way of life. The COVID-19 pandemic and the most recent instances of racial injustice have changed our country in unmistakable ways; most profoundly, the devastating loss of life and livelihood that has affected so many Americans.

During the crisis, Kroger has been guided by our purpose and our values. I am proud of our associates, who stepped up when we were called to be there for our customers, communities, and each other. We are proud of their heroic and dedicated associates, who are on the frontlines serving our customers when they need us most.

As America enters the next phase of the pandemic, we know that our associates will continue to rise to the challenge, delivering Fresh for Everyone and helping our customers, communities, and America emerge even stronger.

I am proud of the measures that we've taken across our business to safeguard and support associates, customers, and our communities. During the pandemic, our priority has been to provide a safe environment for our associates and customers with open stores, e-commerce solutions, and an efficiently operating supply chain, so that our communities have access to fresh, affordable food and essentials.

Since March, the company has invested more than \$830 million to do just that. This includes the \$150 million Thank You Pay for our frontline grocery, supply chain, manufacturing, pharmacy, and call center associates, which we are providing to acknowledge their hard work and dedication to maintaining safe, clean, and stocked stores. We are pleased that our associates will share in the company's success with today's second instalment of Thank You Pay.

We continue to invest in, support, and protect our associates. We are providing emergency leave to associates. We are offering free COVID-19 testing to our associates. We've increased the contribution to our Helping Hands fund to \$15 million to provide additional financial support to associates experiencing hardship due to the virus.

Our work to safeguard associates will continue as long as the pandemic threat exists, and we are proud that Kroger was named in Forbes Magazine as leading one of the top 10 employer responses to the pandemic.

As part of Kroger's commitment to help America reopen safely, our Kroger health team stepped up to help expand access to testing as a partner in the US Department of Health and Human Services public/private testing partnership. Through this initiative, we have tested more than 82,000 patients in 15 states. We also offered free check cashing for stimulus, unemployment, and social security checks. Since launching this service, we've cashed more than 229,000 checks, totaling \$244 million.

Kroger has learned and continued to learn a lot, while keeping our stores and supply chain open and serving America during the pandemic. The company's total COVID-19 incident rate is tracking meaningfully below the markets where we operate and our overall accident rate is the lowest we've ever recorded. I'm incredibly proud of

how our associates have worked together to practice creating a safer environment for our customers, communities, and each other.

We've been able to share our learnings with other businesses and communities to help as they've begun to safely reopen through a resource guide we created called Sharing What We've Learned: A Blueprint for Businesses. Our blueprint includes actionable recommendations and learnings that we've applied, as well as what we've learned through regular interaction with governments, health departments, and with business leaders and other countries, including Italy, Singapore, and China, all of which were ahead of the US in terms of the pandemic cycling through their countries.

Under Restock Kroger, we have made significant strategic choices over the last several years to transform our business model and to redefine the customer shopping experience, partner for customer value, develop talent, and live our purpose. We've invested aggressively in technology to establish a seamless digital ecosystem, and we've made incremental investments in fresh, Our Brands, and personalization.

These investments in our competitive moats helped Kroger build business momentum in the second half of 2015, which continued through the start of our first quarter even before the first phase of the pandemic began in our operating markets in earnest in March.

The benefits of the changes that we've been making to our business model were accelerated by COVID-19. For example, our heavy investments in technology enabled us to reliably sustain the incredible, almost overnight increase in demand for our pickup and delivery services. Here are other examples of how the pandemic accelerated Kroger's transformation.

As you know, we introduced Kroger's brand transformation campaign, Fresh for Everyone, late in 2019. We believe that no matter who you are, where you're from, how you shop, or what you like to eat, everyone deserves to have access to fresh, affordable food. This is proven to be even more important during these times.

In the initial stock-up phase of the pandemic, customers purchased a lot of paper, cleaning products, and center store nonperishable items to fill their pantries. As the first new normal phase began to set in marked by preparing for extended time at home and often with children, our fresh departments took an even greater relevance as more and more customers turned to fresh produce and proteins as staples of home cooked meals. Fresh will continue to be an important driver of sales for Kroger, as demonstrated by our fresh departments, including meat, seafood, and produce, generating strong identical sales in the quarter.

Our Brands had a great quarter as well and grew 21.1%, driven by significant growth across our three largest brands. Having identified plant-based foods as a key trend well before 2019, the simple truth, plant-based platform continues to deliver strong growth, growing over 32% in the first quarter. In this way, by consistently delivering both value and innovation, Our Brands will remain one of our most powerful competitive advantages.

Because of the continued economic anxiety, we are still offering our customers value through personalization and promotions, leveraging our mailers, mobile app, website, and weekly ads. We continued to offer promotions throughout the quarter with a focus on single item purchases.

Kroger began investing in digital several years ago to build a seamless ecosystem that would deliver anything, anytime, anywhere. As a result, we have over 2,000 pickup locations and 2,400 delivery locations, reaching 97% of our customers, with a seamless customer experience that combines the best of our physical stores with digital.

These investments were especially timely, as customer adoption of pickup and delivery grew significantly during the pandemic. And because of our existing ecosystem, we were able to respond quickly to further expand and enhance our e-commerce services.

We were able to quickly offer and promote in-demand no-contact delivery and low-contact pickup services. We expanded and improved contact-free payment solutions, like Scan, Bag, and Go (sic) [Scan, Bag, Go] (00:11:12) and Kroger Pay. We took several steps to support the higher volume of pickup orders, including hiring additional e-commerce associates, adding more order pickup slots, and increasing the frequency of communications with customers. We also began testing a grocery pickup-only location in Cincinnati. All of this contributed to a 92% sales growth in digital channels in the first quarter. In April and May, the sales grew in the triple digits.

We continue to invest in and constantly improve our e-commerce capabilities. Our partnership with Ocado remains an essential part of our evolving seamless ecosystem. Our customer fulfillment centers will accelerate our ability to serve customers seamlessly and in a more cost-effective way. Earlier in June, we identified three new regions, the Great Lakes, the Pacific Northwest, and the West, for placement of our high-tech sheds. When operationally, these facilities will collectively create more than 1,000 new jobs, with the potential for hundreds of additional career opportunities.

As we've shared previously, we believe Ocado's value as a partner is not just its current capabilities, but also in how quickly the company is able to innovate and serve rapidly changing consumer markets. We're designing a flexible distribution network, combining [ph] disaggregated (00:12:54) demand and proximity of our stores, medium-size facilities, and large-size facilities. You can see this strategy taking shape in the new automated CFCs, which will span a range of sizes.

The new facility in the West will measure 300,000 square feet. The new facility in the Pacific Northwest will measure 200,000 square feet. And the facility in the Great Lakes region will measure 150,000 square feet. The varying sizes demonstrate the flexibility of the Ocado fulfillment ecosystem to best serve the respective markets. Our network will flex as demand matures and the optionality will allow us to fulfill same day or next day delivery or pickup and customer or store replenishment.

Kroger has been investing in raised wages for our frontline associates for the last several years. As part of Restock Kroger announced in 2017, Kroger is increasing associate wages incrementally by approximately \$800 million per year through the end of 2020, and this is \$300 million more than the original plan. As a result of this continuing investment, Kroger has increased its average hourly rate to over \$15 per hour and with comprehensive benefits factored in, our average hourly rate is over \$20 per hour, benefits that many of our competitors don't offer.

Because of these investments in our established human capital management processes, we were able to expediate our hiring processes in early March to shorten the time between application and employment, onboarding new hires in an average of 72 hours, and focusing onboarding on culture and safety. We were able to not only generally protect associate jobs in the face of record unemployment, we also created new jobs and new career opportunities for more than 100,000 workers nationwide.

Our expediated hiring and onboarding processes also enabled us to focus on associate and customer safety. We were able to direct immediate support to the expansion of Kroger Pickup availability, as well as an enhanced cleaning and sanitation practices in our stores and facilities, where we needed the help the most. Many of those new roles were bridge jobs, providing laid off workers with a stable job opportunity while furloughed from their previous jobs, many of whom are now starting to return.

Additionally, I'm pleased to note an extension of our human capital commitments. We contributed an additional \$236 million to multiemployer pension plans in the first quarter. This investment will help stabilize future associate benefits.

We worked extremely hard to ensure that we have the right talent, teams and structure, and the right focus areas in our core supermarket business and our alternative profit businesses. Our focus is on developing, training, promoting internal talent, while simultaneously hiring seasoned food industry executives to drive our retail supermarket business.

Kroger remains committed to diversity, equity, and inclusion with our work force. We are creating more opportunities for our associates to openly share their thoughts, feelings, and experiences with discrimination, and for our company and leaders to more deeply and deliberately listen. We will continue to educate and show our leaders and associates how to be more empathetic, supportive, and aware of our own unconscious biases, so that together we can build a better and more inclusive Kroger.

COVID-19 also accelerated our commitment to integrated ESG or sustainability practices. What we are seeing in our communities during the pandemic confirms that our Zero Hunger | Zero Waste mission is more relevant than ever. During the pandemic, more than 80 million people in the US lost their jobs and applied for unemployment benefits and/or food assistance. Many more families are struggling to put food on the table today. Kroger is using our philanthropic dollars and foundations to support our food banks and other key partners.

Additionally, we are now accepting SNAP EBT benefits as payment for our pickup service, allowing more customers to access fresh, affordable food through e-commerce. We also implemented a Dairy Rescue support program for farmers. Many farmers and producers did not have a market for their products as foodservice, hospitality, and restaurants remained closed.

We operate 17 dairies around the country and are uniquely positioned to offer our processing capabilities. Manufacturing and dairy procurement teams rapidly scaled the program to rescue surplus milk donated by Kroger's dairy cooperative suppliers and processed by Kroger-operated dairies, and directed it to food banks and families in need.

Kroger is a trusted brand and our number one priority is to be there for our customers, associates, and communities. We understand the transition to a new normal will not happen uniformly across the country. As America enters the next phase, we're using our own customer insights and monitoring the impact of the affected global markets to help us continue meet customer needs.

And now, I'll turn it over to Gary for more detail into the quarter financials. Gary?

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Thanks, Rodney, and good morning, everyone. Before discussing results for the quarter, I also want to thank our associates for their dedication and all they are doing to serve our customers and communities during this time. The pandemic brought unprecedented challenges, and I'm extremely proud of how our teams responded, as America relied on Kroger as a trusted resource for their food and essential needs.

As a result of the pandemic, we have seen elevated demand across our physical stores and digital channels. Our data insights show customers continue to value the convenience of our physical locations and the use of our seamless ecosystem.

As many of you know, we outlined our Restock Kroger transformation plan in 2017 and as part of that plan, we made the strategic decision to invest in digital. These investments allowed us to quickly add much needed capacity to serve our customers by scaling the foundational capabilities we have built and continue to develop. The outcome of these efforts has been a meaningful uplift in sales across all digital modalities, Kroger Pickup, delivery, and ship.

We made significant investments of more than \$830 million in the quarter to reward associates and safeguard associates, customers, and communities during the pandemic. We also contributed \$236 million to multiemployer pension plans to help stabilize future associate benefits.

Even with these significant investments and accelerated digital growth, we were pleased to achieve an improvement in FIFO operating margin, excluding fuel and adjustment items. We firmly believe that our ongoing investments will help Kroger emerge stronger. And it's clear from our recent customer data insights that our competitive moats: fresh, Our Brands, personalization, and a seamless ecosystem, are even more important as a new normal begins to emerge in food retail.

Now I'd like to discuss our quarterly results in more detail. We delivered an adjusted EPS of \$1.22 per diluted share. Kroger reported identical sales without fuel of 19% during the first quarter. Unprecedented demand for products across grocery and fresh departments led to these strong results. Sales were broadly based across all retail divisions and remained heightened throughout the quarter, as customers adjusted to the new restrictions and started preparing and eating more meals at home.

Leading into the pandemic, our sales were strong. Building our momentum from the second half of 2019, February identical supermarket sales without fuel were ahead of our internal expectations. During the last few days of February, we started to see a shift in customer behavior as shoppers started stockpiling, and that trend accelerated into March, with identical sales of approximately 30%. Sales remained elevated in April and May, both up approximately 20%, as customers continued to eat more at home.

In the first few weeks of the second quarter, we are starting to see some changes in demand, with sales growth becoming more balanced across the store as state restrictions have started to ease. Customers remain focused on health and safety and are still stocking up, but to a lesser degree than during the shutdowns. We are also starting to see a return to some splurge and impulse buying.

Customers are still cooking more at home, even with the easing restrictions, and identical sales so far in the second quarter are trending in the mid-teens. We do expect sales to continue to taper as the quarter progresses.

Digital sales grew 92% and contributed slightly over 3% to identical sales without fuel. New customer engagement with our pickup and delivery services spiked significantly during the quarter, and we have been encouraged by early customer repeat usage. Digital sales in the second quarter remain elevated, up triple digits in the first three weeks.

We continue to invest in digital and offered a fee-free pickup promotion to provide more value for our customers in ways that are most relevant at this time. We were also excited to announce several new enhancements to our

digital customer experience, including the launch of our check-in on arrival option for pickup customers and the launch of contactless doorstep delivery.

Adjusted FIFO operating profit for the first quarter was \$1.45 billion compared to \$957 million in the first quarter of 2019. Gross margin was 24.3% of sales for the first quarter. The FIFO gross margin rate excluding fuel increased 44 basis points due to sales leverage related to shrink, transportation, warehousing, and advertising costs. Our associates continue to do an impressive job managing shrink, which saw significant improvement in the first quarter compared to last year.

The OG&A rate increased 51 basis points excluding fuel and adjustment items. No adjustment was made to this number for COVID-19-related costs. As previously mentioned, during the quarter Kroger made the decision to contribute an incremental \$236 million to multiemployer pension plans. Excluding the incremental pension contribution, fuel and adjustment items, the OG&A rate improved 10 basis points. Rents and depreciation excluding fuel decreased 37 basis points due to sales leverage.

We do expect some COVID-related costs to continue beyond the first quarter, as we continue to invest in associate and customer safety, as well as support heightened digital demand. We also made the decision to delay certain Restock Kroger cost saving initiatives to allow our associates to focus on our most important priorities, safety and stocking shelves. We have now started to reintroduce the delayed initiatives, while also maintaining our commitment to associates and customer safety. We still expect to achieve the vast majority of the targeted \$1 billion of savings in 2020.

Fuel remains an important part of our strategy to drive customer loyalty. We saw a significant decline in gallons during the quarter, as was the national trend. We remain well positioned within our markets due to our fuel procurement practices and market-leading reward program.

The average retail price of fuel was \$2.13 this quarter versus \$2.62 in the same quarter last year. Our cents per gallon fuel margin in the first quarter was \$0.48 compared to \$0.23 in the same quarter last year and, as a result, fuel profitability was a major tailwind in the quarter. For the remainder of 2020, we expect fuel profitability to be a headwind compared to prior year as we cycle margins from 2019 and gallons continue to be impacted by COVID-19.

Kroger's alternative profit model is built from a platform of leveraging supermarket traffic and data, and is expected to achieve profit growth in 2020. During the first quarter, Kroger Personal Finance experienced lower transactions, as customers purchased less gift cards, Money Services, and lottery. Customer activity has started to improve since April as states have reopened. And while we would expect this trend to continue, KPF's profit is expected to be lower than our original expectations for 2020.

Media experienced a slowdown in late March and April, as campaigns were paused to refocus messaging on store and employee safety, and certain in-store programs were impacted by stay-at-home orders. Our media business rebounded strongly in May, and the strength of our digital sales growth has created significant momentum for Kroger Precision Marketing, which is now on track to achieve 50% growth in 2020.

We remain confident in the significant potential alternative profits, especially given the continued growth in traffic across our store and digital ecosystem. Despite short-term headwinds due to COVID-19, we continue to expect alternative profit to be a major accelerator of our model in the future.

As Rodney mentioned, we continue to invest in our associates as a key part of Restock Kroger in a variety of ways, including investments in wages, training, and development. We ratified new labor agreements with the UFCW covering associates in Food 4 Less, California and South Carolina, during the first quarter.

We are currently negotiating with the UFCW for contracts covering store associates in Las Vegas, Roanoke, Little Rock and Houston, as well as Dallas and [indiscernible] (00:28:02). Looking ahead, we have several major negotiations later in the year, including contracts with the UFCW for store associates in Charleston, West Virginia and Fry's associates in Arizona.

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 strive to make our overall benefit package relevant to today's associates.

Our financial results continue to be pressured by 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 create more jobs and career opportunities, and enhance job security for our associates.

Kroger's financial model has proven to be resilient throughout the economic cycle. We continue to generate strong free cash flow and maintain strong liquidity. We are committed to investing in the business to drive profitable growth, maintaining our current investment grade debt rating, and returning excess free cash to investors via share repurchases and growing dividend over time.

We are being disciplined in how we deploy capital and all aspects of our capital plan are being evaluated to make sure that our investments position Kroger for long-term success post COVID-19. We still expect total capital expenditure of between \$3.2 billion and \$3.4 billion in 2020.

Kroger's net total debt to adjusted EBITDA ratio is 1.81 compared to 2.54 a year ago. This is below our target range of 2.3 to 2.5. Kroger held temporary cash investments of approximately \$2.3 billion as of the end of the quarter, reflecting improvements in operating performance and significant improvements in working capital. We expect working capital to improve for the year, although not to the level experienced in the first quarter, which was inflated by the extraordinary sales growth due to COVID-19.

Given the uncertainties that remain related to COVID-19 and the outlook for the remainder of 2020, we believe it's prudent to maintain financial flexibility in the short term. We remain committed to our dividend and share repurchase program, and in the coming months we will also be evaluating the optimal use of any excess free cash flow, consistent with our previously stated capital allocation strategy.

Turning now to the guidance for 2020. The COVID pandemic has dramatically changed the outlook for food and retail, and we continue to monitor, evaluate, and adjust our plans to address the impact to our business. There are still many unknown factors related to the long-term impact of COVID-19 that could influence our financial results for the remainder of 2020, such as continued investments to help our customers and associates; uncertainty surrounding consumer behavior, restrictions, and what will be the new normal; and potential long-term shift in customers eating more food at home.

In recognition of these factors, it's difficult to predict specific outcomes and as such, Kroger is not reaffirming or providing new 2020 guidance. While we do expect to exceed the outlook shared in our April 1 business update for

identical sales without fuel, adjusted FIFO operating profit, adjusted EPS, and adjusted free cash flow, the company is not able to forecast the extent of such upside for the reasons mentioned.

As we continue to proactively adjust our plans in response to the pandemic, we remain committed to investing to ensure a safe environment for our associates and customers. And we will also continue to use our customer insights to invest in delivering greater value for customers in ways they value most and that build loyalty.

Kroger's financial model has proven to be resilient throughout the economic cycle. We remain confident in our business model, as well as our ability to generate strong free cash flow and achieve sustainable and attractive total shareholder returns.

In the second quarter, we expect identical sales excluding fuel to continue at elevated levels, although tapering from the trends we've experienced so far in the quarter. We expect EPS growth in the second quarter to be in the mid-to-high single-digit range, with tailwinds in the supermarket sales partially offset by continued investments and fuel headwinds. As the longer-term impact of COVID-19 becomes clearer, we are committed to providing more clarity on our expectations for the remainder of the year.

I'll now turn it back to Rodney.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thanks, Gary. I am so proud and deeply grateful for our 0.5 million associates, who step forward to be there for our customers and communities when they need us the most. In true Kroger spirit, they have risen to the occasion to each challenge presented with a strong spirit of agility, determination, and service to meet the needs of our customers. And these are the exact skills that will ensure the company will remain relevant to our customers in the future.

As I shared when we first began this call, we quickly had to adapt to a new way of life. We continue to make progress on the underlying business, even with the recent customer demand tailwinds. We are confident that Restock Kroger has allowed us to reposition our business and to create value for all our stakeholders prior to and during the COVID-19 pandemic.

Now we look forward to your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Rupesh Parikh with Oppenheimer. Please go ahead.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Good morning. Thank you for taking my question and congrats on the quarter.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Good morning.

A

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Good morning.

A

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Good morning. Gary, I just want to go back to, I guess, what you just said about Q2 EPS growth mid-to-high single-digit, I think you said mid-to-high single-digit EPS growth. Can you just help us understand more some of the headwinds there getting to that level of growth?

Q

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Yeah. I think the biggest factor, Rupesh, would be that – I mentioned it earlier, but just to maybe to give a bit more color on fuel for quarter one and how we see quarter two potentially shaping up, because that would be, I think, the biggest factor in the numbers. Overall, as I mentioned earlier, when we think about the supermarket business, we're expecting continued strong sales momentum, and we feel good about the ability to manage the margin and the investments that we'll continue to make as a result of COVID-19.

A

I think the biggest factor in the difference between the two quarters as we look at the guidance for the second quarter, in the first quarter fuel has been a significant tailwind for us overall, despite the fact that gallons were significantly lower through COVID. As we start to look at Q2, and we'll be cycling margins from Q2 last year and even though the fuel trend in gallons has continued to gradually get better every week, we're still seeing a decline in year-over-year gallons and the current trend would be in the sort of mid-teens range of negative growth in gallons, which is consistent with what's being seen in the market.

So as we look at the fuel performance in Q2 and what we see today, we're thinking that could be a headwind of anywhere between \$50 million to \$100 million. So, it would be important to think about that as you're thinking about the guidance that we shared for Q2, because that would be, I think, the primary factor that would – despite the continued growth and improvement in performance, that we'd expect over the original budget in the supermarket business. Hope that that helps.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

Great. Okay, that's really helpful. And then just one follow-up question. So just on e-commerce. So as you guys look at – obviously, you have the partnership with Ocado. How does what you've seen recently change, I guess, your e-commerce plans or investments going forward?

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

I love the question. And if you look at the strategic decisions we've made over the last several years, highlighted those decisions, really paid off in the current environment. Our digital and delivery and pickup business in the last two months grew triple digits, and continues to grow at that. And to have the ability to grow at that kind of level that quickly, just so proud of the whole team in terms of the foundations that were already in place, but also the stores and all the other parts and supply chain on being able to supply and hire people and support that.

So, we fundamentally believe the long-term trend will continue, where people will continually depend more on e-commerce. We certainly have seen that being accelerated. We don't think it will stay at the higher level where it is today permanently, but we do think fundamentally the growth has been accelerated and will be higher than where it started before COVID-19, and then grow from there.

One of the things that's incredibly important is all that pieces tied together and including Ocado, will allow us to continue to grow and improve our profitability of that part of the business. As you know, when a customer first switches to online, it typically takes three or four years before that customer's profitability is the same as when they shop in the store. But what we find is we get a significantly higher share of that customer's total household spend.

And there isn't anything that we've seen that wouldn't cause us to believe that the new e-commerce shopper doesn't feel that way. And a lot of those customers are telling us they intend to continue to shop more e-commerce than before, and we would expect to get a higher share of their business. We've also seen a lot of customers new to Kroger come and use our delivery and pickup business, and we're seeing nice repeat purchases from those customers. So, all those things cause us to feel good about the things we have in place and feel even better about Ocado and the other pieces that we're working on going forward.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

Great. Thank you.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

Thanks.

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Thanks, Rupesh.

Operator: The next question is from Simeon Gutman with Morgan Stanley. Please go ahead.

Simeon Ari Gutman

Analyst, Morgan Stanley & Co. LLC

Thanks. Good morning.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Good morning.

A

Simeon Ari Gutman

Analyst, Morgan Stanley & Co. LLC

I was going to ask something different, but – good morning – I wanted to ask you, Rodney, you just made the comment, it takes about three to four years to achieve the same profits. Do you mean that on an ongoing basis, or is that lifetime value? Because over three year to four years, I've purchased enough through the digital channel. And therefore, I guess, the profit becomes equal or on a go-forward basis after year three or four, the variable cost or the actual basket economics of each become even?

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yeah, it's each customer's household. So, if you look, obviously, when they first switch to e-commerce, we're spending the labor to pick their order, where before that the customer spent that labor. What we find is, over time we continue to get more efficient with our picking operations on picking an order, and the customer spends more money with us, so their total spend increases.

A

So, what we find is every – you'd have to look at every single customer separately, so the customers that first started shopping e-commerce three years ago, they're to the point now where their profitability is the same as before they went to e-commerce, but we're getting a higher percentage of their spend. And looking forward, we believe we'll be able to continue to reduce the cost to serve that customer.

A new customer starts day one, so you have that headwind until we are able to earn more of their total household spend, and what we find is we're able to do that.

Simeon Ari Gutman

Analyst, Morgan Stanley & Co. LLC

Yeah, that's helpful. And my follow-up is on the 92% growth in the first quarter, did you say the mix or are you surprised by anything about the mix between delivery and pickup? And then anything you can share on how it impacted gross margins or margins broadly? It sounds like if you picked up a lot of new customers, it would be a pretty dilutive position for that lifetime of the customer, but anything you can share on it, please.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yeah. If you look, delivery was a higher growth than pickup, especially during the peak of the COVID cases. As areas have reopened and companies have reopened their offices and things like that, the growths are starting to get more similar. Gary, on the gross, I'll let you answer the gross and the changes there.

A

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Sure, yeah. Thanks for the question. I would say that the way that we see the digital customer behavior flow through in the P&L, it's not a meaningfully different mix in terms of overall pass-through in gross margin rates. Rodney's point earlier, generally we see customers increase their spend, the basket size increases, and the mix is pretty consistent. The area that would have impacted gross margin would have been more in the fact that we ran the fee waiver promotion. So that would have certainly been a headwind in the gross margin category.

Really where we see the bigger impact on digital is Rodney's earlier response around the incremental labor that's involved in picking the order. So, if you think about the pass-through rate that we might see on a traditional sale through the store, which we've talked about historically being in the 15% plus range, it would be significantly lower than that on the equivalent basis, because you've got the incremental labor associated with those sales. So, it would be more of an impact in the OG&A rate than it would be in gross margin when you think about the quarter.

Simeon Ari Gutman

Analyst, Morgan Stanley & Co. LLC

Okay. Thanks.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thanks.

A

Operator: The next question is from Edward Kelly with Wells Fargo. Please go ahead.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Yeah, hi, guys. Good morning.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Good morning.

A

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Just first a follow-up, and then a real question. As we think about Q2, could you just help us out what are you assuming for IDs in the quarter? What are you thinking about from a continued COVID cost perspective? And how do we think about gross margin relative to what we just saw in Q1?

Q

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Yeah, thanks for the question, Ed. There's couple of parts to that, obviously. I think in terms of sales, as we shared in our brief prepared comments on sales, we're obviously watching the trends very closely. Part of the challenge is it's very hard to know obviously exactly how we expect the customer behavior to return back to whatever a new normal becomes. We certainly expect as states have reopened, to start to see a gradual return to some level of lower food eaten at home, but we do think that's going to be more gradual than a specific stair step down.

A

We're starting to see some change in Q2, as we mentioned during the prepared comments, but it's not really sort of a specific step down. When states have reopened, it's much more of a gradual process as you start to see customers returning to some level of normal behavior. I would also say, it's not very consistent. It's not as though states that reopen first are seeing the bigger step down. It's relatively more tied to when states first experienced a major outbreak of COVID from what we can see, and also depending on how aggressive the spike in sales were in that market when the outbreak first happened, that's tending to more correlate with the gradual change in shopping behavior.

So we're watching it very closely. We are starting to see visit frequency pick-up a bit. We're seeing more the departments that might be more splurged, as I mentioned earlier, growing like deli, bakery, and specialty cheese and floral, but it really is a gradual process, and I think we still say it's too early at the moment, only a few weeks in, to know.

So we're expecting it to be a gradual step down from where we ended Q1, and the trend that we shared so far in Q2. And, obviously, we're watching it very closely and maintaining flexibility to make sure we're winning every dollar from a customer perspective around how we make sure we're continuing to grow market share and grow share of wallet.

From a gross margin perspective, obviously, we haven't gone into specific guidance around what we would expect to see there. We continue to invest in promotions, as Rodney shared, and we certainly expect that to become more and more normal as we go through the year now that the supply chain is starting to normalize. But there are still going to be some areas where it will be more difficult to promote, where there are still some overhangs of supply issues in certain categories.

On the COVID-related costs, if you think about breaking down the total OG&A expense in Q1, it's really three buckets I would kind of categorize it into. The first would be the COVID-specific costs around the \$830 million that we talked about, obviously, in the press release and the prepared comments. The majority of that was around rewarding our associates and making sure that they shared in the success of the quarter. And then there were also some costs associated with incremental labor for cleaning and PPE equipment. We'd certainly be expecting some of those costs to continue as we go through the year, with safety being the top priority.

We're also, obviously, investing labor in supporting our digital growth, and we'd expect that labor to continue as we continue to win that customer and make sure that we're winning their overall loyalty. And the third major cost in OG&A, obviously, was the pension contribution, which we wouldn't be expecting to repeat.

So I think it's really in OG&A, the cost that would flow through are going to be the safety and cleaning costs that we'd expect to continue to be investing in and the incremental labor associated with supporting digital growth going forward.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

One other comment, Ed, on the first part of your question, and it's hard to assign specific numbers and specific numbers just second quarter versus third quarter, fourth quarter, and even 2021. But when we talk to customers, our customers still tell us they plan to eat more meals at home than before. When talking to customers about when their children return to schools, we still have a significantly higher percentage of families telling us they plan to make breakfast for the kids to take to school and lunch for the kids to take to school. All of those things in terms of what customers are telling us, we would expect there'll be more meals eaten at home or prepared at home that, obviously, will help support growth as well.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Q

I understand the reluctance to really give ID guidance. But the only thing that I would say is that it does matter if it's mid-to-high single-digit EPS growth on a double-digit ID versus a single-digit ID from an investment perspective. So, to the extent that you can help out with that, that I think would matter to how people are looking at your story.

The other thing that I needed to ask about is the pension contribution, because I think people are getting kind of hung up here. The 200-plus million dollar contribution that you made this quarter, I believe that relates to that group of four MEPP plans that you essentially kind of control and take in-house. Is that right?

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

A

That's right. So think of it as it's a green status plan. It's over 80% funded, so there's not an obligation for us to make that payment. But, obviously, it's something that we're committed to making sure that long term, we're securing that future liquidity of the plan. And especially during time like this when there's market volatility, sometimes there could be pressure on those plans perhaps to liquidate assets to be able to make contributions, and we wanted to make sure that the plans were not put in that risk. So we decided to basically invest those dollars now to protect the future. And, obviously, over time, that will de-risk the need for us to have to invest, but it wasn't a requirement to make those payments.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Q

Okay. So it sounds like that's pretty funded at this point, so maybe we don't see that type of contribution going forward. The other plans that you have is you have a – you're obviously in the traditional MEPP, right, with other grocers, which is negotiated, and there's no real reason for you to make one-off contributions like this into those plans. Isn't that right?

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

A

That's correct. Yeah. The only way that we would approach those examples would be if we identified an opportunity to be able to pull away from the multi-employer plan and bring them into the same way that we run that UFCW plan, if it made sense for us to do that from an investor and associate perspective, because we could de-risk the future liabilities and be able to take more control of that potential exposure in the future. But we have no obligation on those unless we were to take that action like we did with the plan you described earlier.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Q

Right. And your defined benefit plan, the corporate one is frozen now, right?

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

A

That's right. Exactly. Yes, and that's fully funded.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Q

Okay. Great. Thank you.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thanks, Ed.

A

Operator: The next question is from Karen Short with Barclays. Please go ahead.

Karen Short

Analyst, Barclays Capital, Inc.

Hi. Just following up on that. Thanks for taking my question. So the actual – can you give us an update on what the actual liability is on the multi-employer pension in dollars pre-tax? And then, with this contribution that you just made, is there – do we adjust – and I know you haven't given the annual P&L and cash impact of the multi-employer pension contribution for many years. But are we think – like when we think about modeling it beginning 2Q, does that actual expense dollar amount come down based on the contribution you just made? And then I had a totally separate question.

Q

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Yeah. So it depends on which piece of the plan – just to clarify, Karen – you're talking about. So, as Ed mentioned a moment ago, we have multi-employer plans that we separated and we now manage internally. And as I mentioned earlier, they would be in the green status, so there'd be no obligation for us to be making those payments. But we're, obviously, looking to get them over time to a fully funded status and to minimize the risk to associates. So think about that as it's minimizing. If returns weren't where they needed to be, it minimizes the risk of us having to make contributions in the future and ensures those pension plans are in a strong position for our associates.

A

The multi-employer plans that we're a participant in, but we don't have a current obligation to fund beyond the annual contributions that we're making through our negotiated contracts with the unions, that would be an exposure as of the end of last year and as we reported in the 10-K, \$2.3 billion or \$1.8 billion after tax. And they're ones where over time, we would certainly look at if there are options to figure out different ways to structure our arrangements so that we can address those liabilities. But they would be very specifically defined and ring-fenced transactions that we would, obviously, share publicly in the future if we were to decide that was the right thing to do.

Karen Short

Analyst, Barclays Capital, Inc.

But as we think about the actual expense on the P&L beginning in 2Q – I know, again, you don't guide to that anymore, but how should we think about that?

Q

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Expense related to what, I'm sorry, Karen, I'm not sure I'm following.

A

Karen Short

Analyst, Barclays Capital, Inc.

Q

Well, the multi-employer expense.

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Yeah. So as I mentioned, we would have pension expense related to multi-employer plans that we pay into as part of the negotiated contracts with the unions. And, obviously, where we need to continue to fund the plan that's internal, we'll make those contributions when we need to. But, obviously, that can vary significantly. But most of the most of the, if I call it, pull forward maybe a potential liability in the future, it doesn't relate to what we would do in 2020.

Karen Short

Analyst, Barclays Capital, Inc.

Okay, got it. Thanks. And then just looking at digital, in terms of your overall digital, would you just be able to give us what your actual percent of sales in digital was in 1Q? And then, what the split was between, I guess, Click & Collect and third party, which I would say is mostly Instacart? And then the last question I had was just on your cash balance of the \$2 billion, just thoughts on that.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Well, if you look in terms of overall, digital would have been – I don't know – probably 6.5% or 7% of the total company. It would have been predominantly pickup versus delivery in terms of the mix, but the percentage growth was higher on delivery. And if you look at – the other thing on delivery, a lot is delivered directly to people's homes, either through FedEx or UPS, and that's basically – the similar number is what is delivered via Instacart and other services. On the other piece, Gary, I'll let you answer Karen's other...

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Yeah, thanks, Rodney. Sorry we were all looking to get the digital number for you there, Karen. Can you repeat the second part of the question?

Karen Short

Analyst, Barclays Capital, Inc.

Oh, just on the cash balance. I mean, you haven't had a cash balance like that for a while, so thoughts on where you're at in terms of deployment of that.

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Yeah. So, as I mentioned a little bit in the prepared remarks, certainly we're thrilled with the cash balance that we generated during the quarter. Part of that does reflect the improved operating performance; part of it was a significant improvement in working capital. We want to make sure that, obviously, we maintain maximum flexibility in the short term, just with some of the uncertainty that still exists in the market. And we also want to make sure we understand how much of the working capital benefit will continue, because we do believe we've made strong progress on working capital over the last really 12 months to 18 months as we continue to look at ways to free up cash flow.

But some elements of that will be inflated just because of the higher sales in the first quarter and the way our working capital cycle works. And some of it is also related to the CARES Act, where there's a delay in certain tax payments as part of the way that the CARES Act was structured. So we would expect, as a result of all of that, still to generate incremental free cash flow this year. As we go through the next couple of months, we're really going to focus on what do we think is the optimal way to use that cash flow consistent with our overall capital allocation strategy that we shared with you in our Investor Day in November.

So think about is we'll look at are there opportunities where we could continue to invest in the business to drive longer-term growth. We'll certainly be looking at are there any reasons to restructure any of the pension future MEPP liabilities that would allow us to take that potential liability and risk off the table longer term. And then, of course, we'll also be looking at how might we redeploy that cash to our shareholders consistent with our strategy of continuing to grow our dividend over time, but also looking at buybacks to shareholders as well.

Karen Short

Analyst, Barclays Capital, Inc.

Great. Thanks very much.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thanks, Karen.

A

Operator: The next question is from Judah Frommer with Crédit Suisse. Please go ahead.

Judah C. Frommer

Analyst, Credit Suisse Securities (USA) LLC

Yeah, hi. Thanks for taking my question. One a little bit more long term. You guys probably have some of the best data analytics on your customer base in the industry. So when Rodney mentioned kind of the habits of newer customers and specifically new e-com customers, right, how could you see the opportunity to further monetize or kind of gain further loyalty from new and existing customers kind of beyond the pandemic, right?

If you assume that people are going to eat a little bit more at home and that you have the ability to kind of incentivize your customers to do a little bit more than that, how does maybe next year look for you relative to where you may have thought it would be before the pandemic?

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yeah. We love the question and it's something that we're spending a ton of resources. We had as many new customers come to us in a couple of weeks as what we did all of last year, and we continue to have a lot of new customers. So, we're using all the things that we would normally do on welcoming new customers then, but doing it in a much more aggressive way.

Obviously, one of the things that we want to make sure is they have a great experience. So if you look at our supply chain team working with our merchants, we're getting the stores' inventories back up to pre-COVID levels, so the in-stock position improves; the continued focus on fresh; and continuing to even – fresh was a priority already, but making sure that the products that customers get stays fresh, and then with a friendly smile or an incredibly easy digital experience.

A

So your question, we love, it's the opportunity that we have in front of us. So far, we've been able to gain good market share during the pandemic. And, obviously, we're going to continue to focus on making sure we take care of those customers and keep them and continue to build their basket in terms of what they spend with us versus other places.

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Judah, the only thing I would add is that, to your point around data, we spent a lot of time looking at the data that we have, and also the data that's available in the marketplace over the last 20 years from whether it's government data and more broad market data, along with our own shopping information. And really looking at one of the scenarios around where we see the customer going over, to your point, not really the next sort of month or two, but the rest of the year and into next year and maybe even further out.

We do feel from everything that we see that we're putting ourselves in a strong position based on the investments that we're making as part of Restock Kroger to come out the other side of this in a stronger place. And everything that we see, while it's obviously no one knows and it's hard to predict, would say that based on less around maybe the pandemic, but just on generally when customers are in more of an economically challenged situation and combining that with these restrictions, we do think there'll be some level of a – I won't call it a permanent shift, but a multiple year shift to food eaten at home versus food away from home, and that's been very much the case in our data and the external data when you look at the last couple of recessions.

So our focus is very much on how do we make sure we're using personalization and tools and our strategy around creating value to really make sure that as we look out 12/18 months, we come out of this in a stronger position, both in customers consuming more food at home, but also Kroger's market share, so that it allows us to accelerate our overall long-term model around Restock Kroger, but also delivering shareholder value. And we feel very positive about the way in which we believe we can deliver that over the longer term. I think it's easier to look at the longer-term in some ways than it is probably for the next six months and how exactly the trends will play out.

Judah C. Frommer

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. That's helpful. And if I could just follow-up on kind of two items that maybe we could clean up a little bit. Just first, on the pension in terms of go-forward expense that's hitting the income statement, that hasn't changed at all. Just what's running through the income statement is what you require to contribute to those external net plans. Is that right?

And then second, for the gross margin in Q2, is there still a headwind from alternative profits being a little bit slower than they would be? And is there also some benefit from promotions not being fully back to where you'd expect them to be?

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

A

Sure. On the pension, yes, so the payment that we're making in Q2 is a discrete payment that we deliver – sorry, in Q1, I'm sorry, that we deliberately took the decision as we were in a strong position from a performance perspective and a cash flow perspective. We have no obligation to make that payment. It doesn't cause us to have to make payments later in the year or that we are obligated to some additional commitments later in the year.

It was very much a decision that we made to take advantage of the strong performance and essentially protect that future risk and make sure that our associates' pension plans are in a strong position. So, it's very much more of a forward-looking view of saying, let's make sure we're putting ourselves and putting our associates in a position where we're protecting the future when we have the opportunity to do so.

From a gross margin perspective, yeah, certainly, I think on the alternative profit side, I mentioned it earlier on the media business, we're seeing a tremendous pickup in growth. So, I wouldn't believe that we would see any headwinds from media. That's continuing to bounce back very strongly from a very temporary delay that we experienced in the first quarter, really during the lockdown period and as things were reset.

Kroger Personal Finance is the biggest element of alternative profit from a profit contribution perspective. And that is sort of more, I guess, dependent on some of the broader recovery in the market when you think about gift card sales, restaurants are an important part of that category, and when you think about credit card spend; those elements are all tied to continued improvement in the economic situation. So, while we are still able to tap into opportunity in KPF because we have low penetration of our customer base, we would expect that to continue to be a headwind in terms of impacting gross margin and performance for the year. But media, certainly, we wouldn't have that same view there.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. And we would expect to continue to do promotions. And one of the things when you look at the details behind first quarter, almost basically all the gross margin improvement was driven by leverages and marketing expense from the higher sales, warehouse and transportation and shrink. And our team had incredible strong quarter on shrink. So, it's really those leverage and we would expect continue to have some of those leverage benefits at the higher sales that we're expecting.

Judah C. Frommer

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Thank you.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

Thanks, Judah.

Operator: The next question is higher sales from Michael Lasser with UBS. Please go ahead.

Michael Lasser

Analyst, UBS

Q

Good morning. Thanks a lot for taking my question. Recognizing that it takes several years for a digital customer to become as profitable as an in-store customer, what will be the margin impact over the next three years if your digital penetration remains where it is today?

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. It's a great question and I can tell you, before COVID-19, our digital business had become a tailwind in terms of the incremental improvement from where it was before. And as we look forward, we would expect, as customers mature, that that would still be the case. And that's going to be a combination of customer spending – and I'm talking about it in total, not just the new customers by themselves.

In total, as that customer continues to give us more of their total share of spend for a household and as our teams continue to take costs out in terms of serving that customer, and as our Ocado sheds begin to come online and some of the other facilities to supply our customers, we would expect that digital will be a tailwind for us as we move forward, and it's really just the fact that the business basically doubled overnight.

Michael Lasser

Analyst, UBS

Q

And you mentioned that you're building all different types of Ocado sheds. The first ones are large ones in different parts of the country. What has the learnings from this experience influenced – how does it influence the sheds that you're going to create moving forward?

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

It's really – if you look, as we've been working on in total, and Ocado has done a lot of work to be able to get the economics viable for a smaller shed, over time that will allow us to go into smaller markets with sheds as well. So it's part of the overall supply chain design, and it's playing out as we expected, and Ocado is continuing to up their game as well. So, it's really the experience we're looking forward to Ocado's sheds opening up in Canada and France, and that will provide an additional set of learnings as well.

Michael Lasser

Analyst, UBS

Q

And if I could add one last one. I know this is hard to tease out from the data, but you have a lot of really good information. How have you been able to discern about different meal occasions that are now being eaten at home? So as consumers return to work and eat more of their meals at restaurants around where they work, to what degree is that going to result in the slowdown in the IDs that you're experiencing? Similarly, maybe you can tease out how soups and salads are doing versus something you might eat at dinner, where dinner could also slow as we go [indiscernible] (01:06:22).

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

A

Yeah. Overall, we're still seeing people shop at fewer stores and, as Gary mentioned, a large spend per basket. If you look at the department that's probably the easiest directly to talk about is our deli department. And our deli department, the trends over the last four or five weeks have been significantly improved from where it was in the height of the lockdowns. We would expect a lot of those meals are things where people are preparing at home and taking to work. Our customers tell us they're still minimizing the different places they go and minimizing their exposure, so that's something that we want to make sure that we're there for the customer.

Michael Lasser

Analyst, UBS

Q

Thank you very much, and good luck.

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

Thank you.

A

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Appreciate it.

A

Operator: The next question is from Greg Badishkanian with Wolfe Research. Please go ahead.

Q

Good morning. This is [ph] Spencer (01:07:28) on for Greg. I understand that the situation still remains pretty fluid. But can you just provide some additional color on what you think the new normal looks like for food retail? And do you think COVID has accelerated a structural shift towards sort of eating at home channel?

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yeah. First of all, if you look at things that we think, for sure, is the digital channel and people eating via that accelerated the trends that were already on. If you look at like our Home Chef business, they had an incredible quarter with picking up new customers as well. The thing that I get most hopeful about is when we talk to customers, customers tell us they like eating at home as a family and eating together and having meals together at home.

And one of our responsibility is to help them keep it fresh and innovative and new ideas, and we continue to work on that. But everything that we can see the customer likes that, and they like learning how to cook and cook as a family. So, that trend is something that we focus on a lot and try to make sure we're supportive of it.

Q

That's helpful. And then, we've seen promotions tick down across the industry throughout this crisis. Has COVID changed your philosophy on price investments at all? And then, would you expect an accelerations in promotions in the back half of the year?

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yeah. One of the things that I'm super proud of our teams is we've had an ad and promoted every week during the pandemic to try to help our customers' budget go as far as possible. The only change that we made was we stopped doing buy 10 for 10s, and things like that that incentivized multiple purchases on items that were in short supply, because we wanted to support as many customers as possible getting those.

We would continue to use our data to understand what's important to the customer. And some customers are in different financial situations, whether they lost their jobs or they were able to work from home. And we're supporting both of those customer segments with promotions, loyalty mailings, and other offers that are 1:1 in addition to what you can see in an ad. And we think that's an important component to continue to support.

A

Gary Millerchip

Chief Financial Officer & Senior Vice President, The Kroger Co.

I think the only other thing I would add, Rodney, is we mentioned earlier around the pickup fee being an investment in price with the promotion there. But also, we did adapt our plan around making sure we're giving value to customers where product was more available. And so, the team did a really nice job in promoting on HBC and general merchandise products.

And while it's very true to say that grocery and fresh led the way, we saw significant double-digit growth in both of those categories. And would have seen some lower gross margin in those two categories, because we were more promotional in making sure that as being a business that was open through the pandemic, that we were delivering value for customers. I think that's been a – the team did a really nice job of making sure we were creating value there and delivering value there.

Great. Thank you so much.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thank you.

Operator: The next question is from Ken Goldman with JPMorgan. Please go ahead.

Ken Goldman

Analyst, JPMorgan Securities LLC

Hi. I'll just ask one, because I know we're late. You talked about some of the trends in states that reopened first. Maybe too early, but what are you seeing in states where there are headlines about a second wave or cases increasing? Have you seen any upticks there or, again, is it just too early to say for sure?

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

I think it's too early to tell for sure. And those were states where people were more comfortable going out anyway, even during lockdowns. So, it's really early, but we're really not seeing massive shift changes.

Ken Goldman

Analyst, JPMorgan Securities LLC

Thank you.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thanks, Ken. One last question.

Operator: And that question comes from Michael Montani with Evercore ISI. Please, go ahead. And that question is from Michael Montani with Evercore ISI. Please, go ahead.

Michael David Montani

Analyst, Evercore ISI

Hello? Just want to see if – can you hear me?

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yes.

A

Michael David Montani

Analyst, Evercore ISI

Okay, great. Sorry about that. So the question I have is two parts. The first was on traffic and ticket. I know you don't typically disclose that, but if you could give some incremental color around 19% ID sales on that line?

Q

And then secondly related to that was just, if there's a sense of what percentage of that comp is being generated by existing loyal households versus the new households. Obviously, you had mentioned, Rodney, there was some strong growth in new customer acquisition.

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yeah. If you look at – on the ticket growth, we had significant double-digit increases in the average basket size, and we're finding that customers are going into the store less frequently. And so, well over 100% of the growth is driven by basket size. If you look at new customers and existing customers, it's a meaningful number, but it's maybe a fourth or a third of the total when you look at all the pieces, because we also have a lot of new customers to pick up and where we launched where customers can pay SNAP at pickup and things like that, new customers there as well.

A

Michael David Montani

Analyst, Evercore ISI

Okay. And then, I guess, the other one I had was a lot of the questions I've been getting relate to how you all would be positioned to cycle this kind of comp in a year from now. And so, I was just wondering if you could provide some incremental color around the Ocado partnership. And, I guess, in particular, as it relates to some of the c-store fulfillments and also like center store potential efficiencies that you could gain and reinvest back into competitive positioning.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Yeah. That's a question, obviously, we're spending a lot of time internally talking through and trying to understand as well. The thing that – Gary talked about it a little bit, but if you look at – we would expect 2021 to be better than what the trend would have been for 2021 before COVID. And Gary mentioned that briefly in answering one of the other question. So, everything that we can see, we believe there are certainly meaningful shifts in the way people eat. I won't say permanent, but certainly multiyear. And we would expect 2021 to be better than what 2021 would have been before COVID.

A

To give more specifics than that, I think it's hard to say. As we get to next year, one of the things that we would expect is, certainly, in-stock positions will be better, which will be helpful, but people will be going back to a normal life more so as well. So, we are going to do everything we can to make sure we're taking care of the

customers we have and getting more of their share in the new customers. And the easiest point of context is just we would expect 2021 to be better than what 2021 would have been pre-COVID.

Michael David Montani

Analyst, Evercore ISI

Okay.

Q

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

Thanks, Michael. Appreciate it.

A

W. Rodney McMullen

Chairman & Chief Executive Officer, The Kroger Co.

I think the last question was a great question to end on. If you look at Restock Kroger and the work from Restock Kroger, certainly positioned The Kroger well to build deal, and we had good growth before COVID, and COVID certainly accelerated the infrastructure and foundations we had in place. And as we look to 2021, we would expect that to be better than what it was before COVID.

The other comment that I want to make is, as you know, we always like to share a few final comments directed toward our associates and how we live our purpose every day. The senseless killings of George Floyd, Ahmaud Arbery, Breonna Taylor, and so many more, too many more across our country, have shaken me to the core. We share in everyone's feelings of sadness and outrage for the victims and their families.

I am compelled to use Kroger's voice to express that we're against racism and the injustice towards the black community. To become a greater part of the solution, we believe the most important next step is to listen. Recently I was proud to be invited by Dr. Bernice King of The King Center to listen, learn, and participate in open dialogue about how companies like ours can drive real, tangible change. We also held the first of several listening sessions to hear directly from our associates about how we can better support them.

Informed by deliberate listening, we intend to take more action. As the first step, our company is establishing a \$5 million fund to support the advancement of racial equality and justice. This new investment will be earmarked within the Kroger Foundation for improving diversity, equity, and inclusion. We know there's more work to be done, and we will continue to share our progress.

Thank you for all you have done and will do for each other and our customers and communities. And to all on the call, thank you for joining our call today. Thank you very much.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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