Consumer Staples
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COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

The Kroger Co.

KR — NYSE — Long-term Buy-3

Fiscal 1Q Review; Lowering Estimates and Price Target, But Stock Appears Attractive Here

Key Metrics

KR - NYSE (as of 6/15/17)		$24.56
Intra-day Price (6/16/17)		$21.45
Two Year Price Target		$30.00
52-Week Range		$24.37 - $37.97
Shares Outstanding (mil.) (basic)		914
Market Cap. ($ mil.)		$22,448
3-Mo. Average Daily Volume		9,804,189
Institutional Ownership		80%
Total Debt/Total Capital (5/17)		69%
ROE (TTM ended 5/17)		29%
Book Value/Share (5/17)		$6.71
Price/Book Value		3.7x
Annual Dividend & Yield	$0.48	2.0%
EBITDA Margin (TTM ended 5/17)		4.9%

EPS FY 1/31 (excludes nonrecurring items)

	2016	Prior 2017E	Curr. 2017E ~		Prior 2018E	Curr. 2018E
1Q	$0.71		$0.58	A		
2Q	$0.47	$0.49	$0.37			
3Q	$0.41	$0.50	$0.41			
4Q	$0.53	$0.66	$0.59			
Year	$2.12	$2.22	$1.95		$2.35	$2.05
P/E	11.6x		12.6x			12.0x

Note: The fiscal year ends on the Saturday closest to January 31 of the following year.
Note: P/E multiples are based on 6/15/17 closing price.
Note: Quarterly EPS figures may not add to annual figure due to rounding.
~ Represents a 53-week fiscal year.

Revenue ($ mil)

	2016	Prior 2017E	Curr. 2017E ~		Prior 2018E	Curr. 2018E
1Q	$34,604		$36,285	A		
2Q	$26,565	$27,600	$27,350			
3Q	$26,557	$27,800	$27,265			
4Q	$27,611	$30,800	$30,600			
Year	$115,337	$122,200	$121,500		$125,250	$123,500

Company Description: *The Kroger Co. is the nation's largest traditional grocery retailer. The company recently operated 2,792 retail food stores and multi-department stores in 35 states and the District of Columbia under roughly two dozen names. The company also recently operated 2,255 pharmacies, 782 convenience stores, 311 fine jewelry stores, 1,453 supermarket fuel centers, and 38 food processing plants in the U.S. The company has over 443,000 employees and is headquartered in Cincinnati, OH.*

Investment Highlights

- **1Q results reflected industry challenges, including a tougher competitive environment.** Total sales for the quarter (5/20/17 period end) rose 4.9% to $36.2 billion, slightly above expectations. Merchandise costs and operating expenses both rose faster than sales, leading to lower earnings. Diluted earnings per share of $0.58 were below the year ago level of $0.71 but matched the consensus street expectation.
- **The grocery industry is changing.** Several operators have announced greater expansion plans, while some have become more aggressive on price and service. Changing industry dynamics include what consumers want to eat (such as more prepared meals) and how they want to shop (more online ordering). We have been impressed by management's operating acumen over the years and the company's strong market share positions. We feel the company will have to spend more to achieve success similar to historical levels. Investing in operations and remaining competitive on price could put pressure on margins, however.
- **Management lowered its current year outlook more than we expected.** Changes include an approximate $0.20 reduction to estimated EPS in 2017 due to the aforementioned challenges. We have lowered our 2017 and 2018 earnings outlooks.
- **We maintain our LT Buy rating but are reducing our price target due to a lowered earnings forecast.** Also, we are lowering our Suitability rating from 2 to 3 to reflect a heightened competitive environment. Share price weakness yesterday (20% drop) in reaction to 1Q results and the industry outlook was excessive, in our view. We believe a buying opportunity exists for patient, longer term investors. Given the industry environment, we believe a two-year investment time frame is prudent. Our price target is lowered by $8 to $30 per share, and assumes a future valuation slightly above the current level.

**Note Important Disclosures on Pages 8-9.
Note Analyst Certification on Page 8.**

Exhibit 1
Consolidated Statements of Operations (figures in millions except percentages and per share data)

	1Q Ended		
	5/20/17	5/21/16	% chg.
Total Sales	$36,285	$34,604	4.9%
Merchandise Costs *	28,281	26,669	6.0%
LIFO Gross Profit	8,004	7,935	0.9%
Oper., Gen., & Admin. Exp. **	6,133	5,779	6.1%
Rent	270	262	3.1%
Deprec. & Amort.	736	694	6.1%
Operating Expenses	7,139	6,735	6.0%
Operating Profit	865	1,200	(27.9%)
Interest Expense	177	155	14.2%
Earnings Before Taxes	688	1,045	(34.2%)
Taxes	148	350	(57.7%)
Net Earnings	540	695	(22.3%)
Net Earnings Attributable to Noncontrolling Interests	(6)	(1)	
Net Earnings Attrib. to Kroger	$546	$696	(21.6%)
Diluted EPS	**$0.58**	**$0.71**	(18.3%)
Avg. Diluted Shares Outst.	925	966	(4.2%)
As a % of Total Sales:			**bp. chg.**
Merchandise Costs	77.94%	77.07%	87
Gross Profit (LIFO basis)	22.06%	22.93%	(87)
Gross Profit (FIFO basis) ***	22.13%	22.97%	(85)
Oper., Gen., & Admin. Exp. **	16.90%	16.70%	20
Rent	0.74%	0.76%	(1)
Deprec. & Amort.	2.03%	2.01%	2
Operating Expenses	19.67%	19.46%	21
Operating Profit	2.38%	3.47%	(108)
Net Earnings Attrib. to Kroger	1.50%	2.01%	(51)
Tax Rate	21.51%	33.49%	(1,198)

* Merchandise Costs include advertising, warehousing and transportation expenses as well as LIFO (last in, first out) charges.
** Excludes certain non-recurring expenses related to retirement benefits
*** FIFO (first in, first out) gross margin excludes LIFO charges, which occur more often in times of rising product cost inflation.
*** FIFO gross margin is a common analytical measure for management and the investment community.

Source: Company reports Note: Fiscal year ends on Saturday closest to January 31 of the following year

Comments on fiscal 1Q. Kroger's fiscal 1Q reflected a challenging industry environment that included a heightened competitive environment in certain regions, shifts in consumer behavior, and lingering effects of deflation.

Among the 1Q highlights:

- Total reported sales in 1Q rose 4.9%. Sales excluding fuel increased 2.9% (fuel sales were up due to higher average fuel prices). The September 2016 acquisition of ModernHEALTH (specialty pharmacy services) contributed to overall growth.
- A 0.2% decline in identical food store sales for 1Q was better than the 0.7% decline in 4Q 2016, which ended a 52-quarter streak of gains in this metric.

- Overall tonnage was positive for the quarter. The number of loyal households was up 3.2%, while the number of visits per household was flat. Kroger's total market share was up in the quarter.
- The private label, natural, and organic segments continued to perform well. Kroger's wholly owned brands represented 28% of total units sold in 1Q.
- 1Q marked the tenth consecutive quarter of either declining rates of inflation or realization of deflation, though we believe food costs continue to strengthen and could move from headwind to tailwind status by 2H of this year.
- Digital initiatives continued to grow in the quarter. Examples include Kroger's *ClickList* and Harris Teeter's *Express Lane* (online ordering systems featuring curb-side pick-up by customers), as well as Vitacost.com (e-commerce business focusing on health-related products). During 1Q, the number of new digital customers grew more than 30% and digital revenues more than doubled.
- Fuel margins rose due to a higher average retail price per gallon.
- Reported gross margin declined 87 basis points from the prior year period. Excluding fuel operations, recent mergers, and a LIFO charge, FIFO gross margin declined 45 basis points from a year ago.
- Operating expenses, excluding fuel, mergers, and pension contributions, increased 27 basis points as a percent of total sales.
- Diluted earnings per share of $0.58 were down from a notably strong performance a year ago when EPS came in at $0.71. The $0.58 matched street consensus and exceeded our estimate by a penny.
- Share repurchases in recent quarters ($1.5 billion over the past year) led to a 4.2% drop in the 1Q weighted average share count, which helped EPS a bit.

Financial. Total debt at 1Q end was $13.444 billion. This represents senior notes, debentures, capital lease obligations, and other smaller pieces of debt. Total debt as a percentage of total capital (debt plus shareholders' equity) was 69%. Total cash and equivalents were $335 million while shareholders' equity was $6.135 billion. Kroger has historically maintained a leveraged balance sheet that is comfortably supported by cash flow, in our view. At the end of 1Q, net debt-to-trailing adjusted EBITDA (earnings before interest, taxes, depreciation & amortization) was 2.33x compared to 2.12x a year ago. The increase reflects the acquisition of ModernHEALTH in September 2016 and share repurchase activity.

Cash flow remains at a considerable level, in our view, allowing for several practical uses. Over the past twelve months, the company has spent $1.5 billion on stock buybacks, $438 million in dividends, $3.4 billion on capital projects, and $390 million to acquire ModernHEALTH.

Dividends. Dividends were initiated in 2006 and have been raised every year since. We expect this trend to continue, with rate increases announced around June of each year. In June 2016, the company increased its quarterly dividend rate by 14.3%. The current annual rate of $0.48 per share equates to a yield of 2.0%. We expect a rate increase to be announced later this month. Due to the current earnings pressure, we would expect a potential increase to be at a single-digit percentage rate.

Labor. Although Kroger's highly unionized labor force is occasionally scrutinized, we note there have not been any major work stoppages at the company since 2003. Negotiations are currently in progress with associates in the Atlanta, Dallas, and Southern California markets. The overriding objective in negotiations is to find a "fair and reasonable" balance between competitive costs and compensation packages.

Outlook. Although the grocery industry is known for its ongoing competitive nature, we believe the environment has intensified recently in terms of new entrants, improved shopping experiences from existing competitors, lower prices from several operators, and convenient new services such as online shopping (with home delivery or in-store pick-up).

Stronger competitive efforts include those from common adversaries such as Wal-mart, no-frills operators such as Aldi, and newer, online competitors such as Amazon. Today's announcement from Amazon that it has reached an agreement to acquire grocery operator Whole Foods Market for $13.7 billion is further evidence of a dynamic industry that is attracting more entrants and exploring more ways to connect with and satisfy customers. Clearly, the competitive environment is not likely to subside any time soon, in our view. This is a major factor in our lowered margin assumptions, earnings estimates, and price target (discussed later) for KR.

Management continues to run the business with the long term in mind rather than make sacrifices to temporarily boost sales or lower expenses. Defending its strong market share position remains a priority. Competition has picked up considerably, yet CEO Rodney McMullen stated Kroger "will not lose on price." Recent strategic moves such as increasing labor hours in the store and increasing wages in certain markets are likely to result in noticeable increases in operating expense, but should improve the quality of the work force and enhance the shopping experience, in our view.

Investments in the business, strategic acquisitions to expand products or services (such as Murray's Cheese in-store shops and ModernHEALTH specialty pharmacy services), and use of technology and digital capabilities are other examples of "customer first" initiatives, in our view. We believe managing the business with a long-term focus that benefits customers, shareholders, and employees is prudent. This is frequently mentioned by Kroger management as it navigates numerous short-term challenges at hand.

Goals of the company continue to be: an investment grade debt rating (most debt currently rated BBB by S&P), improving return on invested capital, annual EPS growth of 8%-11% over rolling three to five year time horizons, and dividend growth. The investment grade ratings take pension obligations into consideration, and Kroger has recently borrowed to meet some obligations. We will continue to monitor the company's pension obligations and the impact they could have on free cash flow or borrowing activity.

Guidance. In a move that disappointed the investment community, management lowered 2017 guidance to reflect the operating environment at hand. We feel the company's views on sales were satisfactory, all things considered, but the lowered earnings guidance was perhaps an indication that changes in customer behavior and stiffer competition are requiring greater investments in the business.

For the current year, EPS excluding nonrecurring items (primarily pension-related charges) are now expected in the range of $2.00-$2.05, down from $2.21-$2.25 previously. This includes an approximate $0.09 benefit from a 53rd week in the fiscal year, which ends on the Saturday nearest January 31 of each year. This compares to EPS of $2.12 in 2016 year (a 52-week period). Management expects identical food store sales for the year to be flat to up 1%, unchanged from prior guidance. We project net sales this fiscal year to rise 5.3% to $121.5 billion. We have lowered our gross margin and operating margin assumptions to reflect the issues at hand. This leads to our diluted EPS estimate of $1.95, below the low end of management's guided range and down from our previous figure of $2.22. We believe share buybacks will occur throughout the year, especially in the near-term considering the current stock price.

For fiscal 2018, we note a reversion to a 52-week year from the 53-week year in fiscal 2017. We have updated our fiscal 2018 estimates, which include net sales growth of 1.6% to $123.5 billion and diluted EPS of $2.05. We assume continued margin pressure due to current factors extending into the fiscal 2018 year. We expect share repurchases to continue.

Valuation. Based on the 6/15/17 closing price, KR shares are trading at 12.6x our fiscal 2017 estimate and 12.0x times our 2018 estimate. One year ago, when the industry environment was more favorable, KR traded at 15.3x our fiscal 2016 earnings estimate. Over the past ten years, the shares have traded in a range of roughly 9x to 22x projected forward earnings with a median forward multiple of 13.5x. On a shorter term basis, the stock's median forward multiple over the past five years is 15.0x. On a longer term basis, the median forward multiple over the past twenty years is 13.8x.

KR's forward P/E multiple is currently 0.6x the S&P 500's forward multiple, below premium levels from late 2014 through early 2016, and below the median figure of 0.8x over the past ten years.

On an Enterprise Value/EBITDA basis, KR shares are trading at 6.3x our projection of fiscal 2107 EBITDA. We believe a ten year historical range for this measure is 5-9 times.

Opinion. Being mindful of the industry conditions at hand—such as competition and changes in consumer habits and preferences—we believe Kroger is performing reasonably well. We consider the company to be digging in its heels and preparing for battle in a competitive sense, while devoting considerable resources to meet customers' wants and needs in a dynamic period for the grocery industry. We believe the company has emerged from the recent deflationary environment as a stronger, more efficient company due to general belt-tightening. We have favorable views on the company's pursuit of growth opportunities through acquisitions, the digital/online area, store renovations and expansions, and continued improvements to the Roundy's store bases in Wisconsin and Illinois (acquired in late 2015). We expect shareholder friendly uses of discretionary cash flow such as dividend payments/increases and share buybacks to continue in the years ahead.

The current multiple of 12.6x our fiscal 2017 earnings estimate is appealing to us, although we are mindful of the challenges at hand. We expect EPS growth in the next few years to be below management's 8%-11% compounded annual long-term targeted range, but revert to the lower end of this range in subsequent years as conditions are more favorable and as new business models require less investment and become more profitable. We do not assume a compounded annual growth rate at the upper end of the targeted range in any future multi-year period.

We recommend purchase of KR and reiterate our preference for a two-year investment time frame rather than one year. We believe this longer time frame should allow the company to navigate and emerge from the challenges at hand, and maintain strengths such as industry leadership, management acumen, pursuit of and integration of technology, and focus on shareholder value.

Although current challenges such as price competition and higher operating expenses are curtailing near-term earnings growth, we consider Kroger today to be stronger, larger, and having more growth opportunities (some by acquisition) compared to the past decade. Considering all factors, including the trend of stiffer competition, we believe KR shares deserve to trade below recent higher valuation levels but we feel the current level is too bearish.

Our two-year target is $30 per share, a decline of $8 from our previous figure. The lower target is a function of our reduced earnings outlook and a lower valuation assumption, which result from factors such as the changing competitive landscape, some additional risks associated with new business initiatives, and an assumed higher cost structure. Our target is based on our projection of forward earnings two years from now applied to a 13.0x multiple, which is deservedly below the five-year median multiple of 15.0x, and below KR's ten and twenty year median figures (time periods that capture a greater variety of economic and operating environments). Additionally, our target represents an Enterprise Value/EBITDA multiple of 6.4x based on our projection of forward EBITDA one year from now, similar to the current valuation based on projected forward EBITDA.

Suitability. We are changing our Suitability rating on KR shares from 2 to 3. This reflects a considerably increased competitive environment (current and projected, especially in light of the planned Amazon/Whole Foods deal) and uncertainty regarding the potential duration of such an environment. We also consider Kroger's degree of unionized labor and its debt level in determining suitability. Favorable factors include the company's large sales base, diversity among geographic regions and store concepts/banners, strong market share positions, favorable historical operating results, and large market capitalization.

Risks and Considerations. The competitive environment is a key risk factor, in our view. The industry has always been quite competitive, but recent developments include new entrants to the industry and new ways of connecting with customers. This includes online sales, with either in-store pick-up or home delivery. We believe the recent announcement of Amazon's planned purchase of Whole Foods Market is a testament to the heightened competitive landscape yet also the attractiveness of the industry.

We believe another risk factor with Kroger is its labor profile. A majority of the company's approximate 443,000 employees are covered by collective bargaining agreements negotiated with local unions affiliated with one of several international unions. There are approximately 300 such agreements currently in place, typically with terms of three to five years. Thus, the company has numerous labor agreements that come up for negotiation each year. Common key issues are health care and pension costs. Potential work stoppages could have an adverse effect on operating results.

Other factors that could affect operations include the success of future growth plans, capital spending decisions, completion and integration of acquired businesses, strategic investments, food prices (including periods of sustained deflation and inflation), overall commodity prices, promotional industry environments, industry consolidation, fuel prices, consumer spending, unemployment levels, adverse weather conditions, and the state of financial markets (access to capital).

Exhibit 2

Consolidated Statements of Operations (figures in millions except percentages and per share data)

	FY18E	% chg.	FY17E ~	% chg.	FY16	% chg.	FY15	% chg.
Total Sales	$123,500	1.6%	$121,500	5.3%	$115,337	5.0%	$109,830	1.3%
Merchandise Costs *	96,600	1.8%	94,900	6.0%	89,502	4.7%	85,496	(0.0%)
LIFO Gross Profit	26,900	1.1%	26,600	3.0%	25,835	6.2%	24,334	6.0%
Oper., Gen., & Admin. Exp.	20,210	1.1%	20,000	4.3%	19,178	6.9%	17,946	4.6%
Rent	913	1.4%	900	2.2%	881	21.9%	723	2.3%
Deprec. & Amort.	2,540	2.6%	2,475	5.8%	2,340	12.0%	2,089	7.2%
Operating Expenses	23,663	1.2%	23,375	4.4%	22,399	7.9%	20,758	4.8%
Operating Profit	3,237	0.4%	3,225	(6.1%)	3,436	(3.9%)	3,576	14.0%
Interest Expense	523	(3.1%)	540	3.4%	522	8.3%	482	(1.2%)
Earnings Before Taxes	2,714	1.1%	2,685	(7.9%)	2,914	(5.8%)	3,094	16.8%
Taxes	936	1.1%	926	(3.2%)	957	(8.4%)	1,045	15.9%
Net Earnings	1,778	1.1%	1,759	(10.1%)	1,957	(4.5%)	2,049	17.3%
Net Earnings Attributable to Noncontrolling Interests	(20)		(15)		(18)		10	
Net Earnings Attrib. to KR	$1,798	1.4%	$1,774	(10.2%)	$1,975	(3.1%)	$2,039	18.0%
Adjusted EPS, Excluding Nonrecurring Items	**$2.05**	5.4%	**$1.95**	(8.1%)	**$2.12**	2.9%	**$2.06**	17.0%
Avg. Diluted Shares Outst.	875	(3.8%)	910	(5.0%)	958	(2.2%)	980	(1.3%)
As a % of Total Sales:		bp. chg.		bp. chg.		bp. chg.		bp. chg.
Merchandise Costs	78.22%	11	78.11%	51	77.60%	(24)	77.84%	(99)
Gross Profit (LIFO basis)	21.78%	(11)	21.89%	(51)	22.40%	24	22.16%	99
Gross Profit (FIFO basis) **	21.82%	(14)	21.96%	(46)	22.42%	23	22.18%	88
Oper., Gen., & Admin. Exp.	16.36%	(10)	16.46%	(17)	16.63%	29	16.34%	52
Rent	0.74%	(0)	0.74%	(2)	0.76%	11	0.66%	1
Deprec. & Amort.	2.06%	2	2.04%	1	2.03%	13	1.90%	11
Operating Expenses	19.16%	(8)	19.24%	(18)	19.42%	52	18.90%	63
Operating Profit	2.62%	(3)	2.65%	(32)	2.98%	(28)	3.26%	36
Net Earnings Attrib. to KR	1.46%	(0)	1.46%	(25)	1.71%	(14)	1.86%	26
Tax Rate	34.50%	0	34.50%	166	32.84%	(93)	33.78%	(28)

~ 53-week fiscal year

* Merchandise Costs include advertising, warehousing and transportation expenses as well as LIFO (last in, first out) charges.

** FIFO (first-in, first-out) gross margin excludes LIFO charges (occur more often in times of rising product cost inflation) and credits.

** FIFO gross margin is a common analytical measure for management and the investment community.

Source: Company reports and Hilliard Lyons estimates Note: Fiscal year ends on Saturday closest to January 31of the following yea

Additional information is available upon request.

Prices of other stocks mentioned: Wal-mart Stores Inc. - WMT - $78.91
Amazon.com Inc. - AMZN - $964.17
Whole Foods Market - WFM - $33.06

Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings

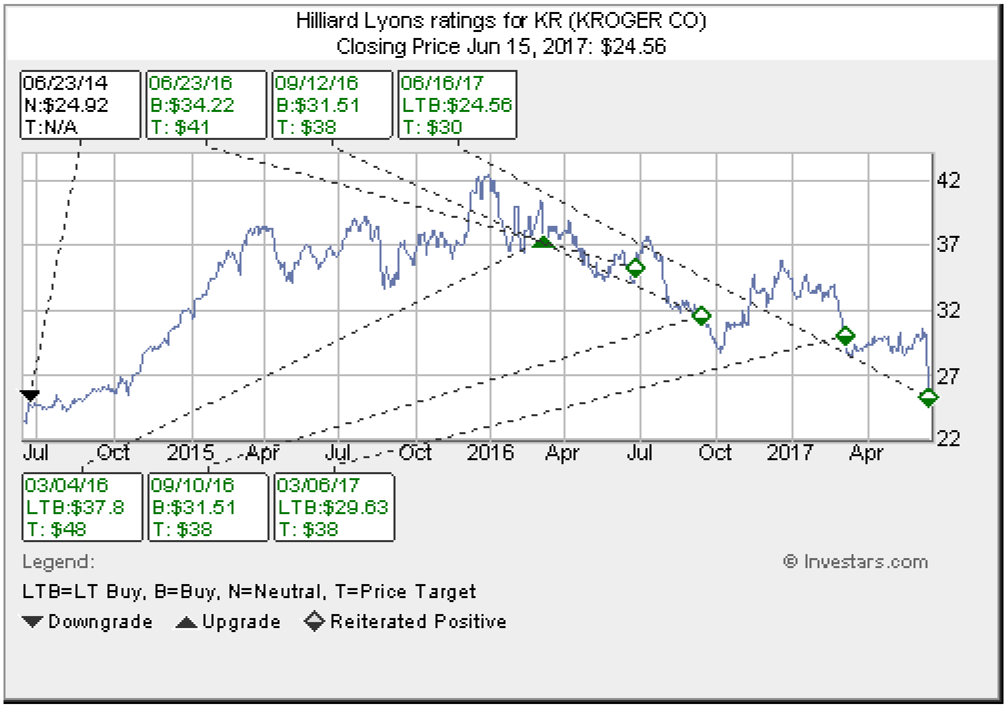
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	34	27%	12%	88%
Hold/Neutral	80	65%	8%	93%
Sell	10	8%	0%	100%

As of 7 June 2017



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

Other Disclosures

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