Consumer Staples
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COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE / RATING CHANGE

Key Metrics

KR - NYSE (as of 3/3/17)		$29.63
Two Year Price Target		$38.00
52-Week Range		$28.71 - $39.22
Shares Outstanding (mil.) (basic)		929
Market Cap. ($ mil.)		$27,526
3-Mo. Average Daily Volume		11,178,177
Institutional Ownership		77%
Total Debt/Total Capital (1/17)		68%
ROE (TTM ended 1/17)		30%
Book Value/Share (1/17)		$7.22
Price/Book Value		4.1x
Annual Dividend & Yield	$0.48	1.6%
EBITDA Margin (TTM ended 1/17)		5.1%

EPS FY 1/31 (excludes nonrecurring items)

	2016	Prior 2017E	Curr. 2017E ~	Prior 2018E	Curr. 2018E
1Q	$0.70		$0.57		
2Q	$0.47		$0.49		
3Q	$0.41		$0.50		
4Q	$0.53		$0.66		
Year	$2.12	$2.25	$2.22		$2.35
P/E	14.0x		13.3x		12.6x

Note: The fiscal year ends on the Saturday closest to January 31 of the following year.
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		$36,000		
2Q	$26,565		$27,600		
3Q	$26,557		$27,800		
4Q	$27,611		$30,800		
Year	$115,337	$120,400	$122,200		$125,250

Company Description: *The Kroger Co. is the nation's largest traditional grocery retailer. The company recently operated 2,796 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, 784 convenience stores, 319 fine jewelry stores, 1,445 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.*

The Kroger Co.

KR — NYSE — Long-term Buy-2

Decent 4Q Results, But Environment Becoming More Challenging; Moving to LT Buy

Investment Highlights

- **4Q results reflected industry challenges, mainly deflation and tougher competition.** Total sales for the quarter (1/28/17 period end) rose 5.5%, slightly above expectations. Food price deflation in certain grocery segments continued to put pressure on the top line, as it has for the past year or so. Identical food store sales declined 0.7%, ending a 52-quarter streak of positive figures. Diluted EPS of $0.53 was below the year ago level of $0.57, but a penny above the street consensus figure and our estimate.

- **The competition seems to be stepping up their game, in our view.** Management noted some customers are operating better stores, making price reductions, and offering generally better shopping experiences**.** We have been impressed with Kroger's market share positions over the long term, and feel the company can defend its share. However, related pricing strategies and store-level expenses could put pressure on profit margins, in our view.

- **We have updated our financial model.** Changes include a $0.03 reduction to our 2017 EPS estimate, based mostly on potential margin pressure. Our sales estimate is increased to better reflect an extra week in the fiscal year (in 4Q). We have also initiated estimates for 2018.

- **We are changing our rating to Long-term Buy from Buy due to an industry environment that has become more challenging in recent months.** Share price weakness has resulted in a lower valuation and an attractive entry point, in our view. However, given the industry environment, we believe a two-year investment time frame is more prudent. Our price target of $38 assumes a future valuation slightly above the current level. Annualized total return potential based on the current price is about 15%.

Note Important Disclosures on Pages 7-8.
Note Analyst Certification on Page 7.

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

	4Q Ended			Year Ended		
	1/28/17	1/30/16	% chg.	1/28/17	1/30/16	% chg.
Total Sales	$27,611	$26,165	5.5%	$115,337	$109,830	5.0%
Merchandise Costs *	21,483	20,193	6.4%	89,502	85,496	4.7%
LIFO Gross Profit	6,128	5,972	2.6%	25,835	24,334	6.2%
Oper., Gen., & Admin. Exp.	4,483	4,355	2.9%	19,178	17,946	6.9%
Rent	215	181	18.8%	881	723	21.9%
Deprec. & Amort.	572	508	12.6%	2,340	2,089	12.0%
Operating Expenses	5,270	5,044	4.5%	22,399	20,758	7.9%
Operating Profit	858	928	(7.5%)	3,436	3,576	(3.9%)
Interest Expense	126	113	11.5%	522	482	8.3%
Earnings Before Taxes	732	815	(10.2%)	2,914	3,094	(5.8%)
Taxes	230	250	(8.0%)	957	1,045	(8.4%)
Net Earnings	502	565	(11.2%)	1,957	2,049	(4.5%)
Net Earnings Attributable to Noncontrolling Interests	(4)	6		(18)	10	
Net Earnings Attrib. to Kroger	$506	$559	(9.5%)	$1,975	$2,039	(3.1%)
Diluted EPS	$0.53	$0.57	(7.1%)	$2.05	$2.06	(0.5%)
Adjusted EPS, Excluding Nonrecurring Items	**$0.53**	**$0.57**	**(7.1%)**	**$2.12**	**$2.06**	**2.9%**
Avg. Diluted Shares Outst.	943	980	(3.8%)	958	980	(2.2%)
As a % of Total Sales:			bp. chg.			bp. chg.
Gross Profit (LIFO basis)	22.19%	22.82%	(63)	22.40%	22.16%	24
Gross Profit (FIFO basis) **	22.19%	22.71%	(51)	22.42%	22.18%	23
Oper., Gen., & Admin. Exp.	16.24%	16.64%	(41)	16.63%	16.34%	29
Rent	0.78%	0.69%	9	0.76%	0.66%	11
Deprec. & Amort.	2.07%	1.94%	13	2.03%	1.90%	13
Operating Expenses	19.09%	19.28%	(19)	19.42%	18.90%	52
Operating Profit	3.11%	3.55%	(44)	2.98%	3.26%	(28)
Net Earnings Attrib. to Kroger	1.83%	2.14%	(30)	1.71%	1.86%	(14)
Tax Rate	31.42%	30.67%	75	32.84%	33.78%	(93)

* Merchandise Costs include advertising, warehousing and transportation expenses as well as LIFO (last-in, first-out) charges and credits.
** 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 Note: Fiscal year ends on Saturday closest to January 31

Comments on fiscal 4Q. Kroger's fiscal 4Q reflected a challenging industry environment that included a continued deflationary environment and a heightened competitive environment in certain regions. 4Q marked the ninth consecutive quarter of either declining rates of inflation or realization of deflation. Management believes the 1H 2017 period could see a continuation of this trend, but followed by an easing (improvement) in 2H.

In addition, although the grocery industry is known for its ongoing competitive nature, we believe the environment has intensified recently in terms of improved shopping experiences in some of Kroger's larger markets. This could include lower prices, better service and selection, and a generally more pleasant experience/ambiance. The stronger representation includes, but is not limited to, one of Kroger's most common competitors, Wal-mart.

Among the 4Q highlights:

- Total reported sales in 4Q rose 5.5%. Sales excluding fuel increased 4.4% (fuel sales were up due to higher average fuel prices). Recent mergers with Roundy's (regional grocery operator) and ModernHEALTH (specialty pharmacy services) contributed to the growth.
- A 0.7% decline in identical food store sales for 4Q ended a 52-quarter streak of gains in this metric. This reflects a deflationary environment in certain grocery categories; inflation-adjusted identical food store sales were positive in the quarter. Management's definition of deflation was measured at 1.3% in 4Q compared to 1.1% in 3Q.
- In addition, the slight drop in identical food store sales reflected a capital investment program whereby 35 strong performing stores were relocated or expanded over the past twelve months, which removed them from the calculation.
- Overall tonnage was positive for the quarter.
- The private label, natural, and organic segments continued to perform well.
- Digital initiatives continued to expand. A prime example is *ClickList*, a fee-based, online ordering system featuring curb-side pick-up by customers. This relatively new service has been popular with customers and is now featured in over 640 store locations, with further expansion planned. The company is experimenting with *ClickList* ordering by offering delivery by Uber drivers rather than curb-side pick-up.
- Reported gross margin declined 63 basis points from the prior year period. Excluding fuel operations, recent mergers, and the LIFO charge, FIFO gross margin declined 22 basis points from a year ago.
- Operating expenses, excluding fuel, mergers, and pension contributions, decreased 11 basis points as a percent of total sales.
- Diluted earnings per share of $0.53 were down from the year ago figure of $0.57, exceeding street consensus and our estimate by a penny.
- Share repurchases in past quarters ($1.7 billion over the past year) led to a 3.8% drop in the 4Q weighted average share count, which helped EPS a bit.

Financial. Total debt at 4Q end was $14.077 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 68%. Total cash and equivalents were $310 million while shareholders' equity was $6.710 billion. Kroger has historically maintained a leveraged balance sheet that is comfortably supported by cash flows, in our view. At the end of 4Q, net debt-to-trailing adjusted EBITDA (earnings before interest, taxes, depreciation & amortization) was 2.31x compared to 2.08x a year ago. The increase reflects a higher debt level due mainly to pension-related debt and the acquisition of 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 1.6%. Due to the current slowdown in earnings, we would expect a potential increase in mid-2017 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. The company recently agreed to new contracts covering associates in North Carolina. Negotiations are currently in progress with associates in the Michigan and Atlanta markets. The overriding objective in negotiations is to find a "fair and reasonable" balance between competitive costs and compensation packages.

Outlook. We remain impressed by Kroger's ability to deliver on key performance measures such as identical food store sales, operating margin, return on invested capital, and market share positions over time and over various macro environments. The company's investments in the business, strategic acquisitions (such as Murray's Cheese and ModernHEALTH) that bring more products and services to customers, and use of technology and digital capabilities has augmented the overall shopping experience, in our view. Most importantly, we believe managing the business with a long-term focus that benefits employees, customers, and shareholders is most prudent. This is frequently mentioned by Kroger management as it navigates the 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.

Management offered 2017 guidance that included EPS guidance in the range of $2.21-$2.25 excluding nonrecurring items (primarily pension-related charges). 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. Excluding this benefit, potential EPS this year of $2.12-$2.16 would compare to EPS of $2.12 for the just completed 2016 year (a 52-week period). Management noted challenges such as deflation (at least in 1H) and a competitive environment. It expects identical food store sales for the year to be flat to up 1%. We have assumed some margin pressure in 2017 in reaction to the industry issues. We project net sales to rise 6%, with diluted EPS coming in at $2.22.

For fiscal 2018, we note a reversion to a 52-week year from the 53-week year in fiscal 2017. We have initiated fiscal 2018 estimates, including net sales growth of 2.5% and diluted EPS of $2.35. We assume some margin pressure due to the industry environment. We also expect share buybacks to continue throughout the year.

Valuation. KR shares are currently trading at 14.0x fiscal 2016 EPS and 13.3x our fiscal 2017 estimate. Over the past fifteen years the shares have traded in a range of roughly 8x to 20x projected forward earnings with a median forward multiple of 13.2x. Because we consider company fundamentals stronger today with more growth opportunities compared to the past decade, we believe that period's median multiple is too low to serve as a benchmark. We feel Kroger's growth (organic and through acquisitions) and operating results over the past five years compare quite favorably to previous periods. Thus, we believe a five year valuation history may be more practical and insightful. On that note, the stock's median forward multiple over the past five years is 14.4x.

KR's forward P/E multiple is 0.7x the S&P 500's forward multiple, below premium levels from late 2014 through early 2016, and below the median figure of 0.9x for the five-year and fifteen-year periods.

On an Enterprise Value/EBITDA basis, KR shares are trading at 6.8x 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—primarily deflation and competition—we believe Kroger is performing about as well as to be expected. We believe the company can emerge from the current 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.

The current forward multiple of 13.3x is appealing to us, although we are mindful of the challenges at hand. We expect EPS growth in fiscal 2017 and fiscal 2018 to be below management's 8%-11% compounded annual long-term targeted range, but revert to this range in subsequent years as conditions are more favorable. We do not assume a compounded annual growth rate at the upper end of the targeted range in any future multi-year period.

We continue to recommend purchase of KR but are lowering our rating to Long-term Buy from Buy because of 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.

Our two-year target is $38 per share. This is based on our projection of forward earnings two years from now applied to a multiple in line with the five-year median figure. Additionally, our target represents an Enterprise Value/EBITDA multiple of 7.0x based on our projection of forward EBITDA one year from now, slightly above the current valuation based on projected forward EBITDA.

Suitability. We maintain our Suitability rating of 2 on KR shares. This reflects the large sales base, diversity among geographic regions and store concepts/banners, strong market share positions, favorable historical operating results, and large market capitalization. Other factors are the company's debt levels, degree of unionized labor, its penchant for acquisitions and new business endeavors, and the long-standing competitive nature of the grocery industry.

Risks and Considerations. We believe one of the most watched risk factors 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, new and non-traditional competitive entry, fuel prices, consumer spending, unemployment levels, adverse weather conditions, and the state of financial markets (sources of liquidity).

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	$125,250	2.5%	$122,200	6.0%	$115,337	5.0%	$109,830	1.3%
Merchandise Costs *	97,420	2.6%	94,940	6.1%	89,502	4.7%	85,496	(0.0%)
LIFO Gross Profit	27,830	2.1%	27,260	5.5%	25,835	6.2%	24,334	6.0%
Oper., Gen., & Admin. Exp.	20,580	1.8%	20,210	5.4%	19,178	6.9%	17,946	4.6%
Rent	920	2.2%	900	2.2%	881	21.9%	723	2.3%
Deprec. & Amort.	2,560	3.4%	2,475	5.8%	2,340	12.0%	2,089	7.2%
Operating Expenses	24,060	2.0%	23,585	5.3%	22,399	7.9%	20,758	4.8%
Operating Profit	3,770	2.6%	3,675	7.0%	3,436	(3.9%)	3,576	14.0%
Interest Expense	515	(2.8%)	530	1.5%	522	8.3%	482	(1.2%)
Earnings Before Taxes	3,255	3.5%	3,145	7.9%	2,914	(5.8%)	3,094	16.8%
Taxes	1,123	3.5%	1,085	13.4%	957	(8.4%)	1,045	15.9%
Net Earnings	2,132	3.5%	2,060	5.3%	1,957	(4.5%)	2,049	17.3%
Net Earnings Attributable to Noncontrolling Interests	(5)		(10)		(18)		10	
Net Earnings Attrib. to KR	$2,137	3.2%	$2,070	4.8%	$1,975	(3.1%)	$2,039	18.0%
Diluted EPS	$2.35		$2.22		$2.05		$2.06	
Adjusted EPS, Excluding Nonrecurring Items	**$2.35**	5.8%	**$2.22**	4.7%	**$2.12**	2.9%	**$2.06**	17.0%
Avg. Diluted Shares Outst.	910	(2.5%)	933	(2.6%)	958	(2.2%)	980	(1.3%)
As a % of Total Sales:		bp. chg.		bp. chg.		bp. chg.		bp. chg.
Merchandise Costs	77.78%	9	77.69%	9	77.60%	(24)	77.84%	(99)
Gross Profit (LIFO basis)	22.22%	(9)	22.31%	(9)	22.40%	24	22.16%	99
Gross Profit (FIFO basis) **	22.23%	(10)	22.33%	(9)	22.42%	23	22.18%	88
Oper., Gen., & Admin. Exp.	16.43%	(11)	16.54%	(9)	16.63%	29	16.34%	52
Rent	0.73%	(0)	0.74%	(3)	0.76%	11	0.66%	1
Deprec. & Amort.	2.04%	2	2.03%	(0)	2.03%	13	1.90%	11
Operating Expenses	19.21%	(9)	19.30%	(12)	19.42%	52	18.90%	63
Operating Profit	3.01%	0	3.01%	3	2.98%	(28)	3.26%	36
Net Earnings Attrib. to KR	1.71%	1	1.69%	(2)	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 - WMT - $70.03

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	36	30%	17%	83%
Hold/Neutral	76	62%	7%	93%
Sell	10	8%	0%	100%

As of 6 February 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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