Consumer Staples
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COMPANY UPDATE / ESTIMATE CHANGE

The Kroger Co.

KR — NYSE — Long-term Buy-3

Investor Conference Highlights

Key Metrics

KR - NYSE (as of 10/12/17)		$21.00
Two Year Price Target		$27.00
52-Week Range		$19.69 - $36.44
Shares Outstanding (mil.) (basic)		897
Market Cap. ($ mil.)		$18,837
3-Mo. Average Daily Volume		14,380,000
Institutional Ownership		78%
Total Debt/Total Capital (8/17)		70%
ROE (TTM ended 8/17)		28%
Book Value/Share (8/17)		$6.85
Price/Book Value		3.1x
Annual Dividend & Yield	$0.50	2.4%
EBITDA Margin (TTM ended 8/17)		4.8%

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		$0.39	A		
3Q	$0.41	$0.40	$0.39			
4Q	$0.53	$0.58	$0.60			
Year	$2.12	$1.95	$1.96		$2.00	$1.99
P/E	9.9x		10.7x			10.6x

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		$27,597	A		
3Q	$26,557	$27,350	$27,300			
4Q	$27,611	$30,568	$30,518			
Year	$115,337	$121,800	$121,700		$123,400	$123,300

Company Description: *The Kroger Co. is the nation's largest traditional grocery retailer. The company recently operated 2,793 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 2,258 pharmacies, 783 convenience stores, 307 fine jewelry stores, 222 retail health clinics, 1,472 supermarket fuel centers, and 38 food processing plants in the U.S. The company has roughly 450,000 employees and is headquartered in Cincinnati, OH.*

Investment Highlights

- **On October 11, Kroger held an investor conference to discuss the industry environment, competitive advantages, strategic direction, and the financial outlook.** While competitive forces are not likely to ease anytime soon, in our view, we believe Kroger has strengths that should help it compete and succeed in a dynamic industry environment.
- **To us, the conference served as a reminder of Kroger's strengths.** These range from physical assets such as its broad store base to intangible assets such as its strong management team and industry leading data research capabilities.
- **The company is exploring strategic alternatives for its convenience store business.** Management is intrigued by existing valuations in that business and would consider purchase offers. Annual revenues for KR's convenience store business are about $4 billion.
- **Management reaffirmed its fiscal 2017 financial outlook.** This includes identical supermarket sales growth (excluding fuel) of 0.5%-1.0% and adjusted EPS of $2.00-$2.05. The EPS figures exclude nonrecurring items and reflect an approximate $0.09 benefit from a 53rd week (extra week in 4Q this year).
- **We have fine-tuned our financial estimates.** We project fiscal 2017 adjusted EPS of $1.96, slightly below management's guided range and one penny above our previous figure. Also, we have lowered our fiscal 2018 adjusted EPS estimate by one penny to $1.99 based on modest changes to various line items.
- **We maintain our Long-term Buy rating, our two-year price target of $27 per share, and our Suitability rating of 3.** We believe the current valuation is attractive, presenting a good buying opportunity for risk-tolerant, longer term investors. Given industry dynamics, we suggest an investment time horizon of two years.

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

Comments on investor conference. The Kroger Co. conducted a well-attended investor/analyst conference on October 11 at the New York Stock Exchange. The event included presentations from CEO Rodney McMullen, CFO Mike Scholtman, and various other members of the management team. Among the conference highlights:

- The focus of the conference was the adoption of a new strategic theme, "Restock Kroger" that encompasses market share battles, capital spending plans, cost savings, and free cash flow. The theme is also a not-so-subtle reference to the stock and the desire for higher share price levels.
- The forward-looking theme is also built around the mindset of "what got us here, won't get us there." Management believes the company can benefit from the changing industry landscape (new services, offerings, and technologies), adaptive actions, and a strategic plan that casts a wider net.
- The company's current profile is compelling: 450,000 associates serving over 9 million customers a day from over 60 million households (half of all U.S. households). Most customers live within 1-2 miles of a company store.
- Management believes Kroger's potential market is the entire food industry, estimated at $1.5 trillion in annual sales. This includes retail grocery ($800 billion) as well as restaurants/foodservice ($700 billion).
- The company will open its first full-service restaurant this month. Dubbed *Kitchen 1883* (a reference to Kroger's origins), the restaurant will feature "a fresh take on American comfort food." It will be located near, but not inside, an existing Kroger supermarket. Other restaurant concepts are likely to be tested at later dates, in our view.
- Management is committed to re-defining the shopping experience, and is budgeting $3 billion in capital expenditures each year. This includes store expansion, re-models, and adoption of customer-friendly technologies and services aimed at greater customer satisfaction.
- The online shopping experience continues to be refined and expanded. *ClickList*, the company's online ordering system, remains a priority and is being rolled out across the company's various divisions. This primarily includes curbside pick-up but home delivery options are becoming more prevalent.
- In-store shopping will remain a focal point, and technologies are consistently improving the overall customer experience. This will include more efficient front-end store design and easier check-out procedures, with long-term plans for customers to "pick, pack, and go" with use of self-scanning devices (eventually smartphones) while shopping, and no check-out lines.
- Growth areas for the company include produce (rising market share growth), natural and organic (double-digit growth), fresh prepared (including complete meal kits), and *ClickList*.
- Competitive advantages include an approximate 2,800 retail store base covering most of the U.S., a strong private label business featuring numerous brands (such as *Kroger*, *Simple Truth*, *Private Selection*, *Psst* and others), 38 food processing plants, and a massive loyalty/reward card program.
- Management feels a lesser known competitive advantage is the company's *84.51* data research entity (largest collector of food purchase data in the U.S., and wholly owned by Kroger) that analyzes customer behaviors, influences, and motivations. This results in over 3 billion personalized product/shopping recommendations to customers each year.
- Recent hurricanes and the related impact on area stores are reflected in the latest financial guidance. In the situation of a hurricane, there is typically a surge in business followed by a period of low store traffic. The net effect is often a mild positive.
- One surprise announcement at the conference was the exploration of strategic alternatives for the company's convenience store division (recently 783 stores under numerous banners such as *Turkey Hill*, *Tom Thumb*, *KwikShop*, and others). According to management, valuations are relatively high in the convenience store industry at this time (greater than KR's valuation), so it feels compelled to explore all options, which could include sale of the business. This consideration does not include the company's fuel centers that are often adjacent to its grocery stores. Revenues (food and fuel) for KR's convenience

stores were $4.0 billion last year. We do not have detailed profit data on this business, or a comparable transaction history, to estimate a potential transaction value.

- Operating margins are expected to rise in future years (we conservatively estimate beginning in fiscal 2019) despite potential gross margin pressure. This is due to significant operating expense reductions and cost containment efforts, while the company continues to compete on price in a highly competitive environment.
- Operating cash flow is expected to approximate $15 billion over the next three years, greater than the $14 billion generated in the past three years.
- Capital investments over the next three years are expected at $9 billion, or roughly $3 billion per year. This will support numerous digital initiatives, new store development and remodels, and various growth projects.
- Free cash flow for the 2015-2017 time frame is projected at roughly $2.1 billion; this is expected to more than double for the 2018-2020 period. This could allow for continued share repurchases and annual dividend increases, in addition to allowing the company to improve its capital structure or consider strategic acquisitions.

Competitive environment. The industry landscape changed this year with Amazon's acquisition of Whole Foods Market, with a wide range of possible strategies and consumer offerings emanating from the combination. Also, some traditional grocery operators have announced expansion plans, while others have become more aggressive on price. Consumer preferences are also changing as it relates to what they eat and how they shop, with trends related to convenience and immediacy.

We have been impressed by Kroger's history of strong market share positions for its various banners, but feel the company will have to spend more and lower some prices to maintain share positions in the coming year. We do not believe the competitive environment is likely to subside any time soon; this is factored in our margin assumptions, earnings estimates, and price target for KR.

We believe a combination of physical store and online retailing will become the norm for the grocery industry. Importantly, we feel Kroger is dominant with the former and is moving aggressively and effectively with the latter. The company's geographic reach, quality of its store base, digital initiatives, and long history as an industry leader could help as it re-defines itself in the dynamic environment.

Management continues to run the business with the long term in mind, and defending its strong market share position remains a priority. Competition has indeed picked up considerably, yet CEO Rodney McMullen often states Kroger "will not lose on price." Recent strategic moves such as increasing labor hours in stores and increasing wages in certain markets will add to operating expenses, but should improve the quality of the work force and enhance the shopping experience, in our view.

Earnings outlook. Earlier this year, management announced it will no longer provide long-term financial guidance. In the recent past, this outlook included 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 annual dividend growth. We do not believe these goals have been terminated, but will likely be kept internal for now. However, the former EPS growth goal would be difficult to achieve in the next few years given the competitive environment, in our view.

Management will continue to provide financial guidance for the current year, and reaffirmed its guidance at the recent investor conference. For fiscal 2017, EPS excluding nonrecurring items (primarily pension-related charges) are still projected at $2.00-$2.05. This includes an approximate $0.09 benefit from a 53rd week in the current fiscal year, which ends on the Saturday nearest January 31 of each year (February 3, 2018 for this fiscal year). This compares to EPS of $2.12 in fiscal 2016 (a 52-week period). Management expects identical food store sales of 0.5%-1.0% for the current year, with the second half of the year improving over the first half.

We have fine-tuned our fiscal 2017 model with modest changes to various line items. We project net sales to rise 5.5% to $121.7 billion. This jump reflects fiscal 2017 being a 53-week year compared to the normal 52-week year in fiscal 2016. Our EPS estimate is $1.96, a penny above our previous figure but below management's guided range of $2.00-$2.05, a reflection of our views of the competitive environment particularly over the 4Q holidays. We believe share buybacks will occur throughout the year, especially in the near-term considering the current share price.

For fiscal 2018, we note a reversion to a 52-week year from the 53-week year in fiscal 2017. Management made general comments regarding fiscal 2018, including full year identical food stores sales growth greater than fiscal 2017, and flat to slight higher EPS compared to a fiscal 2017 figure adjusted to a 52-week basis (roughly $1.91-$1.96). We have made minor revisions to our fiscal 2018 estimates, which now include net sales growth of 1.3% to $123.3 billion and diluted EPS of $1.99. We assume continued gross margin pressure due to current competitive factors extending into fiscal 2018. We expect share repurchases to continue, allowing for a slight EPS gain despite a decline in net income.

Valuation. KR shares are trading at 10.6x our estimate of forward earnings. Roughly one year ago, when the industry environment was more favorable, KR traded at 14.1x estimated forward earnings. 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 13.3x. 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 13.7x.

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 just under 6.0x based on our projection of twelve-month forward 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 and have no problems with the company's strategies or execution. We consider the company to be digging in its heels 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 the digital/online area, store renovations, and acquisitions. We expect shareholder friendly uses of discretionary cash flow such as dividends and share buybacks to continue in the years ahead.

The current stock valuations are appealing to us, although we are mindful of the challenges at hand. We expect compounded annual EPS growth in the next few years to be moderate due to the impact of greater competition and higher costs of meeting customers' shopping needs. This includes remaining competitive on price and expanding the online shopping service, which represents a drag on earnings in the early stages due to start-up expenses. Free cash flow (after capital expenditures) over the next few years could be substantial, even assuming a heightened competitive environment. This could allow for significant amounts for uses such as dividends, share repurchases, or acquisitions.

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 the challenges at hand, and maintain strengths such as industry leadership, integration of technology, and a focus on shareholder value. Considering all factors, including the trend of stiffer competition, we believe KR shares deserve to trade below recent median valuation levels but we feel the current level is too bearish.

Our two-year target is $27 per share. We have tried to reflect the current competitive landscape, a higher operating cost structure to defend market share positions, and some additional risks associated with new business initiatives. Our target is based on our projected forward earnings per share two years from now of $2.25 applied to a 12.0x multiple, which is well below historic median multiples. Additionally, our target represents an Enterprise Value/EBITDA multiple of just over 6.0x based on our projection of forward EBITDA one year from now, slightly above the current valuation but near the low end of the historical range.

Suitability. Our Suitability rating on KR is 3. This reflects the competitive environment (current and projected, especially in light of the Amazon/Whole Foods combination) 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 our suitability rating. 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 Amazon's recent 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 450,000 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	$123,300	1.3%	$121,700	5.5%	$115,337	5.0%	$109,830	1.3%
Merchandise Costs *	96,525	1.5%	95,110	6.3%	89,502	4.7%	85,496	(0.0%)
LIFO Gross Profit	26,775	0.7%	26,590	2.9%	25,835	6.2%	24,334	6.0%
Oper., Gen., & Admin. Exp.	20,220	1.1%	20,005	4.3%	19,178	6.9%	17,946	4.6%
Rent	915	0.8%	908	3.1%	881	21.9%	723	2.3%
Deprec. & Amort.	2,500	2.0%	2,451	4.7%	2,340	12.0%	2,089	7.2%
Operating Expenses	23,635	1.2%	23,364	4.3%	22,399	7.9%	20,758	4.8%
Operating Profit	3,140	(2.7%)	3,226	(6.1%)	3,436	(3.9%)	3,576	14.0%
Interest Expense	555	(1.8%)	565	8.2%	522	8.3%	482	(1.2%)
Earnings Before Taxes	2,585	(2.9%)	2,661	(8.7%)	2,914	(5.8%)	3,094	16.8%
Taxes	892	(2.9%)	918	(4.1%)	957	(8.4%)	1,045	15.9%
Net Earnings	1,693	(2.9%)	1,743	(10.9%)	1,957	(4.5%)	2,049	17.3%
Net Earnings Attributable to Noncontrolling Interests	(17)		(20)		(18)		10	
Net Earnings Attrib. to KR	$1,710	(3.0%)	$1,763	(10.7%)	$1,975	(3.1%)	$2,039	18.0%
Adjusted EPS, Excluding Nonrecurring Items	**$1.99**	1.5%	**$1.96**	(7.6%)	**$2.12**	2.9%	**$2.06**	17.0%
Avg. Diluted Shares Outst.	860	(4.4%)	900	(6.1%)	958	(2.2%)	980	(1.3%)
As a % of Total Sales:		**bp. chg.**		**bp. chg.**		**bp. chg.**		**bp. chg.**
Merchandise Costs	78.28%	13	78.15%	55	77.60%	(24)	77.84%	(99)
Gross Profit (LIFO basis)	21.72%	(13)	21.85%	(55)	22.40%	24	22.16%	99
Gross Profit (FIFO basis) **	21.76%	(16)	21.91%	(50)	22.42%	23	22.18%	88
Oper., Gen., & Admin. Exp.	16.40%	(4)	16.44%	(19)	16.63%	29	16.34%	52
Rent	0.74%	(0)	0.75%	(2)	0.76%	11	0.66%	1
Deprec. & Amort.	2.03%	1	2.01%	(1)	2.03%	13	1.90%	11
Operating Expenses	19.17%	(3)	19.20%	(22)	19.42%	52	18.90%	63
Operating Profit	2.55%	(10)	2.65%	(33)	2.98%	(28)	3.26%	36
Net Earnings Attrib. to KR	1.39%	(6)	1.45%	(26)	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 31 of the following year

Additional information is available upon request.

Prices of other stocks mentioned: Amazon.com Inc. - AMZN - $1000.93

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	39	32%	8%	92%
Hold/Neutral	74	60%	9%	91%
Sell	8	7%	0%	100%
Restriction	2	2%	100%	0%

As of 5 October 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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