



Kroger (KR)

Updated August 8th, 2018 by Aristofanis Papadatos

Key Metrics

| | | |
|-------------------------------|--|---------------------------------------|
| Current Price: \$30 | 5 Year CAGR Estimate: 5.7% | Volatility Percentile: 83.7% |
| Fair Value Price: \$29 | 5 Year Growth Estimate: 5.0% | Momentum Percentile: 76.1% |
| % Fair Value: 105% | 5 Year Valuation Multiple Estimate: -1.0% | Valuation Percentile: 52.3% |
| Dividend Yield: 1.7% | 5 Year Price Target \$37 | Total Return Percentile: 36.4% |

Overview & Current Events

Kroger is the largest supermarket chain in the U.S. It has about 2,800 stores in 35 states and serves more than 60 million households every year.

Kroger has been on a roller coaster since last summer, when Amazon acquired Whole Foods for \$14 B. The market panicked over the potential repercussions of the takeover on Kroger, as the latter was already operating at razor-thin margins. During the last decade, the operating margin of Kroger has hovered between 1.5% and 3.3%. Thus Kroger plunged 25% on the announcement of the above deal. Amazon entered the grocery business aggressively, lowering its prices after the completion of its takeover.

Moreover, Kroger is facing great pressure from Walmart, which implemented aggressive price reductions last year and is now expanding its online grocery delivery service to 100 metropolitan areas. Thanks to this initiative, Walmart will reach about 40% of the domestic population. Overall, the competition in the retail sector has heated more than ever. As a result, while Kroger had grown its same-store sales for years, it stalled in the second half of 2016.

However, the company has begun to adjust to the fast-changing business landscape. It has initiated a strategic plan called "Restock Kroger", which aims to increase its operating income by \$400 M by 2020 by maximizing its efficiency and its cost savings and using the proceeds to the benefit of its customers and shareholders. Thanks to this project, Kroger grew its same-store sales by 1.4% and exceeded the analysts' EPS estimates by a wide margin in its fiscal Q1 (\$0.73 vs. \$0.63). The stock jumped 10% upon its earnings release.

Kroger is also trying to improve its online sales. It increased them 90% last year and 66% in its fiscal Q1. Moreover, it recently established an exclusive partnership with the British online retailer Ocado, which will provide its technology for online ordering, automated fulfillment and home delivery capabilities. This is a major step in the efforts of Kroger to improve its online sales, though it is not expected to affect its earnings this and next year.

Growth on a Per-Share Basis

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2023 |
|------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------------|---------------|
| EPS | \$0.95 | \$0.87 | \$0.87 | \$1.00 | \$1.32 | \$1.43 | \$1.76 | \$2.06 | \$2.12 | \$2.04 | \$2.12 | \$2.71 |
| DPS | \$0.18 | \$0.19 | \$0.20 | \$0.22 | \$0.27 | \$0.32 | \$0.35 | \$0.41 | \$0.47 | \$0.50 | \$0.53 | \$0.68 |

If Kroger meets the analysts' estimates this year, it will have grown its earnings per share at an 8.2% average annual rate in the last five years. However, the company has failed to grow its earnings per share in the last three years due to the heating competition. In addition, although it impressed the market with its Q1 results, it essentially left its guidance intact for this year. On the other hand, Kroger is likely to improve its margins via its "Restock Kroger" plan. Moreover, it has reduced its share count by 5% per year in the last two years and is poised to reduce it at a similar pace this year. Overall, the retailer can be reasonably expected to grow its earnings per share by 5.0% per year over the next five years.

Valuation Analysis

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | Now | 2023 |
|------------------|------|------|------|------|------|------|------|------|------|------|-------------|-------------|
| Avg. P/E | 14.1 | 12.5 | 12.4 | 11.8 | 9.1 | 12.9 | 14.5 | 18.2 | 16.4 | 12.8 | 14.2 | 13.5 |
| Avg. Yld. | 1.3% | 1.7% | 1.9% | 1.9% | 2.2% | 1.7% | 1.4% | 1.1% | 1.3% | 1.9% | 1.7% | 1.8% |

Kroger has rallied 30% in the last five months thanks to its strong performance and its partnership with Ocado. Consequently, the stock does not have a bargain valuation any more. It is trading at a P/E ratio of 14.2, which is higher than its 10-year average of 13.5. As it is reasonable to expect the stock to revert to its average valuation level over the next five years, the stock is likely to incur a 1.0% annualized drag due to the contraction of its P/E ratio over this period.

Safety, Quality, Competitive Advantage, & Recession Resiliency

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2023 |
|-----------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------------|--------------|
| GP/A | 73.8% | 75.7% | 76.9% | 77.6% | 80.4% | 80.8% | 69.1% | 75.3% | 71.8% | 70.8% | 73.0% | 75.0% |
| Debt/A | 78.0% | 77.2% | 78.7% | 77.5% | 83.1% | 82.9% | 81.6% | 82.2% | 79.9% | 81.6% | 81.4% | 80.0% |
| Int. Cov. | 5.5 | 5.1 | 2.2 | 4.9 | 2.9 | 6.0 | 6.2 | 6.4 | 7.4 | 6.6 | 4.0 | 4.0 |
| Payout | 18.9% | 21.8% | 23.0% | 22.0% | 20.5% | 22.4% | 19.9% | 19.9% | 22.2% | 24.5% | 25.0% | 25.1% |
| Std. Dev. | 19.8% | 24.8% | 20.5% | 17.0% | 14.9% | 19.9% | 19.9% | 22.1% | 21.9% | 37.6% | 30.0% | 20.0% |

While most companies saw their earnings collapse during the Great Recession, Kroger marginally increased its earnings per share, from \$0.85 in 2007 to \$0.87 in 2009. Thus the company exhibited exceptional resilience in the last recession. On the other hand, as Kroger always operates at a razor-thin operating margin, which currently stands at 2.0%, the stock is extremely sensitive to competitive pricing pressures. To be sure, when Amazon announced its takeover of Whole Foods, Kroger plunged 25% in just two days.

As Kroger offers a dividend yield close to that of S&P and has a markedly low payout ratio of 25.0%, income-oriented investors may be attracted by the stock. However, due to the fierce competition in the retail sector, Kroger has been heavily investing in its business. Consequently, its free cash flows have been less than 1/3 of its earnings in each of the last three years and are likely to remain suppressed for the foreseeable future. As a result, the company is likely to continue to raise its dividend at a slow pace, just like it has in the last two years.

Final Thoughts & Recommendation

Due to its 30% rally in the last five months, Kroger is not a screaming bargain any more. Nevertheless, the stock can still offer a 5.7% average annual return over the next five years thanks to 5.0% annual EPS growth and its 1.7% dividend, which will be partly offset by a 1.0% annualized drag due to the contraction of its P/E ratio.

Total Return Breakdown by Year

