



Kroger Company (KR)

Updated September 13th, 2018 by Aristofanis Papadatos

Key Metrics

| | | |
|-------------------------------|--|---------------------------------------|
| Current Price: \$29 | 5 Year CAGR Estimate: 6.5% | Volatility Percentile: 83.2% |
| Fair Value Price: \$29 | 5 Year Growth Estimate: 5.0% | Momentum Percentile: 83.0% |
| % Fair Value: 101% | 5 Year Valuation Multiple Estimate: -0.3% | Valuation Percentile: 63.0% |
| Dividend Yield: 1.8% | 5 Year Price Target \$37 | Total Return Percentile: 43.0% |

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 billion. 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%. Kroger plunged 25% on the announcement of the above deal. However, in the first 12 months of operation of Whole Foods under Amazon, the actual impact on Kroger has been much less than initially feared.

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.

However, Kroger has begun to adjust to the fast-changing business landscape. Early this year, it initiated a strategic plan called "Restock Kroger", which aims to increase its operating income by \$400 million by 2020 by maximizing its efficiency and its cost savings. In addition, Kroger recently announced a partnership with the Chinese online giant Alibaba. Thanks to this partnership, Kroger will start to sell select Simple Truth items to Chinese consumers. If this move proves successful, Kroger will add more products to this initiative. While this move is not likely to move the needle in the short run, it may become a significant growth driver in the long run if the execution goes as planned.

Kroger reported its financial results for the second quarter of fiscal 2018 today. The company grew its adjusted same-store sales by 1.8% and exceeded the analysts' estimates, as it posted earnings per share of \$0.41 (vs. expected \$0.37). It also continued to grow its digital sales by more than 50%, just like it did last year and in Q1. However, its gross margin shrank from 21.7% to 21.3% due to price discounts and rising transportation costs. Moreover, management kept its guidance constant for this year. As the market had built expectations for an improved guidance, it punished the stock with an almost 10% plunge on the announcement of its results.

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 |

The latest earnings report has not changed our estimate for the earnings per share of this year. If Kroger meets our estimates, 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. 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 its share count by 10% 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.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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 | 13.7 | 13.5 |
| Avg. Yld. | 1.3% | 1.7% | 1.9% | 1.9% | 2.2% | 1.7% | 1.4% | 1.1% | 1.3% | 1.9% | 1.8% | 1.8% |

Due to its plunge after its earnings release, Kroger is now trading at a P/E ratio of 13.7, which is very close to its 10-year average of 13.5. If the stock reverts to its average valuation level over the next five years, it will incur a mild 0.3% 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% | 80.1% | 80.0% |
| Int. Cov. | 5.5 | 5.1 | 2.2 | 4.9 | 2.9 | 6.0 | 6.2 | 6.4 | 7.4 | 6.6 | 4.5 | 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% |

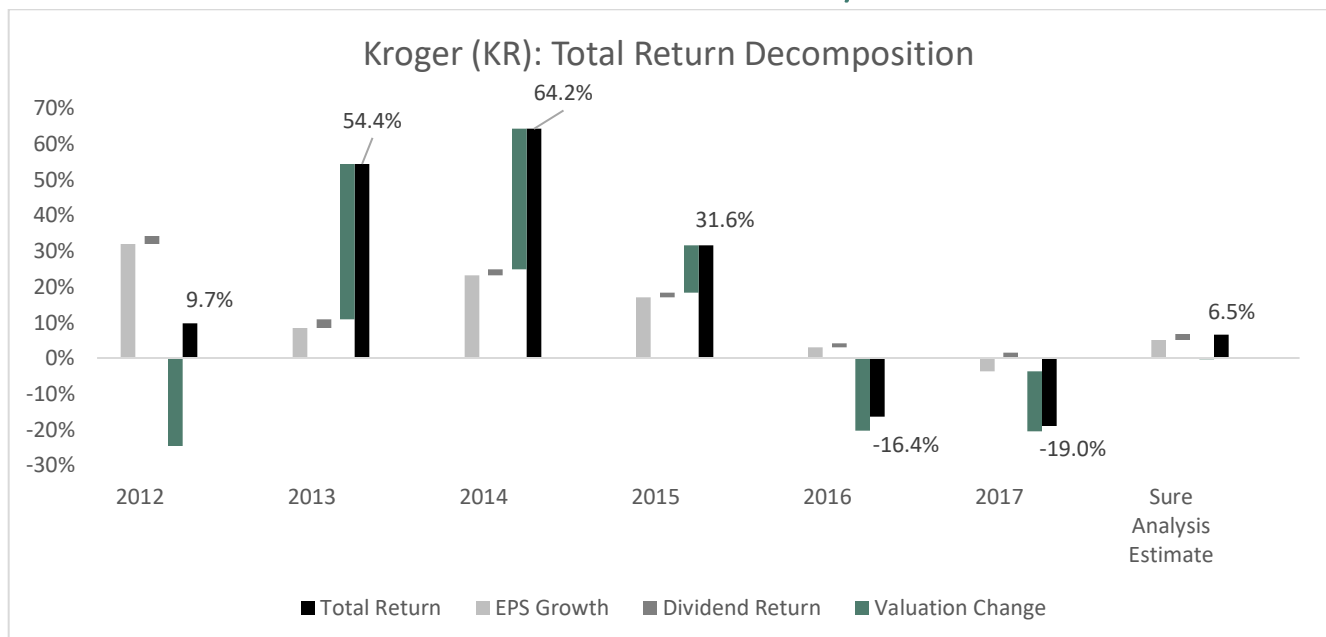
While most companies saw their earnings per share collapse during the Great Recession, Kroger increased them by 2% and thus exhibited exceptional resilience. On the other hand, as Kroger always operates at a razor-thin operating margin, which currently stands at 2.0%, the stock is extremely sensitive to competitive pricing pressures.

Kroger's dividend yield is very close to that of S&P. Due to the competition in its sector, Kroger has been heavily investing in its business. Consequently, its free cash flows have been less than 1/3 of its earnings in the last three years and are likely to remain suppressed. As a result, Kroger is likely to raise its dividend slowly in the years ahead.

Final Thoughts & Recommendation

Thanks to its recent correction, Kroger seems to be fairly valued right now. The stock can offer a 6.5% average annual return over the next five years thanks to 5.0% annual earnings-per-share growth and its 1.8% dividend, which will be partly offset by a 0.5% annualized drag from P/E contraction. However, due to the intense competition in the sector, we recommend waiting for a better entry point, around \$26, just below the gap formed after its previous earnings release.

Total Return Breakdown by Year



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