



Kroger (KR)

Updated December 11th, 2018 by Aristofanis Papadatos

Key Metrics

Current Price:	\$29	5 Year CAGR Estimate:	6.7%	Volatility Percentile:	82.2%
Fair Value Price:	\$29	5 Year Growth Estimate:	5.0%	Momentum Percentile:	78.2%
% Fair Value:	101%	5 Year Valuation Multiple Estimate:	-0.1%	Growth Percentile:	31.1%
Dividend Yield:	1.8%	5 Year Price Target	\$37	Valuation Percentile:	44.2%
Dividend Risk Score:	B	Retirement Suitability Score:	C	Total Return Percentile:	27.4%

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 the summer of 2017, when Amazon acquired Whole Foods for \$14 billion. The market panicked over the potential repercussions of the takeover on Kroger due to Kroger's 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 15 months of operation of Whole Foods under Amazon, the actual impact on Kroger has been much less than initially feared.

Nevertheless, the competition in the retail sector has heated more than ever. Amazon recently expanded the grocery delivery service of Whole Foods to more key regions in the U.S. In addition, according to a Bloomberg report, Amazon intends to open about 3,000 cashier-less stores by 2021. Moreover, Walmart implemented drastic price reductions last year and is expanding its online grocery delivery service to 100 metropolitan areas.

Kroger has successfully responded to the competition so far. 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 early December, Kroger reported (12/6/18) its financial results for the third quarter of fiscal 2018. The company grew its adjusted same-store sales by 1.6% (vs. consensus of 1.7%) and exceeded the analysts' estimates, as it posted adjusted earnings-per-share of \$0.48 (vs. expected \$0.43). It also expanded Kroger Ship to all divisions and continued to grow its digital sales by more than 50%, just like it has done for several quarters in a row. However, its gross margin shrank from 22.5% in last year's quarter to 21.6% due to price discounts and rising transportation costs. Moreover, management reiterated its guidance for this year's adjusted earnings-per-share of \$2.00-\$2.15.

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	\$2.14	\$2.73
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
Shares	1298	1284	1240	1122	1028	1016	974	967	924	870	780	630

As Kroger slightly exceeded our expectations in the third quarter, we have marginally raised our earnings-per-share estimate for this year, from \$2.12 to \$2.14. If Kroger meets our estimates, it will have grown its earnings-per-share at an 8.4% average annual rate in the last five years. However, the company has failed to grow its earnings-per-share significantly in the last three years due to the fierce competition in the retail sector. 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.



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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	13.6	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%

The valuation of Kroger has remained around its historical average since our last research report. Kroger is trading at a P/E ratio of 13.6, which is almost equal 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 0.1% 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
Payout	18.9%	21.8%	23.0%	22.0%	20.5%	22.4%	19.9%	19.9%	22.2%	24.5%	24.8%	24.9%

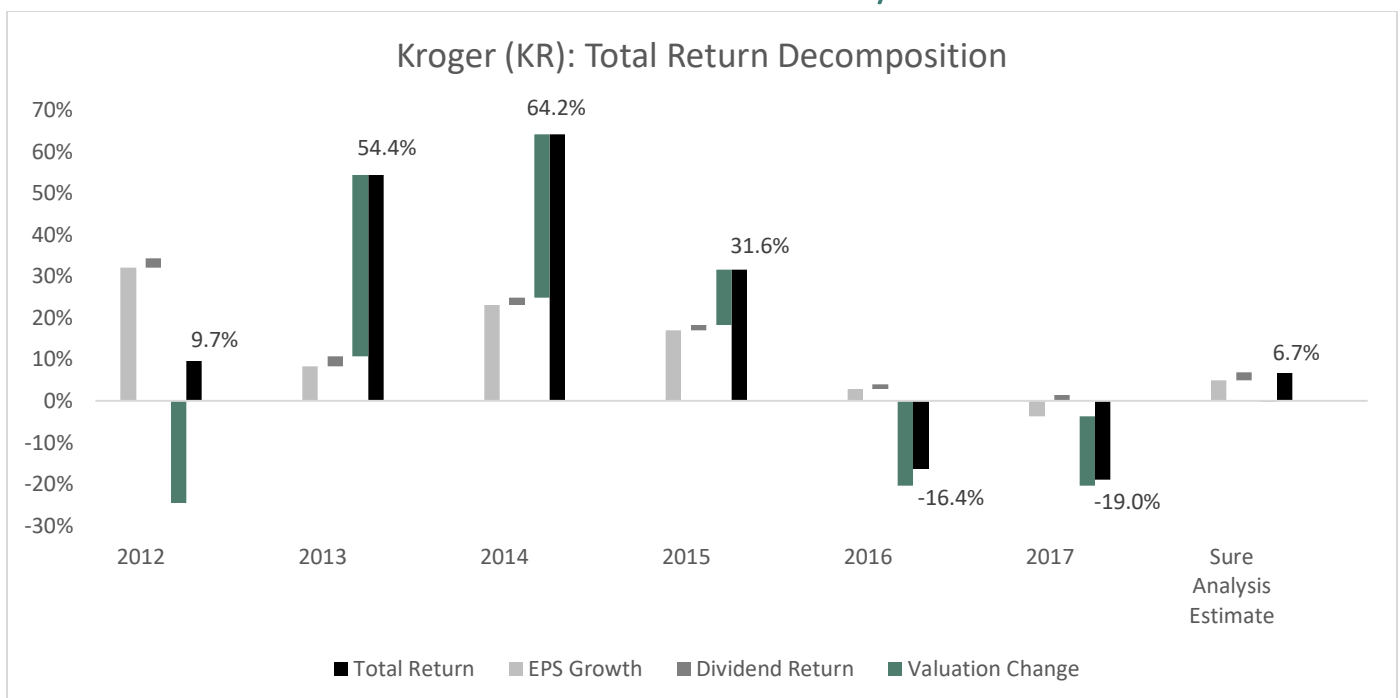
While most companies saw their earnings-per-share collapse during the Great Recession, Kroger increased them by 2% and thus exhibited exceptional resilience. On the other hand, as Kroger always operates at a razor-thin operating margin, which currently stands at 2.4%, the stock is extremely sensitive to competitive pricing pressures.

Kroger's dividend yield is very close to that of the S&P 500. 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

In our last research report, in September, we stated that Kroger was fairly valued. The stock has remained flat since then. Kroger can offer a 6.7% average annual return over the next five years, mostly thanks to modest margin expansion and its aggressive share repurchases. However, due to the intense competition in its business, we recommend waiting for a better entry point and rate the stock as a hold at current prices.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	76.15	76.73	82.05	90.27	96.62	98.38	108.47	109.83	115.34	122.66
Gross Profit	17604	17775	18246	18880	19893	20237	22953	24334	25835	27000
Gross Margin	23.1%	23.2%	22.2%	20.9%	20.6%	20.6%	21.2%	22.2%	22.4%	22.0%
SG&A Exp.	13709	14046	14446	15964	15477	15809	17868	18669	20059	22479
D&A Exp.	1443	1525	1600	1638	1652	1703	1948	2089	2340	2436
Operating Profit	2452	2204	2200	1278	2764	2725	3137	3576	3436	2085
Op. Margin	3.2%	2.9%	2.7%	1.4%	2.9%	2.8%	2.9%	3.3%	3.0%	1.7%
Net Profit	1249	70	1116	602	1497	1519	1728	2039	1975	1907
Net Margin	1.6%	0.1%	1.4%	0.7%	1.5%	1.5%	1.6%	1.9%	1.7%	1.6%
Free Cash Flow	747	625	1447	760	892	1243	1384	1568	573	604
Income Tax	717	532	601	247	794	751	902	1045	957	-405

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	23257	23126	23505	23476	24634	29281	30497	33897	36505	37197
Cash & Equivalents	894	1078	1491	188	238	401	268	277	322	347
Acc. Receivable	N/A	N/A	N/A	949	1051	1116	1266	1734	1649	1637
Inventories	4905	4935	4966	5114	5146	5651	5688	6168	6561	6533
Goodwill & Int.	2271	1158	1140	1138	1364	2837	3061	3777	4184	4025
Total Liabilities	17957	18200	18207	19510	20420	23886	25055	27099	29795	30292
Accounts Payable	3822	3890	4227	4329	4484	4881	5052	5728	5818	5858
Long-Term Debt	8063	8056	7892	8165	8879	11310	11597	12079	14077	15589
Total Equity	5205	4852	5296	3981	4207	5384	5412	6820	6698	6931
D/E Ratio	1.55	1.66	1.49	2.05	2.11	2.10	2.14	1.77	2.10	2.25

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	5.5%	0.3%	4.8%	2.6%	6.2%	5.6%	5.8%	6.3%	5.6%	5.2%
Return on Equity	24.7%	1.4%	22.0%	13.0%	36.6%	31.7%	32.0%	33.3%	29.2%	28.0%
ROIC	9.5%	0.5%	8.5%	4.8%	11.9%	10.2%	10.2%	11.4%	10.0%	8.8%
Shares Out.	1298	1284	1240	1122	1028	1016	974	967	924	870
Revenue/Share	57.86	59.03	64.30	76.11	89.96	94.59	109.23	112.07	120.39	135.69
FCF/Share	0.57	0.48	1.13	0.64	0.83	1.20	1.39	1.60	0.60	0.67

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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