



# Kroger Co. (KR)

Updated March 8<sup>th</sup>, 2019 by Aristofanis Papadatos

## Key Metrics

<b>Current Price:</b>	\$26	<b>5 Year CAGR Estimate:</b>	10.0%	<b>Volatility Percentile:</b>	83.0%
<b>Fair Value Price:</b>	\$30	<b>5 Year Growth Estimate:</b>	5.0%	<b>Momentum Percentile:</b>	53.8%
<b>% Fair Value:</b>	87%	<b>5 Year Valuation Multiple Estimate:</b>	2.8%	<b>Growth Percentile:</b>	35.1%
<b>Dividend Yield:</b>	2.2%	<b>5 Year Price Target</b>	\$38	<b>Valuation Percentile:</b>	80.6%
<b>Dividend Risk Score:</b>	B	<b>Retirement Suitability Score:</b>	B	<b>Total Return Percentile:</b>	66.4%

## Overview & Current Events

Kroger is the largest supermarket chain in the U.S. It has almost 2,800 stores in 35 states and serves more than 60 million households every year. It has a market cap of \$20 billion.

Kroger has been on a roller coaster ride 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 1.4% and 3.3%. Kroger plunged 25% on the announcement of the above deal. However, in nearly two years of operating 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 WSJ report, Amazon intends to open dozens of grocery stores across the U.S., with a lower price point and broader offerings than Whole Foods. The first store may open at the end of this year. Moreover, Walmart is expanding its online grocery delivery service to 100 metropolitan areas. Kroger has successfully responded to the competition so far. Last year, it initiated a strategic plan called "Restock Kroger", which aims to increase its operating income by \$400 million until the end of 2020 by maximizing its efficiency and its cost savings.

In early March, Kroger reported (3/7/19) financial results for the fourth quarter of fiscal 2018. The company grew its adjusted sales by 1.6% but its gross margin shrank from 22.9% in prior year's quarter to 22.0% due to changes in mix, price discounts and investment in supply chain. The operating margin was 1.4%, much less than the consensus of 2.4% and the prior year's mark of 1.8%. Adjusted earnings-per-share missed the consensus (\$0.48 vs. \$0.52). As the intense competition took its toll on the results of Kroger, the stock plunged 10% on the day of its earnings release. Management expects 2.0%-2.25% same-store sales growth this year and adjusted earnings-per-share of \$2.15-\$2.25.

## Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
<b>EPS</b>	\$0.87	\$0.87	\$1.00	\$1.32	\$1.43	\$1.76	\$2.06	\$2.12	\$2.04	\$2.11	<b>\$2.23</b>	<b>\$2.85</b>
<b>DPS</b>	\$0.19	\$0.20	\$0.22	\$0.27	\$0.32	\$0.35	\$0.41	\$0.47	\$0.50	\$0.53	<b>\$0.58</b>	<b>\$0.75</b>
<b>Shares</b>	1284	1240	1122	1028	1016	974	967	924	884	806	<b>765</b>	<b>630</b>

Kroger has grown its earnings-per-share at an 8.1% 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 about 5% per year on average in the last three years. Overall, we expect that the retailer can grow its earnings-per-share by 5.0% per year over the next five years.



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## Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	12.5	12.4	11.8	9.1	12.9	14.5	18.2	16.4	12.8	13.2	11.7	13.4
Avg. Yld.	1.7%	1.9%	1.9%	2.2%	1.7%	1.4%	1.1%	1.3%	1.9%	1.9%	2.2%	2.0%

Due to the plunge of the stock after its earnings release, Kroger is trading at a price-to-earnings ratio of 11.7, which is lower than its 10-year average of 13.4. If the stock reverts to its average valuation level over the next five years, it will enjoy a 2.8% annualized gain thanks to the expansion of its earnings multiple over this period.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	21.8%	23.0%	22.0%	20.5%	22.4%	19.9%	19.9%	22.2%	24.5%	25.1%	26.0%	26.3%

Although the large scale of Kroger offers some economies of scale and thus some sort of competitive advantage, competition has heated more than ever in the retail sector. As a result, Kroger lacks a meaningful moat.

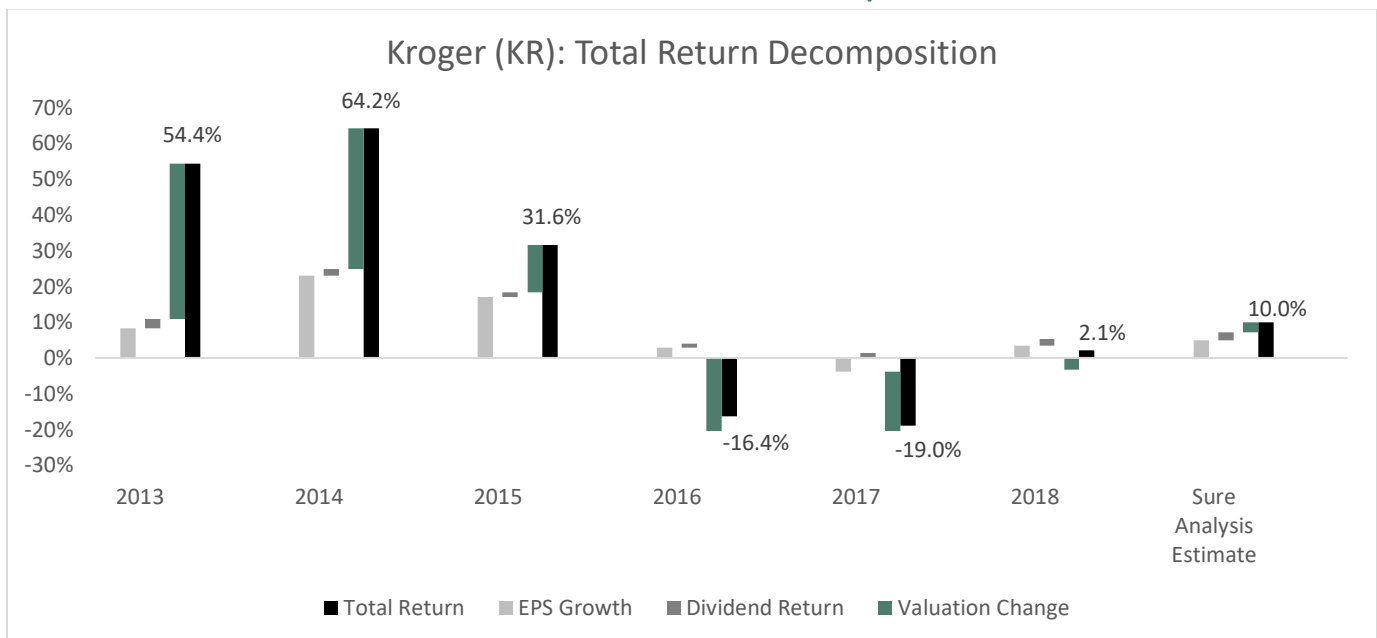
While most companies saw their earnings-per-share collapse during the Great Recession, Kroger increased earnings by 2% and thus exhibited exceptional resilience. On the other hand, as Kroger always operates at a razor-thin operating margin, which currently stands at 1.4%, the stock is extremely sensitive 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

Thanks to its recent share price decline, Kroger has become somewhat attractive and can offer a 10.0% average annual return over the next five years, mostly thanks to modest margin expansion and share repurchases. However, due to the intense competition in its business, we recommend waiting for a better entry point and thus rate the stock as a hold.

## Total Return Breakdown by Year



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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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## Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
<b>Revenue (\$B)</b>	76.73	82.05	90.27	96.62	98.38	108.47	109.83	115.34	122.66	121.16
<b>Gross Profit</b>	17775	18246	18880	19893	20237	22953	24334	25835	27000	26268
<b>Gross Margin</b>	23.2%	22.2%	20.9%	20.6%	20.6%	21.2%	22.2%	22.4%	22.0%	21.7%
<b>SG&amp;A Exp.</b>	14046	14446	15964	15477	15809	17868	18669	20059	22479	21189
<b>D&amp;A Exp.</b>	1525	1600	1638	1652	1703	1948	2089	2340	2436	2465
<b>Operating Profit</b>	2204	2200	1278	2764	2725	3137	3576	3436	2085	2614
<b>Op. Margin</b>	2.9%	2.7%	1.4%	2.9%	2.8%	2.9%	3.3%	3.0%	1.7%	2.2%
<b>Net Profit</b>	70	1116	602	1497	1519	1728	2039	1975	1907	3110
<b>Net Margin</b>	0.1%	1.4%	0.7%	1.5%	1.5%	1.6%	1.9%	1.7%	1.6%	2.6%
<b>Free Cash Flow</b>	625	1447	760	892	1243	1384	1568	573	604	1197
<b>Income Tax</b>	532	601	247	794	751	902	1045	957	-405	900

## Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
<b>Total Assets</b>	23126	23505	23476	24634	29281	30497	33897	36505	37197	38118
<b>Cash &amp; Equivalents</b>	1078	1491	188	238	401	268	277	322	347	429
<b>Acc. Receivable</b>	N/A	N/A	949	1051	1116	1266	1734	1649	1637	1589
<b>Inventories</b>	4935	4966	5114	5146	5651	5688	6168	6561	6533	6846
<b>Goodwill &amp; Int.</b>	1158	1140	1138	1364	2837	3061	3777	4184	4025	4345
<b>Total Liabilities</b>	18200	18207	19510	20420	23886	25055	27099	29795	30292	30283
<b>Accounts Payable</b>	3890	4227	4329	4484	4881	5052	5728	5818	5858	6059
<b>Long-Term Debt</b>	8056	7892	8165	8879	11310	11597	12079	14077	15589	15229
<b>Total Equity</b>	4852	5296	3981	4207	5384	5412	6820	6698	6931	N/A
<b>D/E Ratio</b>	1.66	1.49	2.05	2.11	2.10	2.14	1.77	2.10	2.25	N/A

## Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
<b>Return on Assets</b>	0.3%	4.8%	2.6%	6.2%	5.6%	5.8%	6.3%	5.6%	5.2%	8.3%
<b>Return on Equity</b>	1.4%	22.0%	13.0%	36.6%	31.7%	32.0%	33.3%	29.2%	28.0%	N/A
<b>ROIC</b>	0.5%	8.5%	4.8%	11.9%	10.2%	10.2%	11.4%	10.0%	8.8%	N/A
<b>Shares Out.</b>	1284	1240	1122	1028	1016	974	967	924	884	806
<b>Revenue/Share</b>	59.03	64.30	76.11	89.96	94.59	109.23	112.07	120.39	135.69	148.12
<b>FCF/Share</b>	0.48	1.13	0.64	0.83	1.20	1.39	1.60	0.60	0.67	1.46

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

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