



The Kroger Co. (KR)

Updated September 12th, 2019 by Eli Inkrot

Key Metrics

Current Price:	\$25	5 Year CAGR Estimate:	8.1%	Volatility Percentile:	85.2%
Fair Value Price:	\$26	5 Year Growth Estimate:	5.0%	Momentum Percentile:	29.6%
% Fair Value:	96%	5 Year Valuation Multiple Estimate:	0.8%	Growth Percentile:	38.3%
Dividend Yield:	2.5%	5 Year Price Target	\$34	Valuation Percentile:	63.3%
Dividend Risk Score:	B	Retirement Suitability Score:	B	Total Return Percentile:	48.9%

Overview & Current Events

Founded in 1883, Kroger is the largest supermarket chain in the U.S. The company has over 2,700 retail stores, 1,500 fuel centers, 2,200 pharmacies and 250 fine jewelry stores in 35 states. The \$20 billion company serves more than 60 million households every year.

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 and Kroger's share price fell 25% on the announcement of the Whole Foods deal. However, in 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 up more than ever. Amazon recently expanded the grocery delivery service of Whole Foods to more key regions in the U.S. Moreover, Walmart is expanding its online grocery delivery service. Kroger, which has successfully responded to the competition so far, 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.

On September 12th, 2019 Kroger reported Q2 fiscal year results for the period ending August 17th, 2019. (Kroger's fiscal year ends the Saturday closest to January 31st.) For the quarter Kroger reported \$28.17 billion in sales, up from \$28.01 billion in Q2 fiscal 2018. Total sales excluding fuel were up 2.2% compared to the prior year period. Adjusted operating profit came in at \$626 million against \$566 million previously, while adjusted earnings-per-share equaled \$0.44 compared to \$0.41 in the year ago period.

Kroger also confirmed its identical sales, operating profit and EPS guidance for 2019. The company expects adjusted sales growth of 2.0% to 2.25%, operating profit of \$2.9 billion to \$3.0 billion and EPS of \$2.15 to \$2.25.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	\$0.87	\$0.87	\$1.00	\$1.32	\$1.43	\$1.76	\$2.06	\$2.12	\$2.04	\$2.11	\$2.20	\$2.81
DPS	\$0.19	\$0.20	\$0.22	\$0.27	\$0.32	\$0.35	\$0.41	\$0.47	\$0.50	\$0.55	\$0.64	\$0.82
Shares¹	1,284	1,240	1,122	1,028	1,016	974	967	924	870	798	798	750

During the last decade Kroger has grown its earnings-per-share by an 8.3% average annual rate. 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. Moreover, we do not expect spectacular top-line gains from this point.

With that being said, Kroger does have some growth levers available. For instance, Kroger can continue to improve its margins via its "Restock Kroger" plan. Moreover, the company has reduced its share count by about 5% per year on average over the last decade. While we do not anticipate this sort of advance moving forward, we do note that these items can allow slow top-line growth to turn into mid-single-digit improvement on the bottom line. Overall, we expect that the retailer can grow its earnings-per-share by 5.0% per year over the next five years.

¹ In millions.

Disclosure: This analyst is long the security discussed in this research report.



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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	11.5	12.0
Avg. Yld.	1.7%	1.9%	1.9%	2.2%	1.7%	1.4%	1.1%	1.3%	1.9%	2.0%	2.5%	2.4%

During the last decade shares of Kroger have traded hands with an average P/E ratio of 13.4 times earnings. We have reduced our estimate slightly to 12 times earnings, as growth expectations are not as robust moving forward. Still, based on the current multiple of 11.5, this implies the potential for a small valuation tailwind in the coming years.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	22%	23%	22%	20%	22%	20%	20%	22%	25%	26%	29%	29%

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

Still, while most companies saw their earnings collapse during the Great Recession, Kroger exhibited exceptional resilience posting earnings-per-share results of \$0.95, \$0.87, \$0.87 and \$1.00 during the 2008 through 2011 stretch. Kroger always operates at a razor-thin margin, standing at 1.4% last year, which allows it to keep competitors at bay but also means that the stock is extremely sensitive to competitive pricing pressures.

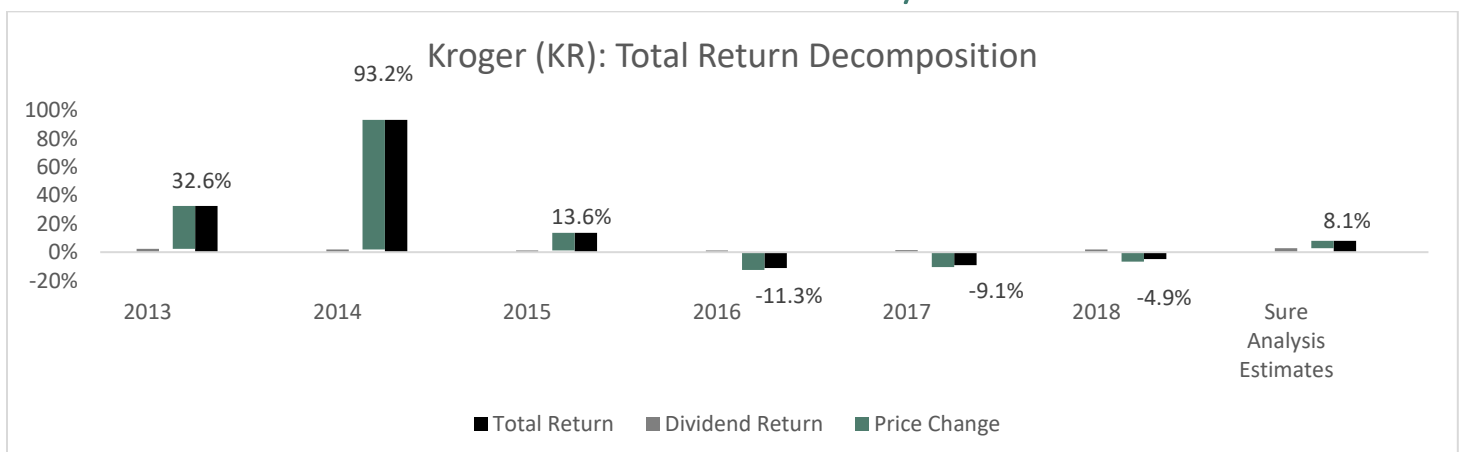
Kroger has been prudent about its dividend, with a payout ratio sticking around the 20% range in the last decade and only recently climbing slightly amid stagnating earnings. The larger capital return focus has been, and likely will continue to be, on share repurchases. We believe this is prudent considering the competitive landscape of Kroger's industry.

At the end of Q2 Kroger held \$354 million in cash, \$10.1 billion in current assets (64% of which is inventory) and \$44.5 billion in total assets (49% of which is property and equipment) against \$13.4 billion in current liabilities and \$35.8 billion in total liabilities. Long-term debt stood at \$12.1 billion against underlying annual earnings power of about \$1.7 billion.

Final Thoughts & Recommendation

Shares are up 9% since our last update, while earnings expectations are unchanged. Kroger has proven to be a strong and resilient business, but the industry is not getting any easier. We see the potential for 8.1% annual returns, stemming from 5% growth, a 2.5% starting yield and a small valuation tailwind. Still, due to the intense competition in its business, we continue to rate shares as a hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue (\$B)	76.73	82.05	90.27	96.62	98.38	108.5	109.83	115.34	122.7	121.16
Gross Profit	17775	18246	18880	19893	20237	22953	24334	25835	27000	26268
Gross Margin	23.2%	22.2%	20.9%	20.6%	20.6%	21.2%	22.2%	22.4%	22.0%	21.7%
SG&A Exp.	14046	14446	15964	15477	15809	17868	18669	20059	22479	21189
D&A Exp.	1525	1600	1638	1652	1703	1948	2089	2340	2436	2465
Operating Profit	2204	2200	1278	2764	2725	3137	3576	3436	2085	2614
Op. Margin	2.9%	2.7%	1.4%	2.9%	2.8%	2.9%	3.3%	3.0%	1.7%	2.2%
Net Profit	70	1116	602	1497	1519	1728	2039	1975	1907	3110
Net Margin	0.1%	1.4%	0.7%	1.5%	1.5%	1.6%	1.9%	1.7%	1.6%	2.6%
Free Cash Flow	625	1447	760	892	1243	1384	1568	573	604	1197
Income Tax	532	601	247	794	751	902	1045	957	-405	900

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	23126	23505	23476	24634	29281	30497	33897	36505	37197	38118
Cash & Equivalents	1078	1491	188	238	401	268	277	322	347	429
Acc. Receivable	N/A	N/A	949	1051	1116	1266	1734	1649	1637	1589
Inventories	4935	4966	5114	5146	5651	5688	6168	6561	6533	6846
Goodwill & Int.	1158	1140	1138	1364	2837	3061	3777	4184	4025	4345
Total Liabilities	18200	18207	19510	20420	23886	25055	27099	29795	30292	30283
Accounts Payable	3890	4227	4329	4484	4881	5052	5728	5818	5858	6059
Long-Term Debt	8056	7892	8165	8879	11310	11597	12079	14077	15589	15229
Total Equity	4852	5296	3981	4207	5384	5412	6820	6698	6931	N/A
D/E Ratio	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
Return on Assets	0.3%	4.8%	2.6%	6.2%	5.6%	5.8%	6.3%	5.6%	5.2%	8.3%
Return on Equity	1.4%	22.0%	13.0%	36.6%	31.7%	32.0%	33.3%	29.2%	28.0%	N/A
ROIC	0.5%	8.5%	4.8%	11.9%	10.2%	10.2%	11.4%	10.0%	8.8%	N/A
Shares Out.	1,284	1,240	1,122	1,028	1,016	974	967	924	870	798
Revenue/Share	59.03	64.30	76.11	89.96	94.59	109.23	112.07	120.39	135.69	148.12
FCF/Share	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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