

The Kroger Co. (KR)

Updated September 11th, 2020 by Eli Inkrot

Key Metrics

Current Price:	\$34	5 Year CAGR Estimate:	7.6%	Market Cap:	\$26.9 B
Fair Value Price:	\$39	5 Year Growth Estimate:	3.0%	Ex-Dividend Date¹:	11/14/20
% Fair Value:	88%	5 Year Valuation Multiple Estimate:	2.5%	Dividend Payment Date¹:	12/01/20
Dividend Yield:	2.1%	5 Year Price Target	\$45	Years Of Dividend Growth:	14
Dividend Risk Score:	A	Retirement Suitability Score:	B	Last Dividend Increase:	12.5%

Overview & Current Events

Founded in 1883 and headquartered in Cincinnati, Ohio, Kroger is the largest supermarket chain in the U.S. The company has nearly 2,800 retail stores under two dozen banners, 1,500 fuel centers, 2,200 pharmacies and 170 jewelry stores in 35 states. The \$27 billion company serves more than 60 million households every year.

On June 25th, 2020 Kroger announced a 12.5% dividend increase, from \$0.16 to \$0.18 per quarter, representing the company's 14th consecutive year of paying a higher dividend.

On September 11th, 2020 Kroger reported Q2 2020 results for the period August 15th, 2020. (Kroger's fiscal year ends the Saturday closest to January 31st.) For the quarter Kroger reported \$30.49 billion in sales, up from \$28.17 billion in Q2 2019. Total sales excluding fuel and dispositions were up 13.9% as the company continued to see a benefit from the COVID-19 pandemic as more consumers are eating at home. Digital sales grew 127%, after being up 92% last quarter. Adjusted operating profit equaled \$894 million compared to \$626 million in Q2 2019, while adjusted earnings-per-share totaled \$0.73 versus \$0.44 in the year ago period.

Prior to the pandemic Kroger provided 2020 guidance for sales being up more than 2.25% and adjusted EPS coming in between \$2.30 and \$2.40. This guidance was withdrawn in Q1 2020, but a new target was set in Q2 2020. Kroger now anticipates greater than 13% sales growth and \$3.20 to \$3.30 in earnings-per-share this year. We have updated our forecast accordingly.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	\$0.87	\$1.00	\$1.32	\$1.43	\$1.76	\$2.06	\$2.12	\$2.04	\$2.11	\$2.19	\$3.25	\$3.77
DPS	\$0.20	\$0.22	\$0.27	\$0.32	\$0.35	\$0.41	\$0.47	\$0.50	\$0.55	\$0.60	\$0.72	\$1.06
Shares²	1,240	1,122	1,028	1,016	974	967	924	870	798	805	780	740

In the 2008 through 2019 period Kroger grew its earnings-per-share by an 7.9% average annual rate. However, the company failed to grow its earnings-per-share significantly in the last few years due to the fierce competition in the retail sector. Prior to this year, growth was difficult to come by.

Of course, that has changed dramatically in the last few quarters. The COVID-19 pandemic, which has plagued many businesses, has been a tailwind for groceries and Kroger in particular. To this point, earnings are anticipated to be materially higher this year. While this will make future growth more difficult (as results will be compared to a much higher base) it has proven to be a boon for the company's current financials.

In addition, Kroger does have some growth levers available outside of the current crisis. For instance, Kroger can continue to improve its margins via its "Restock Kroger" plan. Moreover, the company has reduced its share count significantly over the last decade. Collectively we are anticipating 3% growth off of a significantly higher base, implying improved intermediate-term expectations.

¹ Estimate

² In millions.

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

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	12.4	11.8	9.1	12.9	14.5	18.2	16.4	12.8	13.2	11.6	10.6	12.0
Avg. Yld.	1.9%	1.9%	2.2%	1.7%	1.4%	1.1%	1.3%	1.9%	2.0%	2.4%	2.1%	2.3%

During the last decade shares of Kroger have traded hands with an average P/E ratio of about 13 times earnings. We have reduced our estimate slightly to 12 times earnings, as growth expectations are not as robust moving forward, this year notwithstanding. With shares trading near 11 times earnings, this implies the potential for a valuation tailwind.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	23%	22%	20%	22%	20%	20%	22%	25%	26%	27%	22%	28%

Although the large scale and reach of Kroger offers some economies of scale, and thus a 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, in-between 1% and 2%, which allows it to keep competitors at bay but also means that the stock is extremely sensitive to competitive pricing pressures.

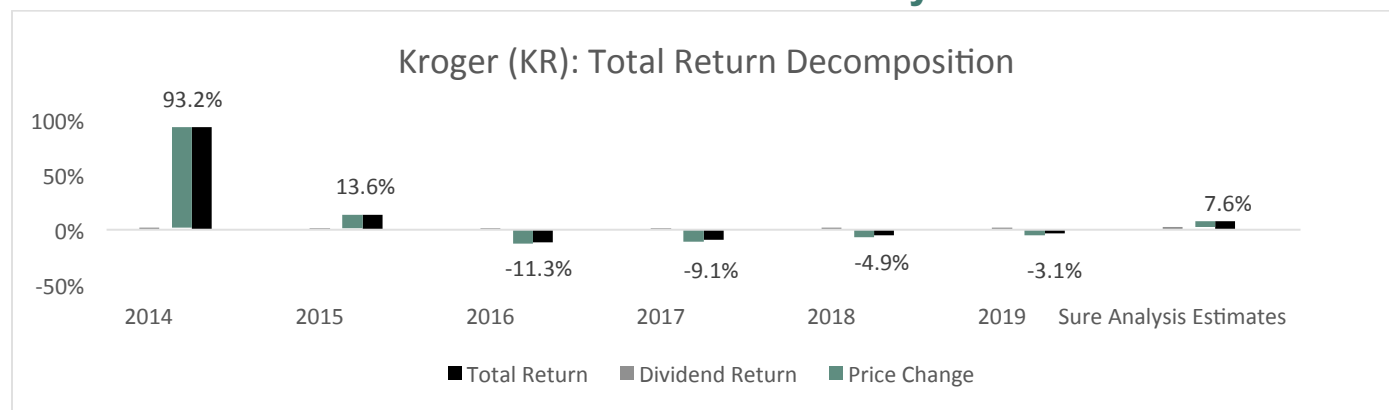
Kroger has been prudent about its dividend, with a payout ratio sticking around the 20% range in the last decade and only recently climbing slightly. The larger capital return focus has been, and likely will continue to be, on share repurchases. We believe this is prudent considering the competitive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

At the end of quarter Kroger held \$372 million in cash, \$12.3 billion in current assets (52% of which is inventory) and \$47.5 billion in total assets (46% of which is property and equipment) against \$14.6 billion in current liabilities and \$37.8 billion in total liabilities. Long-term debt stood at \$12.4 billion against underlying earnings power of about \$2.5 billion.

Final Thoughts & Recommendation

Shares are up 8% since our last report, while earnings expectations have improved as well. Kroger has proven to be a strong and resilient business, but the industry is not getting any easier; although results should improve dramatically in the short-term. We see the potential for 7.6% annual returns, stemming from 3% growth, a 2.1% starting yield and a valuation tailwind. Due to the intense competition in its business and average expected returns, we continue to rate shares as a hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue (\$B)	82.05	90.27	96.62	98.38	108.5	109.83	115.34	122.7	121.16	122.29
Gross Profit	18246	18880	19893	20237	22953	24334	25835	27000	26268	26992
Gross Margin	22.2%	20.9%	20.6%	20.6%	21.2%	22.2%	22.4%	22.0%	21.7%	22.1%
SG&A Exp.	14446	15964	15477	15809	17868	18669	20059	22479	21189	22092
D&A Exp.	1600	1638	1652	1703	1948	2089	2340	2436	2465	3289
Operating Profit	2200	1278	2764	2725	3137	3576	3436	2085	2614	2251
Op. Margin	2.7%	1.4%	2.9%	2.8%	2.9%	3.3%	3.0%	1.7%	2.2%	1.8%
Net Profit	1116	602	1497	1519	1728	2039	1975	1907	3110	1659
Net Margin	1.4%	0.7%	1.5%	1.5%	1.6%	1.9%	1.7%	1.6%	2.6%	1.4%
Free Cash Flow	1447	760	892	1243	1384	1568	573	604	1197	1536
Income Tax	601	247	794	751	902	1045	957	-405	900	469

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	23505	23476	24634	29281	30497	33897	36505	37197	38118	45164
Cash & Equivalents	1491	188	238	401	268	277	322	347	429	399
Acc. Receivable	N/A	949	1051	1116	1266	1734	1649	1637	1589	1692
Inventories	4966	5114	5146	5651	5688	6168	6561	6533	6846	7084
Goodwill & Int.	1140	1138	1364	2837	3061	3777	4184	4025	4345	4142
Total Liabilities	18207	19510	20420	23886	25055	27099	29795	30292	30283	36591
Accounts Payable	4227	4329	4484	4881	5052	5728	5818	5858	6059	6349
Long-Term Debt	7892	8165	8879	11310	11597	12079	14077	15589	15229	14076
Total Equity	5296	3981	4207	5384	5412	6820	6698	6931	N/A	8573
D/E Ratio	1.49	2.05	2.11	2.10	2.14	1.77	2.10	2.25	N/A	1.64

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	4.8%	2.6%	6.2%	5.6%	5.8%	6.3%	5.6%	5.2%	8.3%	4.0%
Return on Equity	22.0%	13.0%	36.6%	31.7%	32.0%	33.3%	29.2%	28.0%	N/A	20.2%
ROIC	8.5%	4.8%	11.9%	10.2%	10.2%	11.4%	10.0%	8.8%	N/A	7.3%
Shares Out.	1,240	1,122	1,028	1,016	974	967	924	870	798	805
Revenue/Share	64.30	76.11	89.96	94.59	109.23	112.07	120.39	135.69	148.12	151.91
FCF/Share	1.13	0.64	0.83	1.20	1.39	1.60	0.60	0.67	1.46	1.91

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

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