BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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The Kroger Co. EQ Review

Current EQ Rating*	Previous EQ Rating
4+	na

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of KR with a 4+ (Acceptable) rating.

The company has beaten EPS forecasts the last two quarters and is at the half-way point of its 3-year plan to transform the competitiveness and profitability of the company. There is some lumpiness between spending and seeing results in the Restock Kroger Plan and the company is calling for flat EPS for 3Q19 and a large gain in 4Q19.

Based on our review of the accounting we found little of concern except for exposure to multi-employer pension plans, which are expected to need additional cash contributions. We also think EPS growth will not receive nearly the push from share repurchases going forward. A three-year transformation results in asset sales, acquisitions, reviews of carrying values, and several other one-time events. We are reviewing those as well as ongoing accounting procedures for sustainability and impacts on cash flow.

- **We give Kroger very high marks on earnings quality as it laid out a three-year $4 billion investment in Kroger Restock and has not labelled any of it as a "one-time" restructuring charge that should be added back to adjusted earnings.** This is a combination of employee raises, lower prices for customers, new work in data & technology, adding more store-brands.

- **To put that in perspective – Kroger's EPS has been running just over $2 per share and $4 billion of cost investments over three-years is $3.50-$3.75 per share. That is quite a penalty Kroger is taking in being more conservative than many other companies we see doing restructurings.** Its goal is to out earn that investment via higher sales and report a $400 million profit gain net of the $4 billion in costs.

- **The multi-employer plans Kroger is dealing with have improved with only 2 of the 12 plans showing funding levels under 65% vs. 5 in 2016.** After several years of contributions, all plans have policies in place to cure the shortfalls and 8 are over 80% funded with 2 between 65%-80%.

- **However, the funding gap estimated as Kroger's share has not improved since 2015 despite Kroger contributing $1.6 billion in the last 3-years. The company expects to continue making contributions to these funds and working to correct the situation further.** Kroger is very focused on keeping its debt to EBITDA between 2.3-2.5x and it currently is just under 2.5x. The estimated $3 billion in pension shortfall here – would skew their ratio to 3.0x if ratings agencies viewed it as debt.

- **One-time adjustments called out are very modest and what would be expected such as some mark-to-market issues, gains/losses on selling non-core assets, and pension adjustments. Of twelve items called out to calculate adjusted EPS of more than 1-cent in impact, five are related to pensions. Another is an extra week in 2017 plus the Tax-Act that all US companies had an adjustment for.**

- **Two pension plans at Kroger are in good shape funding-wise and Kroger's more conservative assumptions were a 4-cent headwind on EPS last year.** The primary qualified plan is fully funded. Kroger also is moving pension assets into investment grade bonds to have PBO and assets more closely aligned. Their goal is 80% of assets in this area up from 12% in 2016. Kroger cut the expected rate of return last year from 7.5% to 5.9% for a $47 million earnings headwind, a further decline in that 5.9% figure may still come.

- **Inventories have increased slightly as Kroger implements its Restock plan.** That plan includes selling more store-brand products which may reduce the inventory investment – but offset by offering more value-added products such as ready-to-cook meals and take-home prepared meals as well as more fresh produce and protein. **DSIs have not grown over the last 3-years. We do not see a problem with inventories and do not expect the cash investment to rise much at this point.**

- **Cash Flow has some tailwinds. Capital spending is coming down as Kroger works on improving existing stores more than building new ones. Pension funding at the qualified plan should also decline. Dividend coverage looks much more appealing now too.** Kroger has focused on debt reduction as well, which improves flexibility and reduces interest expense.

- **EPS has a few more headwinds. The company's capital spending on higher-tech items means faster depreciation and higher expense. Also, in recent years, heavy share repurchases have driven EPS growth** – the company simply cannot afford to spend at levels near $2 billion on shares at this point.

The Kroger Restock Plan – Halfway Through – Quick Overview

We have seen many restructuring plans over the years. Two things are VERY common – 1) the company claims it will achieve enormous savings and spend very little and 2) the income statement calls out 50% or more of the spending as being 3rd party consultants, duplicate wages, massive write-downs and claims the bulk of the spending is one-time in nature, which should be added back. The first goal is often over-stated and the second seems to deny that the company cannot simply return to a time when it doesn't upgrade tech, modernize stores, or give wage increases while boosting prices.

What is refreshing about Kroger is it announced a $4 billion plan and is expensing it through the income statement as the new way of doing things. For example, it planned to reduce prices to customers in many areas and have that drive more traffic to the stores. It wanted to offer more of its own store brands at lower price points too as well as add more digital platforms – it estimated this would be $3.1 billion of the investment. It does not plan to reverse this spending going forward and it would become the new income statement.

There would be some cost-cutting too such as higher training and retention for staff with increased wages. While, KR would spend $500 million on this area, it forecast that the addition of more self-checkout registers, streamlining the stocking process, and slowing turnover and retraining – they could get by with fewer people in those areas and move others to new areas to drive more revenue such as online order fulfillment and car delivery or more ready to eat meal preparation. That was forecast to add back $375 million in operating margin.

The result is expected to be $4.4 billion in higher-income coming from same-store store growth that will pay for the $4.0 billion in investments in better logistics, pricing, wages, technology.

To be sure – there is some lumpiness to results because many of the cost issues move in a stair-step manner, while the revenue grows in a linear manner. Also, selling off the convenience store unit as non-core, for example, will impact revenues and costs. Eventually, the lumpiness may smooth out over time.

While we give Kroger high marks on earnings quality they will talk about fluctuations in margins quarter to quarter as "we invested more in price in the last quarter" which hurt gross margins or "we lapped last year's wage increase" which helped operating costs decline as a percentage of sales – they aren't calling this out as one-time figures that should be added back to adjusted earnings.

Also, many companies talk about restructuring and make the case "you can't save your way to prosperity" and then roll-out a plan to slash costs. Kroger is taking the opposite view and saying the goal is to grow revenues and enhance customer satisfaction to boost business.

The Multi-Employer Pension Plans – Improving But Still Largest Risk

This is one of the bigger issues in recent years at Kroger. Several of the various unions that have employees at Kroger stores have other pension plans in place beyond the standard defined benefit plan at Kroger. These plans have been grossly underfunded in some cases and Kroger has been making significant contributions to these plans:

Multi-Employer Plans	2018	2017	2016	2015
KR Contribution	$385	$964	$289	$426
KR Underfunding Share	$3,100	$2,300	$3,000	$2,900
plans under 60% funded	2	2	5	6
plans over 80% funded	8	8	7	7

The first line shows the cash contribution by Kroger followed by Kroger's estimate of its underfunding share of the liability. After funding another $1.6 billion from 2016-18, its share of the liability rose from $2.9 billion to $3.1 billion.

Some of that is due to the decline in interest rates and the company also attributes it to lower returns on assets in the funds. In other cases, plans have been combined or Kroger has funded withdrawals. We believe the plans have improved. Only 2 of the 12 plans are now under 65% funded vs. 6 of 13 in 2015. Not all these plans had agreements in place to correct that funding level and now they do. The number of funds over 80% funded has increased and there are two more with funding levels between 65%-80% of PBO. So, there has been some positive progress made.

However, even Kroger still believes this will be a cash flow drain for several years to come as it continues to pay down the underfunded levels in these plans – from the last 10-K:

> *"We believe that the present value of actuarially accrued liabilities in most of these multi-employer plans substantially exceeds the value of the assets held in trust to pay benefits, and we expect that Kroger's contributions to those funds will increase over the next few years."*

Kroger also considers it a risk factor that this will be viewed as debt on its balance sheet that would skew leverage ratios when agencies look at its debt rating. Even though these are not direct obligations to Kroger, this also gives more reason that the company will seek to close the underfunding gap.

The company's Debt to EBITDA ratio was 2.46x after the 2Q19. Their target is to remain between 2.3-2.5x. Adding in the full $3 billion of underfunding would move the debt number from $14 billion to $17 billion and the ratio 3x. The end result appears to us that Kroger will continue to fund $300-$500 million annually to these plans as it seeks to restructure the situation further and cure the gap. They do not list what assumptions are being used to determine all figures on these plans, but it also possible that those assumptions could decline and continue to increase the headwind in closing the gap.

Adjustments to EPS Have Been Minor Given the Restructuring and Largely Reflect Changes to the Multi-Employer Pensions

If we can use the term "normal restructuring" and not sound too much like Newell – Kroger gets solid marks here. For a company making some serious efforts to transform its business and remove non-core assets – the volume of restructuring-related charges called out as one-time items has been very small. In fact, the bulk of the adjustments relate to changes made in recent years to corral the problems in the multi-employer pension area. Those would be happening even without the Kroger Restock plan:

Adjustments to EPS	2018	2017	2016
KR Reported EPS	$3.76	$2.09	$2.05
Tax Act 2017	-	-$1.02	-
Gain on Sale of Convenience Stores	-$1.65	-	-
Pension/Retirement	$0.15	$0.90	$0.07
Impairments/Adjustments	$0.06	$0.07	-
Mark to Market	-$0.21	-	-
53rd week	-	-$0.09	-
Total Adjustment	-$1.65	-$0.14	$0.07
Adjusted EPS	$2.11	$1.95	$2.12

In total, there were 12 adjustments made that amounted more than 1-cents. Of those 5 were pension/retirement settlement related. Also, the Tax Act was an adjustment every US company made and most retailers adjust for years with an extra week.

The mark-to-market gain concerns Ocado stock. That company partnered with Kroger to build more of its logistics upgrades. As part of that deal, Kroger bought 33.1 million shares of Ocado stock for $243 million. Before that partnership agreement, Kroger had made two purchases of Ocado stock totaling 14.6 million shares. The partnership deal resulted in the value of the initial shares appreciating and Kroger pulled the gain out in adjusting EPS.

The goodwill impairments for the pharmacy are minor in comparison to other companies doing a major restructuring and the gain from selling the convenience stores is expected too. We think a case can be made that there has only been $0.13 of impairment-related charges added back to EPS.

In 2019 thus far, pension adjustments were an 8-cent hit and other gains on asset sales and adjustment of the Ocado stock amounted to $0.23 that was subtracted out.

The Other Pensions Look Solid and the Contribution Figure May Decline – EPS May Have a Headwind

Kroger has a Qualified Defined Benefit Plan that was fully funded at the end of fiscal 2018. It also has a Non-Qualified plan for employees who exceed certain targets to earn additional benefits. In recent years, Kroger has contributed money to these plans as well:

Pension Plan Contributions	2018	2017	2016	2015
Qualified Plan	$185	$1,000	$3	$5
Non-Qualified Plan	$25	$21	$19	$17

Here is the funding status for these plans:

Funding Status	Qualified	Non-Qualified
PBO	$2,994	$298
Assets	$3,010	$0

In 2017, the company's $1 billion contribution was made to cover $1.2 billion in settlements for employees who wanted lump-sum payouts. The PBO fell from over $4 billion.

We do not anticipate much in the way of contributions going forward (and the company is only forecasting $41 million in 2019). However, there are two other aspects of the plan to keep in mind. First, Kroger has been moving assets into high-grade bonds aiming for 80% of assets to get there. This move has happened over the last couple of years. This is designed to lower duration risk and also have assets move in tandem with liabilities. If PBO rises with lower interest rates, the assets should move up too. If rates rise, PBO falls and assets can be reinvested more quickly at higher rates.

That brings of the second point – Kroger cut its assumption for expected rate of return on pension assets last year. The figure fell from 7.5% in 2017 to 5.9% in 2018. This had the impact of lowering the basic pension income figure for Kroger:

Pension Cost(Income)	2018	2017	2016
Service Cost	$35	$53	$68
Interest Cost	$124	$163	$177
Rate of Return	-$174	-$233	-$238
Net	-$15	-$17	$7

When the expected rate of return fell 160bp, it cost Kroger $47 million in income. It also had the PBO discount rate rise by 23bp and the interest expense assumption fall by 25bp. We spoke of this two weeks ago as something we don't expect to see last. That ended up helping pension income by $8 million. In total, Kroger lost about 4-cents in EPS last year from these changes.

Going forward, we would not be surprised if the rate of return assumption declines further creating another minor headwind. The company is also stopping the accrual of new benefits for non-union employees at the end of 2019, that should also lower service cost to offset some of that headwind.

We are going to highlight this as another area of conservative accounting hurting Kroger results. Not many other companies are changing their pension assumptions in a way that lowers EPS.

The Inventory Investment Has Increased Slightly – It May Not be A Major Headwind for Cash Flow Going Forward

The company uses LIFO accounting for 90% of its sales. However, it typically reports its results in FIFO margins. The inventory turns fairly fast and the LIFO/FIFO adjustments are minor. The company's goal is to increase the percentage of sales from its store brands, which tend to cost less. They also do more ready-to-cook meal preparation packets with existing inventory other prepared meals that use in-store inventory – but create a value-added product too.

Looking at inventory, the dollar figures are up about $200 million from two years ago, but at the same time the COGS has also risen and the DSIs and turnover rates have stayed very flat. We see little reason for concern here as a cash flow drag.

	2Q19	1Q19	4Q18	3Q18
FIFO Inventory	$7,820*	$7,998	$8,123	$8,368
COGS	$21,977	$28,983	$21,902	$21,699
DSI	32.5	25.2	33.8	35.2
Inv Turn/Q	3.6	4.7	3.5	3.3

- We need the 10-Q to get a firm number for FIFO Inventory. The Press Release carries only LIFO and we estimated based on prior adjustment figure.

	2Q18	1Q18	4Q17	3Q17
FIFO Inventory	$7,515	$7,650	$7,781	$8,222
COGS	$21,964	$29,419	$24,240*	$21,532
DSI	31.2	23.7	33.8*	34.8
Inv Turn/Q	3.7	4.9	3.6*	3.4

- The 4Q17 is skewed by an extra week in the quarter adding to COGS, we reduced COGS by $2.7 million and sales by $3.0 million to compute ratios.

	2Q17	1Q17	4Q16	3Q16
FIFO Inventory	$7,698	$7,676	$7,852	$8,268
COGS	$21,609	$28,281	$21,483	$20,653
DSI	32.5	24.8	33.4	36.5
Inv Turn/Q	3.6	4.7	3.5	3.2

Cash Flow Has some Tailwinds

The interesting things about the restructuring is Kroger expects to spend $4 billion over 3 years and generate an incremental $4.4 billion in EBITDA and total capital spending will actually decline as the company focuses less on store growth.

	2015-17	**2018-20e**
Stores	$3.5	$1.2
Remodels	$4.1	$3.7
Restock Project	$1.1	$3.0
Infrastructure	$1.5	$1.1
Total	$10.2	$9.0

So capital spending is actually supposed to come down. At the same time, they sold the convenience stores and realized $2.2 billion and another nearly $600 million with non-core asset sales in the 1H19.

What is interesting so far is despite the heavy pension payments and divesting the convenience store business last year, cash flow remained fairly stable even as many of the new expenses have flowed through the income statement:

	1H19	1H18	2018	2017	2016
CFO	$3,277	$3,260	$4,164	$3,413	$4,272
CapX	$1,581	$1,487	$2,967	$2,809	$3,699
FCF	$1,696	$1,773	$1,197	$604	$573
Dividend	$226	$211	$437	$443	$429
Repurchase	$23	$1,979	$2,010	$1,633	$1,766

The company does easily cover the divided at this point. In 2017, there was the $1 billion contribution to the qualified pension plan which hurt free cash flow and in 2016 the capital spending was much higher.

Going forward, we believe contributions to the qualified plan will drop off and help free cash flow. Last year's $185 million is supposed to be $41 million in 2019. Free cash flow should be in the range of $1.2-$1.4 billion against a dividend of about $450 million.

We do not think they will be buying shares at the same rate and may still focus on some reduction in debt overall.

EPS May Have some Headwinds:

We will give kudos to Kroger for not cutting advertising during the restructuring. Also, its investment in new technology and distribution systems makes sense that it will help sales and income. However, they do bring higher depreciation rates. Information technology is depreciated over 5 years and that is where a large amount of capital spending is happening. That compares to 3-15 years for plant and distribution equipment, stores over 40 years, and store equipment over 3-9 years. Depreciation was up 4.2% y/y in 1H19 even though capital spending has come down from prior years.

Also, we doubt the share repurchases can continue at past rates. Free cash flow would need to top $2.5 billion and even the company's goal doesn't show that. Their goal in rough terms seems to be about $3.0 billion in capital spending so to cover $2.5 billion in dividends and repurchases, Kroger would need to do $5.5 billion in cash from operations. They are forecasting a $400 million pick up in EBITDA vs. cash from operations running about $4.1-$4.3 billion now.

	1H19	1H18	2018	2017	2016
Shares	805	829	818	904	958
Adjusted EPS	$1.16	$1.15	$2.11	$1.95	$2.12
EPS without repo	$1.13	-	$1.91	$1.84	-

Looking at this table, if the same 904 million shares were outstanding for 2018 as 2017 – EPS would have fallen from $1.95 to $1.91. Kroger already lapped the biggest repurchase impacts as it reported 805 million shares for both 2Q18 and 2Q19. On the positive side, for that quarter, EPS grew from $0.41 to $0.44 without help from repurchases. However, the repurchases have been a big driver of recent EPS gains, and we doubt they can afford them now.

Lancaster Colony (LANC) EQ Update-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3+

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are lowering our earnings quality rating to 3- (Minor Concern) from 3+ (Minor Concern).

LANC reported EPS of $1.20 in the 6/19 quarter versus the consensus estimate of $1.30. However, results were inflated by a 21 cps share non-operational gain from the write down of the remainder of the estimated value of contingent consideration from the Angelic acquisition. This was partially offset by 5 cps from spending on its EPR initiative and 5 cps from a restructuring and impairment charge related to the closure of a frozen bread facility. This gives us an adjusted EPS number of $1.09 which was 21 cps below the consensus target.

The deterioration in our rating largely reflects the non-operating gain from the reduction of Angelic contingent consideration and the associated increase in risk of a future write-down of goodwill and intangibles related to the business.

- LANC wrote off the entire balance of the contingent consideration liability stemming from the Angelic acquisition. When LANC acquired Angelic for $35.5 million in November of 2016, the purchase price did not include contingent consideration that was contractually based on a pre-determined multiple of Angelic's 2021 EBITDA. LANC has been estimating the value of the contingent consideration liability since then and posts losses to reflect increases in the estimated liability and gains to reflect declines in the liability. The initial estimated value of the contingent liability was $13.9 million. This rose until it peaked at $17.1 million at the end of fiscal 2018. As we noted in previous reviews, that time period experienced non-operating losses to reflect the increase in the value of the liability. However, deteriorating results at Angelic led to declines in the expected earn-out payments which led to cuts to the liability and non-operating gains during fiscal 2019. In the 6/19 quarter, LANC wrote off the remaining $6.7 million of contingent liability which provided a $0.21 per share non-operating boost to reported EPS in the period.

  Management stated the following in the conference call with regard to the sources of problems at Angelic:

> *"I guess I would say ascribe it to a couple of things. One is the perimeter of the grocery store is probably a little bit tougher a category we've learned and I would also point to -- the flat out acquisition as a case in point in that I would say that's a contributor. The other thing that really has probably resulted in the biggest impact in the write-down is we had a pretty significant piece of the business that was tied to private label when we acquired the business. And we made a decision to begin to wean ourselves on that private label as we have worked to ramp-up our branded business in loaf bread, but also our branded business in wraps and crust and other products. And essentially what's happened as we have taken out the private label pounds, it's made that factory run less efficiently.*
>
> *So, the other parts of the business tend to be growing, but not as rapidly as we want. So, our expectation on this is, is not that the game is over. It's just taking us longer to get this business where we want it to go. And as you can appreciate Frank with the mark-to-markets on an earn out that's a relatively short duration you just have to square right into it and let the accounting numbers tumble where they fall."*

Of the original consideration of $49.4 million ($35.5 million purchase price plus $13.9 million contingent consideration), LANC recorded $24.4 million as goodwill and $18.8 million as other intangible assets. There have been no impairment charges taken against these amounts and management's description above seems to indicate it believes it can turn things around at the acquired business. Should conditions continue to deteriorate at Angelic, we believe there is a strong possibility that LANC will have to recognize an impairment. We also note that management has indicated that it has invested significant cash in expanding and automating production at acquired Angelic operations. While this will not technically impact the calculations to determine impairment, it does weaken any argument for synergies provided by the acquired operations if it took more investment to bring them up to necessary size.

- Cash from operations rose by 23% in fiscal 2019 with a huge boost from lower working capital. Inventory DSI fell by almost 4 days in the 6/19 quarter versus a year ago while payable days jumped by almost 6. About 30% of the increase in payables was due to an increase in capex-related payables which will eventually cycle through investment cash spending rather than operating cash spending. Still, the rise in trade-related payables was a significant boost to cash from operations. We note that the company's days payable of under 30 indicates that it is far from over-pressuring its suppliers unlike some other packaged food companies we have reviewed.

Nevertheless, such a large cash flow jump from working capital can't continue at this pace. We do not view this as a large concern for cash flow health, however, as cash flow growth adjusted for working capital impacts still topped 12%.

- Capital spending skyrocketed in the fiscal year ended 6/19 to $71 million from $31 million a year ago. This is being driven by investments in capacity expansion projects in a dinner roll production facility which is expected to be complete by mid-fiscal year 2020, a recently-completed R&D facility, as well as investments in capacity and automation in its acquired Angelic operations. The high level of spending is expected to continue in fiscal 2020 with management estimating $80-100 million in spending for the full period. Even with the increased level of spending, free cash flow of $127 million was more than sufficient to cover the dividend ($70 million), the buyback ($7 million) and the acquisition spending ($55 million).

Explanation of EQ Rating Scale

Rating	Explanation
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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