BEHIND THE NUMBERS
Quality of Earnings Analysis

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The Kroger Company (KR) Earnings Quality Update 10/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of KR with a 5+ (Strong) rating.

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

Summary

Kroger's 3Q showed much of the same story so we will keep this short. EPS beat forecasts by 5-cents as the company enjoyed higher sales and margins. We are pleased to see Kroger devote some of its higher COVID cash flow toward fixing its multi-employer pension obligations which will help future cash flow. Also, Kroger has retired about 20% of its stock in recent years at about 10x earnings. In 2017, to earn $3 per share on $122 million in sales, KR needed an operating margin before rent, depreciation, and interest of 6.15%. Today sales are higher with COVID and attracting new customers. But with the lower share count and lower leverage, KR can earn $3 per share with a 5.05% margin on the same $122 million in sales. If they keep sales at $125 million, they can earn $3 on a 4.95% margin. That is a ton of deleveraging of fixed costs if sales do decline that KR can withstand.

Earnings quality remains high as Kroger does not adjust out the COVID related costs for additional employees, overtime, incentive pay, cleaning, etc. Kroger has pulled out enormous costs in recent years but plowed back the savings into higher wages and lower prices. There should be millions in COVID-related costs that can decline with COVID sales levels too.

What is strong?

- When we first wrote KR, the over-riding negative issue was its exposure to multi-employer pension plan shortfalls. KR has been cleaning this up with additional payments along with withdrawing from plans it has funded. At the end of 2018, the KR share of the liability was $3.1 billion. By the end of 2019, it was $2.3 billion. KR has used some of the COVID windfall profits and cash flow to further reduce this problem area. It announced in 4Q that it will withdraw from another plan and fund its remaining payments of $962 million over three years beginning in 2020.

- Funding for these multi-employer plans has been heavy in recent years: $236 million through 3Qs of 2020, $461 million in 2019, $385 million in 2018, and $954 million in 2017. KR will continue to make payments toward these plans, but the size of the problem is getting smaller and perhaps the end can be seen. Kroger's target for leverage is 2.3-2.5x EBITDA, and it was at 1.74x after 3Q20 so the liquidity is here and we applaud the company using some of it to remove some open-ended liabilities.

- Kroger remains one of the few companies we have seen that reports adjusted EPS that actually come in lower than GAAP EPS. GAAP was 80-cents in 3Q20 while adjusted EPS was 71-cents. The adjustments relate primarily to marking an investment in a logistics firm to market which was a 15-cent gain in 3Q, netted against 2-cents in higher contingent payments for the Home Chef acquisition exceeding forecasts (WOW a company that made two home-run acquisitions – investors don't see that every day), and 4-cents related to store closing fees.

- More importantly, Kroger does not add back COVID costs – which are elevated for extra warehouse space, overtime, extra employees, cleaning, and reconfiguring stores and all operating spaces. Kroger does not add back the costs to roll-out and expand its digital sales such as online ordering or waiving pick-up fees. It does not add back its investments in reducing prices to customers. They have talked about adding $1 billion in spending incrementally each of the last two years in these areas. That is nearly $1 in annual EPS that is compounding that Kroger is not adjusting back for a company earning about $3. The move is on to educate investors that the incremental sales are coming against already incurred fixed costs. Thus, the incremental $1 in sales is boosting profit by 25-cents rather than 5-cents.

What to watch

- The debate has begun on will Kroger lose sales and earnings as COVID demand wanes. We believe Kroger may have a transition quarter or two where it continues paying higher COVID related costs as sales normalize more – which could mean negative sales comps. In the larger picture, we believe Kroger has the potential to offset much of this with less overtime pay, fewer total employees and even charging for people who pick up their orders rather than go into the stores.

  Some back of the envelope sensitivity analysis shows us that every $500 million in sales lost as COVID wanes would reduce quarterly EPS by about 2.6-cents. Sales were about $2.5 billion higher y/y in 3Q. So if sales normalize down $1.5 billion per quarter that's about 8-cents in lower EPS. Also, there is some margin leverage from the higher sales, and operating margin was 5.5%. Every 25bp lost on the remaining sales from margin contraction is about 6-cents in lower EPS too. Thus, if sales later in 2021 normalize at $1.5 billion less and 50bp of margin is lost – EPS would see pressure of about 20-cents per quarter. That assumes Kroger doesn't do anything to offset that like normalizing staff or seeing COVID costs decline or not needing as much warehouse space, or capping fuel subsidies at 10-cents per gallon, etc. Given how much extra cost is in the system now that could come out, we think non-COVID quarters will probably cost EPS by about 10-12 cents per quarter. Also, keep in mind – if you're comparing Kroger EPS before the RESTOCK program to now – they have retired 144 million shares at this point, that alone would boost EPS by 20% from what it was in 2017.

- Kroger did not see a huge issue with inflation after 3Q. It believes its operating model is built to absorb 0.5%-1.0% inflation without issues. It is seeing inflation of late at about 2% and much of that was due to COVID-related closures at meat facilities. If you like branded consumer product companies and branded food companies (Conagra comes to mind) – you may want to take note of the following things pointed out by Kroger on its call. **First, we know Kroger makes a higher profit margin on its own store-brand merchandise, which it sells for lower price to the consumer – which counters inflation. Kroger noted that its store brands took market share and grew at 8.6%** in 3Q with *Private Selection* growing at 17% and *Simple Truth* at 15%. It also introduced 250 new items.

  Second, Kroger all but said its way of handling cost inflation is pushing it back on the branded companies. The CEO said, *"**You're going to always work with CPGs initially to try to find ways to take costs out of the system, so that our customers don't have to have inflation.** And it's something that every CPG that partnership is a different approach in terms of trying to figure out a way to minimize the impact on customers."*

- Inventories remain below normal levels in our view. That should also help preserve some margin at KR, but we do expect them to in invest some cash flow in building stocks further and they have taken on more warehouse space.

Kroger Inventory	Nov. 20	Aug. 20	May. 20	Feb. 20
Inventory	$7,478	$6,344	$6,297	$7,084
COGS	$22,901	$23,551	$31,454	$22,507
Inventory DSIs	29.8	24.6	18.3	28.7

	Nov.19	Aug. 19	May. 19	Feb. 19
Inventory	$7,412	$6,526	$6,707	$6,846
COGS	$21,798	$22,007	$28,983	$21,955
Inventory DSIs	31.0	27.1	21.1	28.5

During 3Q, Inventory consumed $1.16 billion of cash flow at Kroger as it was already rebuilt. The higher earnings still enabled Kroger to post positive cash flow from operations in the quarter with help from rising payables too. We do not expect that level of inventory growth in 4Q.

Explanation of EQ Rating Scale

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 Concern)- 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 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 upcoming quarters. 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.

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