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October 9, 2020 | www.btnresearch.com

Kroger (KR) EQ Update- 7/20 Qtr.

Current EQ Rating*	Previous EQ Rating
5+	5+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We maintain our earnings quality rating on Kroger (KR) at 5+ (Strong).

The company beat forecasts handily with EPS of $0.73 vs. forecasts of $0.54. The effective tax rate falling 180bp helped by 2.4-cents. Also, the cents/gallon on fuel came in stronger y/y and fuel profits fell only $30 million y/y. KR had guided to fuel profits being down $50-$100 million for 2Q. **That incremental $20-$70 million in fuel profits helped by 2-7 cents in the quarter. Thus, KR still had a solid beat.**

What we still like is adjustments to EPS are minimal and largely related to gains/losses. For a company that has invested $300 million more in wages than forecast in the Restock Plan, spent heavily on COVID mitigation policies, and continues to invest in pricing for customers – it isn't removing any of that in adjusted results. The only adjustment in 2Q was for $21 million in costs related to store closings and some third-party consulting fees.

We like KR's efforts to improve longer-term cash flow and its balance sheet by funneling some of the higher cash flow into resolving more of the multi-employer pension plans. This has been a continual use of cash for several years. It announced that it expects to sign a deal in 3Q20 to withdraw from the UFCW union plan for a contribution of $962 million to be paid in three installments. These multi-employer plans have been the one negative we found when we started to follow Kroger. The company also repaid its credit revolver and all its commercial paper. All of these actions should help Kroger's future results.

Items that deteriorated

- Inventory declined significantly in 1Q20 and produced cash flow. However, that was not intentional. KR grew DSIs back in 2Q but not completely.
- We expect inventories to rise for seasonal reasons in 3Q and to adjust back to pre-COVID levels on DSIs. That could be a $500 million cash drain, offset partially with higher payables.
- Capital spending should also be higher in 2H20 than in 1H20 and could be another $500 million higher cash outflow.

Items that improved

- Liquidity was up considerably with KR paying off its revolver, all its commercial paper, and still holding $2.8 billion in cash (up $2.4 billion since year-end).
- Net debt to EBITDA is at 1.7x vs. goals of 2.3-2.5x. Even assuming inventory build, KR should remain below its target and may return more cash to shareholders.
- Its share of obligations under multi-employer pension plans fell to $2.3 billion from $3.1 billion
- Adjustments to EPS from GAAP are benign. KR only added back 3-cents related to third-party legal expenses and some store closings. It has not added back COVID costs for new training, overtime nor has it added back its restructuring charges or new investments in lower prices.

Ongoing Items

- KR expects to sign a deal to withdraw from more of the multi-employer pensions in 3Q. This should cost $962 million spread over 3-years.
- Multi-employer plans have consumed considerable cash flow in recent years but repeated withdraw actions should transition KR to a smaller expense and cash drain going forward.

History of Multi-Employer Plans for Kroger – It Is Improving

These plans are often set up by unions for various employees. Because the employees of each union may work for one of several companies, these pension plans have multiple companies making cash payments to the pension plans to support the benefits.

Several years ago, many of these plans were underfunded by a significant amount and ERISA and others started to step in to develop plans to cure the funding shortfalls. As we noted in our original report, KR has been making sizeable contributions to these plans and the number of plans with weak funding has dropped from six to two. Like many other pension plans, the long-term drop in interest rates continued to drive up the obligations and even with significant cash payments to the plans, the underfunding levels were remaining largely flat. This is why we anticipated that Kroger would continue to see large cash payments to some of these plans in the future.

Multi-Employer Plans	2019	2018	2017	2016	2015
KR Contribution	$461	$358	$964	$289	$426
KR Underfunding Share	$2,300	$3,100	$2,300	$3,000	$2,900
plans under 60% funded	2	2	2	5	6
plans over 80% funded	6	7	8	7	7

The share of the underfunding is not a direct liability to Kroger. However, we took it as an indication that large cash contributions would likely continue. What Kroger has started to do is withdraw from some of these pensions. The plan can work up an estimated cost for any party to leave – if they agree to pay the pension plan to ensure the funding is there. In 2017, Kroger reached a withdrawal payment with its Central States Pension plan for $550 million.

During these years, Kroger has made the following payments related to withdrawing from certain plans:

	2Q20	1Q20	2019	2018	2017	2016	2015
Withdraw fees	$0	$0	$135	$155	$467	$28	$0
Other payments	$0	$236	$326	$203	$497	$261	$426

- In 2016 – withdraw fees of $111 million were expensed with a cash payment of $28 million in 2016 and the rest in future years.
- In 2017, withdraw fees of $550 million were expensed with a cash payment of $467 made and the rest in future years.

In the 2Q20, Kroger announced it has reached a withdrawal plan for the UFCW International Union Pension Fund. It expects to pay $962 million to the fund plus a $27 million transition reserve. These payments would be funded over three years.

It is not clear if this impacts all the various UFCW plans – Kroger lists five plans related to that union. UFCW has been where much of the recent cash spending from Kroger has gone in recent years:

	2019	2018	2017
So. CA UFCW	$75	$71	$66
Desert Sts. UFCW	$19	$19	$18
Rocky Mtn UFCW	$23	$20	$19
Retail Food UFCW	$10	$10	$10
UFCW Cons Plan	$174	$55	$201
Total UFCW	$301	$175	$314
Total Multi- Spend	$461	$358	$954

In our view, this is a positive move. Cash flow is up at Kroger with COVID and the Kroger Restock program. This agreement should reduce a sizeable amount of future cash payments to the multi-employer pension plans in return for cash upfront in 2020-2022. While the $2.3 billion of underfunding representing Kroger's share at the end of 2019, it may be able to cut $900 million off that total.

Kroger Did Rebuild Inventory in 2Q on DSIs- Not Much in Dollars

In 1Q20, KR had enormous cash flow due to higher earnings. However, it also picked up over $1.5 billion from seeing inventory decline and payables increase. The company noted that COVID demand was outstripping the logistics to get products into stores during 1Q and it wanted to return inventory levels to pre-COVID levels. It saw DSIs increase sequentially, which is normal. Actual levels may still be lower than optimal and this could be a mild headwind going forward:

	2Q20	1Q20	4Q19	3Q19
DSIs	30.1	22.4	34.3	36.3

	2Q19	1Q19	4Q18	3Q18
DSIs	32.5	25.2	33.8	35.2

Adding another 2-3 days of inventory would mean about $500-$700 more of additional inventory. Also, 3Q is normally a period of time of higher inventory given holiday purchases beginning. **Looking at the sequential change in dollar terms, inventory fell $756 million in 1Q and only grew by $70 million in 2Q. Thus, we still think there is a headwind coming for cash flow.**

On payables, the DSPs reached a more normalized level in 2Q and consumed $261 million in cash in the quarter from 1Q.

	2Q20	1Q20	4Q19	3Q19
DSPs	26.6	20.7	25.7	28.5

	2Q19	1Q19	4Q18	3Q18
DSPs	26.0	20.2	25.2	27.4

Looking at 1Q and 2Q key cash flow components and reported cash from operations, cash flow gains have been huge in 2020 so far – history shows higher inventory may be matched against higher payables for 3Q:

	3Q19	2Q20	2Q19	1Q20	1Q19
Net Inc. less gains	$45	$457	$232	$778	$424
Dep/Amort	$772	$760	$740	$1,018	$976
Inventory Chg.	-$362	-$71	$150	$756	$124
Payables Chg.	$599	-$261	-$155	$783	$364
Reported CFO	$771	$1,160	$1,009	$4,245	$2,268

- 2Q20 was helped by deferring the employer's share of Social Security taxes under CARES Act for $329 million.
- 1Q19 was helped by a $295 contribution from a contract payment on selling a business.

Cash and Debt Have Improved

Cash is up to $2.8 billion at the end of 2Q20 from $400 million at the end of 4Q19. It is also worth pointing out that KR has repaid all of its commercial paper. It also drew down $1 billion on the credit line in March but repaid that in full during May. With all the cash on hand, the net debt figure has dropped by nearly $3 billion in the last 6-months. At the same time, trailing 4Q's EBITDA has been increasing:

	2Q20	1Q20	4Q19
Debt net of cash	$11,034	$11,170	$13,945
Adj. EBITDA	$6,492	$6,183	$5,629
Debt/EBITDA	1.70	1.81	2.48

There are several points to make here:

- KR's goal is to have a Debt/EBITDA ratio of 2.3-2.5x
- Even if we add in the $2.3 billion of its share of multi-employer pensions, the ratio would be 2.05x now
- Therefore, we think paying the $962 million over three years – will improve the ratio adjusted for that as debt as EBITDA has only been elevated for two quarters at this point.
- According to management, their data are showing more people wanting to eat healthier and cook more at home. This has KR believing recent COVID gains will hold in 2020 and 2021 will exceed pre-COVID levels.
- **The trailing 12-months EBITDA of $6.5 billion is not adjusted for everything under the sun. There are $80 million of severance charges and $119 million in charges for store closures and 3rd party consulting. That's only 3% of the adjusted EBITDA.**
- Having inventory increase by $500 million without having payables increase – would only add 0.08 turns to the debt/EBITDA.
- Capital spending will be a larger head-wind in 2H20 as guidance still calls for $3.0-$3.4 billion in investments for the year with only $1.34 billion spent in the 1H20.
- When we look at all the cash, the rising cash flow, we believe Kroger is in very good shape going forward to remain below its debt ratio targets.
- The company noted it will continue to allocate investments to digital sales and higher productivity. It also expects to grow its dividend and return additional cash via share repurchases as well.

Adjustments to EPS Look Benign to Us

The company continues with its policy of not adding back its Restock Kroger costs. That's still a very nice sight given how many companies we review who add back every nickel of expected costs related to restructuring, integration, and acquisitions in adjusted earnings. KR is not even adding back COVID-related costs.

The company's investment in Ocado – related to its logistical infrastructure has continued to perform well and GAAP has KR marking this to market every quarter. KR's adjusted results are penalized by subtracting the gain. Its investment in Home Chef has also performed well since the acquisition. It came with some contingent payment obligations if it beat expectations, which has happened. So those payments are considered one-time and added back. Finally, part of Restock involved some third-party consulting fees and some store closing costs. Those are added back but do not appear that material to us.

Adjusted 2Q20	Income	EPS
GAAP	$819	$1.03
MTM Ocado	-$278	-$0.35
Home Chef	$19	$0.02
Transformation	$21	$0.03
Adjusted income	$581	$0.73

As noted earlier, KR beat by 19-cents. It did pick-up just over 2-cents from a lower tax rate and it's expected headwind for lower fuel profits came in at -$30 million rather than -$50 to -$100 million. That added at least 2-cents more. The minor transformation cost related to some real estate and third-party fees of 3-cents being added back did not make a difference in KR beating forecasts.

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 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.

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