BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Kroger (KR) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
5+	4+

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 are upgrading our earnings quality rating to 5+ (Strong) from 4+ (Acceptable)

Kroger's margins benefitted from selling fewer gallons of gasoline which is lower margin in the first place – volume was down 24.6% in 1Q20. It also benefited from earning 48-cents per gallon vs. 23-cents the prior year. We estimate this to be a 21-cent boost to EPS in 1Q20 and a boost to cash flow of about $168 million. As the country has opened more, fuel is returning to normal margins with lower volumes and Kroger is forecasting a $50-$100 million headwind for the 2Q20 or 5-10-cents of EPS.

Our initial rating focused on potential problems with multi-employer pension plans and the company being at the high-end of its debt target. Both situations have improved in recent quarters and we are boosting the rating for four reasons:

- **Multi-Employer Pensions have received higher funding in 2019 and 1Q20. KR's share of underfunding has fallen by $800 million since the end of 2018.** KR's debt target is to be at 2.3-2.5x EBITDA – it is now at 1.8x without this pension debt or 2.2x with it. That is down from 3.0x a few quarters ago.

- **The restructuring efforts and capital improvements in digital have helped boost sales and leverage those higher sales with margin gains. The higher operating earnings should drive higher cash flow as well.**

- **Inventory provided a large boost to cash flow in 1Q20 that will likely reverse going forward as KR wants to get stores back to pre-COVID levels of inventory to avoid out-of-stocks. DSIs fell by 3-days in 1Q20.** Other segments of working capital are helping cash flow due to higher sales as well and should keep working capital as a cash generator in 2020 even as inventory levels increase. Total working capital changes produced $1.3 billion in cash from operations in 1Q20,

- **Adjustments to EPS remain very benign.** We still give Kroger high marks for not adding back restructuring charges, new investments in employees, and COVID related costs. In recent quarters the only adjustments made are a mark-to-market gain/loss for a stock holding, issues for a divestment, and contingent liabilities for an acquisition meeting a milestone. Those all appear non-operating and one-time in nature.

The Multi-Employer Pensions Received More Sizeable Infusions of Cash from Kroger in Fiscal 2019 and 1Q20

Kroger continues to believe that its contributions will be elevated in the coming years – the same warning language that was in the 10-K for fiscal 2018. Here's what is different:

- **KR's share of underfunding for these plans is lower by $800 million** – some of that is due to a higher expected rate of return on the assets:

Multi-Emp. Plans	1Q20	2019	2018	2017
KR Contribution	$236	$461	$358	$954
KR Underfunding Share	n/a	$2,300	$3,100	$2,300

- **KR's range for net-debt to EBITDA is 2.3-2.5x. In our initial EQ review, the ratio was 2.46x. It is now 1.81x.** Also, the company's share of underfunded pension debt was $3.1 billion and KR warned that could be viewed as debt

that would boost its debt ratio 3.00x. It still has that warning in the latest 10-K, but adding the $2.3 billion would still have the ratio at 2.18x – below Kroger's range. **Debt fell by $600 million in 1Q20 and what really moved the ratio down was the cash balance rising by $2.3 billion.** We expect some of that cash to reserve back out in future quarters, as we'll discuss below – **but even if they lose $1 billion and add in the $2.3 billion in pension debt – KR would still be at the low-end of its leverage target of 2.34x net debt/EBITDA.**

KR's Operating Profit is Rising as the Costs Savings from the Restock Kroger Plan Are Seen and Higher Sales Are Being Leveraged More

Some of this in 1Q is clearly due to COVID issues – but sales are remaining strong. If we remove the impact of fuel margins in 1Q20 – adjusted operating profit would have been about $1,232 million or about 3.0% of sales. Excluding fuel and the pension contribution, KR reported margins were up 54bp to 3.1%.

Op Results	1Q20	1Q19	4Q19	4Q18	3Q19	3Q18
Sales	$41,549	$37,251	$28,893	$28,286	$27,974	$27,831
Adj Op. Profit	$1,453	$957	$758	$628	653%	$664
Margin	3.5%	2.6%	2.6%	2.2%	2.3%	2.4%

The first-quarter results are punished further by adding all the COVID safety issues for cleaning, testing, barriers, and additional staff for on-line orders and stocking. Even if fuel is a headwind in 2Q of $50-$100 million, 2Q19 is an easy comp where margins before fuel were down 15bp last year. Higher sales in 2Q20, leveraging those over fixed costs, and the cost savings being seen – could be worth $350-$500 million in higher operating profit. The pension cost of 1Q20 is unlikely to recur as well. That should more than offset the fuel headwinds.

It is also important to note that with operating profit up $500 million in 1Q and likely up about $300 million in 2Q – that is a net positive of $600 million incremental cash flow after taxes. Capital spending for the year is only forecast to rise $100-$300 million to $3.2-$3.4 billion in 2020. The free cash flow figure should already be coming in above last year.

Inventory Tailwind on Cash Flow May Reverse in Coming Quarters

While income was clearly surging in 1Q20 and helping cash from operations rise by $2.0 billion y/y – working capital contributed $1.3 billion of the total. Some of that is due to rising sales, costs, and employees. Some of that is due to receivables being a small part of working capital to be a drain on cash flow as sales grow. We noticed Accounts Payable rose by $783 million vs. $364 million the year before – adding $419 million to cash flow. Inventory also fell by $746 million vs. a decline of $124 million in 1Q19 – adding $622 million more to cash flow in 1Q20.

	1Q20	1Q19
Cash from Ops	$4,265	$2,268
Decline in Inv.	$756	$124
Increase in A/P	$783	$364
CFO without Inv/AP	$2,726	$1,780

In the case of accounts payable – we do not see a problem. It rises seasonally in 1Q and the jump in sales explains most of it. The Days Payable only rose by 0.5 days:

	1Q20	4Q19	3Q19	2Q19
DSPs	20.7	25.7	28.5	26.0

	1Q19	4Q18	3Q18	2Q18
DSPs	20.2	25.2	27.4	24.7

Inventories are another issue – they declined more seasonally amid rapidly rising sales than the year before and the DSIs declined by 3 days:

	1Q20	4Q19	3Q19	2Q19
DSIs	22.4	34.3	36.3	32.5

	1Q19	4Q18	3Q18	2Q18
DSIs	25.2	33.8	35.2	31.2

According to management, inventories are likely to rise going forward in dollars and DSIs. On the 1Q20 call it was noted,

> *"if you look at our supply chain team working with our merchants,* ***<u>we're getting the stores' inventories back up to pre-COVID level, so the in-stock position improves</u>****, the continued focus on Fresh and continuing to even – Fresh was a priority already, but making sure that the products that customers get stays fresh and then with a friendly smile or an incredibly easy digital experience."*

While that should offset some of the cash flow seen in 1Q20 – overall working capital is expected to be a cash generator in 2020:

> "*We expect working capital to improve for the year, although not to the level experienced in the first quarter which was inflated by the extraordinary sales growth due to COVID-19."*

> *"We certainly were thrilled with the cash balance that we generated during the quarter. Part of that does reflect improved operating performance. Part of it was a significant improvement in working capital… But some elements of that will be inflated just because of the higher sales in the first quarter and the way our working capital cycle works and some of these are also related to the Cares Act where there is a delay in certain tax payments as part of the way that the Cares Act was structured. So, we would expect as a result of all of that, still to generate incremental free cash flow this year."*

Adjusted EPS Remains Very Clean

When we first addressed Kroger – we were impressed that it is not adjusting results to add back the costs of the Restock Kroger Program. It also has not added back items like the contributions to multi-employer pension plans when it reports adjusted EPS.

The most common change is the mark to market gain/loss of its share in Ocado. This is the company that Kroger partnered with to build out its logistic upgrades. The other items are understandable as one-time items:

EPS Adjustments	1Q20	4Q19
GAAP EPS	$1.52	$0.40
MTM Ocado	-$0.40	$0.01
Chg. to Chef deal	$0.06	-$0.05
Transformation Chg.	$0.04	$0.04
Withdrawal from Pension	$0.00	$0.01
Impairment to Divest Lucky's	$0.00	$0.16
Adjusted EPS	$1.22	$0.57

The Chef acquisition has contingent payments based on the unit hitting milestone targets. That contingent portion is revalued and results in changes in the value. The transformation is related to closing some stores and Lucky's was deconsolidated. Kroger also withdrew from one of the pension plans.

We consider the company's earnings quality to be above average given the nature of the adjustments and how many other things Kroger could be adding back related to COVID, increased spending on digital tools, and the restructuring since 2017.

Explanation of EQ Rating Scale

Rating	Description
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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