

**Second Quarter 2011**  
**Investor Conference Call Prepared Remarks**  
**September 9, 2011**

***Cindy Holmes, Director of Investor Relations:***

Good morning and thank you for joining us. Before we begin, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions, and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings, but Kroger assumes no obligation to update that information.

Both our second quarter press release and our prepared remarks from this conference call will be available on our website at [www.thekrogerco.com](http://www.thekrogerco.com).

After our prepared remarks, we look forward to taking your questions. In order to cover a broad range of topics from as many of you as we can, we ask that you please limit yourself to one topic with one question, and one follow-up question, if necessary. Thank you.

I will now turn the call over to Dave Dillon, Chairman and Chief Executive Officer of Kroger.

***Comments by Dave Dillon:***

Thank you, Cindy. Good morning everyone and thank you for joining us today. With me to review Kroger's second quarter 2011 results are Rodney McMullen, Kroger's

President and Chief Operating Officer, and Mike Schlotman, Senior Vice President and Chief Financial Officer.

### **Second Quarter Performance**

We are pleased with Kroger's strong performance this quarter, which we believe is the outcome of our consistent approach to managing the business and executing our Customer 1<sup>st</sup> strategy. Our ongoing investments in the four keys – our people, products, prices and the shopping experience – continued to enhance our connection with customers and drive positive identical sales growth.

Identical supermarket sales for the second quarter increased 5.3%, excluding fuel. This is Kroger's 31<sup>st</sup> consecutive quarter of positive identical sales growth. These industry-leading results are due to the efforts of our associates to delight our customers while at the same time delivering good savings on expenses. Kroger's second quarter performance was broad-based across the country and supermarket departments. Each of our 18 retail divisions produced positive identical sales growth, excluding fuel. Every supermarket department also experienced positive identical sales growth in the quarter, with the strongest increases in Natural Foods, Deli/Bakery, Produce and Meat.

Overall, the second quarter results reflect the balance we strive for in our business. We want to consistently deliver value to both our customers and shareholders. Despite the stagnant economy, our sales grew, tonnage remained positive, and both total and loyal household counts are up. Fuel performed better. And we maintained good cost control. In keeping with those solid measures of our performance, we also delivered earnings and earnings per share growth right in line with our internal expectations.

## **Influencing Factors**

In March and again in June, we discussed five external factors that are shaping the overall operating environment this year. I'd like to briefly update you on how we are managing our business in the context of these factors.

- First, the sluggish economy continues to strain household budgets while increasing consumer anxiety. In fact, customers tell us their expectations for the economy are more pessimistic now than at any time this year. And, for the first time, customers list instability of the financial markets as one of the top economic concerns. These examples illustrate how consumer sentiment changed during the quarter, and are important because most discretionary spending is based on what people feel or perceive about the economy.
- Second, food and fuel prices increased again this quarter. In June, Rodney noted that we were beginning to detect slight changes in consumer behavior due to increased variability in the economy and food inflation. We read the shifting sentiment correctly, which played out this quarter. Our market share continues to grow as we benefit from the credit customers give us for the investments we have made – and continue to make – to lower the overall pricing of items in our stores. Rodney will have more to say about how food inflation is affecting shopper behavior shortly.

- Third, the overall competitive retail environment is rational and our price checks show that most competitors are passing higher costs on to consumers, particularly in the center of the store. There are some exceptions to this. One example is in produce. During the quarter, retails did not rise at the same pace as cost because of a shortage of some product due to the late growing season.
- Fourth, in the last quarter, we told you that we expected to see an increase in pension and health care costs for the year. The increase will be slightly less than originally projected but remains a significant challenge.
- Finally, during the second quarter, our retail fuel operations generated higher earnings per share compared to last year. Fuel is an important part of our business and, as you know, has a high level of variability.

We will continue to follow our business strategy and make adjustments as needed to manage these factors which, along with our commitment to the Customer 1<sup>st</sup> strategy, are having the most impact on our business over the course of the year. The goal of our Customer 1<sup>st</sup> strategy is to consistently reduce the overall cost of running our business, and do it in a way that does not negatively impact our customers. We then reinvest those savings in our customers to drive higher sales which, in turn, will increase earnings. Our strategy generated positive momentum and financial results that met our goals in the second quarter.

Rodney will now offer some insight into Kroger's business trends this quarter.

***Comments by Rodney McMullen:***

Thank you, Dave. Good morning everyone.

The customer is going through a lot of change right now, and we are doing everything we can to minimize the impact on them of higher food costs. Dave just discussed how we are working our strategy in the context of the broader operating environment.

Associates are working hard to cut costs, and we are finding ways to help customers save, even as product cost increases are passed on. We estimate we have lowered our customers' shopping bill by \$2.1 billion per year. Also in keeping with our strategy, as it became clear during the quarter that the 5 cent earnings per share tax benefit was coming, we accelerated several investments in our four keys. Looking at quarter and year-to-date results, we have made many investments to deliver value today *and* invest for the future.

**Loyal Household Growth**

One of the most important measures of our business is loyal household growth, because it lets us know how well we are connecting with our best customers. Loyal household growth is also a convincing indicator of the strength of our Customer 1<sup>st</sup> strategy because our best customers are the primary beneficiaries of the investments we are making in our four keys. For the quarter, our loyal household count grew at a faster rate than total household growth, which is also up for the quarter.

Similarly, we achieved positive identical sales for both total households and loyal households. Identical sales growth among loyal households was stronger than the total household result.

While customers visited our stores slightly more often this quarter, they are purchasing smaller baskets on each visit. Price per unit was higher in the second quarter compared to a year ago, reflecting the effect of price increases from our vendors. I'll talk a little bit more about how we're managing through that in a few minutes. Sequential improvement in identical sales was driven primarily by the combination of more households and higher price per unit.

### **Tonnage Growth**

Kroger saw slightly positive tonnage growth for the quarter compared to last year. This is significant in light of the factors Dave discussed earlier and the trend toward smaller baskets for the quarter. We continue to balance tonnage growth with the pass-through of higher product costs.

### **Strong Corporate Brands**

In the second quarter, Corporate Brands share grew more than national brands. Corporate Brands represented approximately 27% of Grocery department sales dollars and 34% of the Grocery department units sold. These figures compare with 26% and 34%, respectively, for the second quarter last year. When you look at these trends compared to our first quarter results, Corporate Brand dollar share and total units each increased by 100 basis points.

Our multi-billion dollar Corporate Brands portfolio is a competitive advantage because it gives our customers more choices – in variety and value – to complement the broad assortment of national brand products we offer. This is particularly important today as

many shoppers continue to watch expenses and look for quality items at affordable prices.

In addition to assisting customers on their quest for value, we also want our Corporate Brand products to appeal to a diverse customer base. We do this by providing the right products at the right price in our stores, and also by communicating with our customers in the right way for them. We launched our first bilingual website, [comfortsforbaby.com](http://comfortsforbaby.com), this quarter. The website provides parents a place to discover the high-quality products offered under the Comforts brand, and the Spanish-language version of the site even includes content specifically tailored to Hispanic parents. We are also expanding our selection of Big K brand of soda flavors to appeal to diverse customer tastes. We are launching several new flavors based on customer feedback, including Apple, Pineapple Passionfruit, Watermelon Kiwi, Blackberry Citrus and Mandarin.

### **Food Costs**

As Dave said, rising food costs are affecting consumer behavior. While our estimated product cost inflation, excluding fuel, was approximately 5.2% for the quarter, we were able to slightly increase our penny profit per item in the Grocery category.

Rising product costs continue to affect all departments. Inflation continues to be higher in our perishable departments including Meat, Produce, and especially Seafood.

Last quarter we were beginning to read the shift in consumer sentiment, which translated into more obvious behavior changes this quarter. Customers are even more value-conscious when they shop, are buying smaller baskets and are selecting some

lower cost items including our Corporate Brand products. This has made the value we offer our customers through lower everyday prices, weekly promotions and personalized rewards to loyal households even more compelling. We will continue to pass along product cost increases from suppliers. At the same time, we will continue to invest for the future – in pricing, people, products and customer shopping experience.

### **Sustainability Efforts**

We continue to make good progress on our sustainability efforts and I'm pleased to announce that seven of our manufacturing facilities have achieved their goal of sending zero waste to landfills. Zero waste means that every ounce of raw material that arrives in a plant is either used for product, turned into energy, or recycled by our associates.

### **Labor**

Turning now to labor relations, we have a number of unsettled labor contracts currently past their original expiration dates, including negotiations in Southern California and southeastern Ohio, and with the Teamsters at our distribution center in Washington State.

These negotiations are challenging because of our efforts to manage the increase of health care and other costs. A sluggish economy and our need to compete against non-union retailers with lower cost structures are contributing factors, as well.

Our objective in every negotiation is to find a fair and reasonable balance between competitive costs and compensation packages that provide good wages, high-quality,

affordable health care and retirement benefits for our associates. We are hopeful that both sides will continue their hard work to find mutually acceptable solutions.

Contracts in the Charleston, West Virginia area and the Memphis area are set to expire during the third quarter.

Now, Mike will discuss our second quarter results and Kroger's financial strategy in detail. Mike?

***Comments by Mike Schlotman:***

Thanks, Rodney. Good morning everyone.

**Second Quarter 2011 Results**

**Second Quarter Net Earnings**

As we reported earlier today, Kroger's second quarter net earnings totaled \$280.8 million, or \$0.46 per diluted share. Net earnings in the same period last year were \$261.6 million, or \$0.41 per diluted share.

Both the current and prior year quarters benefited from certain tax adjustments. Without the benefit of these adjustments, earnings per share would have been \$0.41 in the second quarter this year, and \$0.38 in the second quarter last year. This 7.9% increase is consistent with Kroger's expectations for the quarter and long term earnings growth expectations of 6% to 8%.

FIFO gross margin, excluding retail fuel operations, decreased 53 basis points. This decline was mostly offset by improvements in our OG&A rate of 20 basis points, rent of

6 basis points and depreciation of 10 basis points. Our FIFO operating margin therefore declined 17 basis points. Our LIFO operating margin without fuel declined by 30 basis points due to the 13 basis point effect of our higher LIFO charge.

The reduction of 20 basis points in OG&A demonstrates the leverage of our strong identical food store sales and cost control efforts in the face of rising credit card fees, pension and health care expenses. Also, as a result of our current expected operating performance for the year, our incentive plans are estimated to pay off at a higher rate than last year. Collectively, credit card fees, pension, health care, and incentive plans have increased 30 basis points, with incentive plans being the largest of these. Additionally, we increased our general liability reserves and incurred warehouse start-up costs which together increased our OG&A rate by 10 basis points.

We continue to believe it is most beneficial to look at operating margin over an annualized timeframe. Excluding fuel, on a rolling four quarters basis, the company's operating margin increased 10 basis points. For the full year, we expect the operating margin change to be less than this.

### Retail Fuel Operations

Kroger's retail fuel operations, in the second quarter, earned approximately 17.4 cents per gallon compared to 14.3 cents in the same quarter last year. For the latter half of the year, we expect margins of approximately 11.5 cents per gallon.

### Financial Strategy

#### Capital Investment

I'll now update you on our long-term Financial Strategy. We are very focused on allocating the substantial cash flow of Kroger's business to reward our shareholders – both today and in the future. During 2011, Kroger is using cash flow from operations and cash on hand to fund capital expenditures, repurchase shares, pay dividends to shareholders, and maintain our current debt rating.

Capital investment, excluding acquisitions and purchases of leased facilities, totaled \$428.5 million for the second quarter, compared with \$402.5 million for the same period last year. We expect capital investment for the year to be slightly above \$1.9 billion, excluding acquisitions and purchases of leased facilities.

We also saw a strong EBITDA return on net operating assets, or ERONOA, of 19.91%, which is an increase of 106 basis points from a year ago.

Kroger saw strong improvement in working capital during the quarter. We have implemented systemic improvements that will advance our progress in this area. In addition, higher fuel costs have helped improve working capital by \$152 million.

### Share Repurchase

During the second quarter, we invested \$258.6 million to repurchase 10.6 million shares of stock at an average price of \$24.30 per share during the second quarter. At the end of the second quarter, approximately \$403.4 million remained under the \$1 billion stock repurchase program announced in March 2011. Since the end of the quarter, Kroger has purchased 4.5 million shares of stock at an average price of \$22.87 per share for a total of \$103.5 million. We expect to use the full billion dollars during Fiscal Year 2011.

### Debt Reduction

Net total debt was \$6.9 billion, a decrease of \$49.0 million from a year ago. On a rolling four quarters basis, Kroger's net total debt to EBITDA ratio, adjusted for impairment charges in 2010 and 2009, was 1.71 compared with 1.87 during the same period last year.

### Updated Guidance for Fiscal 2011

Based on the second quarter results, we are increasing our identical supermarket sales guidance for fiscal 2011. We now expect identical supermarket sales growth, excluding fuel, of 4% to 5% for the year. The previous guidance range was 3.5% to 4.5%.

Kroger maintained its full-year earnings guidance of \$1.85 to \$1.95 per diluted share.

Based on the current operating environment, the company expects to achieve results near the top end of this range.

We continue to expect product cost inflation to be in the range of 3% to 4% for the year.

Keep in mind the factors Dave mentioned that will continue to influence Kroger's sales and earnings performance throughout the year:

- The pace of the economic recovery;
- The impact of rising gasoline and food prices on customer spending;
- The competitive environment;
- Higher pension and healthcare costs; and
- Retail fuel margins.

Our long term growth model is to generate 6% to 8% annual earnings per share growth over a rolling three-to-five-year time horizon. Including a dividend yield of 1.5% to 2.0%, the total shareholder return rate is 8% to 10%. We aim to produce this with less volatility than the S&P 500 over that same timeframe. We are not opposed to a year occasionally exceeding this range, which is what we expect to deliver in 2011.

Now, I will turn it back to Dave.

***Comments by Dave Dillon:***

Kroger had a solid quarter because our associates delivered strong results in line with our Customer 1st strategy and consistent with our expectations. The economy is sluggish. One of Kroger's strengths is our insight into our customers. As a result, we are able to adjust our offerings to meet the customers' changing needs. Whatever the environment, our Customer 1st strategy will maintain the right balance for our customers and shareholders, growing customer loyalty and delivering earnings and earnings per share growth consistently. We will continue to deliver value today and invest for the future.

Now, we look forward to your questions.

***Comments by Dave Dillon:***

Before we end the call, I want to share some additional thoughts with our associates. As you know, Sunday is the tenth anniversary of the tragic attacks of September 11. We

have asked that all of our supermarkets pause for a moment of silent reflection to remember the victims and honor the heroes of 9/11.

Kroger supermarkets in the Eastern Time Zone will pause for a moment of silence at 8:46 a.m. on Sunday, marking the time when American Airlines Flight 11 struck the World Trade Center's North Tower ten years ago. Because of the time difference, stores operated by Kroger in other parts of the country will do the same later that morning.

We can do much more to honor the memory of those who perished, and many associates will join in special remembrances where they work. King Soopers store manager Tim Dowdell, whose brother, Lt. Kevin Dowdell, was among the 343 firefighters who lost their lives in New York on 9/11, displays our flag prominently at his store every day, and I love that.

I also encourage you to join in our local efforts throughout the month of September to recognize and thank our everyday heroes. Whether it is a special celebration, the gift of a meal or a simple "thank you," you can help show our deep appreciation to the men and women who help keep our families, communities and stores safe.

That completes our call today. Thank you for joining us.

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*The remarks contain certain forward-looking statements about the future performance of the Company. These statements are based on management's assumptions and beliefs in light of the information currently available to it. Such statements are indicated by*

*words or phrases such as “will,” “guidance,” “expect,” and “maintained.” These forward-looking statements are subject to uncertainties and other factors that could cause actual results to differ materially. Our ability to achieve identical supermarket sales and earnings growth and earnings per share goals, the timing that those earnings occur within the year, our ability to achieve results near the upper end of our earnings guidance range, our ability to continue to invest in the four key components of our Customer 1st strategy, and our ability to deliver FIFO operating margins at projected levels, may be affected by: labor disputes, particularly as the Company seeks to manage health care and pension costs; industry consolidation; pricing and promotional activities of existing and new competitors, including non-traditional competitors, and the aggressiveness of that competition; our response to these actions; unexpected changes in product costs; the state of the economy, including interest rates and the inflationary and deflationary trends in certain commodities; the extent to which our customers exercise caution in their purchasing behavior in response to economic conditions; the number of shares outstanding; the success of our future growth plans; goodwill impairment; changes in government-funded benefit programs; volatility in our fuel margins; and our ability to generate sales at desirable margins, as well as the success of our programs designed to increase our identical sales without fuel. In addition, any delays in opening new stores, or changes in the economic climate could cause us to fall short of our sales and earnings targets. Our ability to increase identical supermarket sales also could be adversely affected by increased competition and sales shifts to other stores that we operate, as well as increases in sales of our corporate brand products. Earnings and sales also may be affected by adverse weather conditions,*

*particularly to the extent that hurricanes, tornadoes, floods, and other conditions disrupt our operations or those of our suppliers; create shortages in the availability or increases in the cost of products that we sell in our stores or materials and ingredients we use in our manufacturing facilities; or raise the cost of supplying energy to our various operations, including the cost of transportation. Our results also will be affected by rising commodity costs, the inconsistent pace of the economic recovery, changes in government-funded benefit programs, consumer confidence, and changes in inflation or deflation in product and operating costs. Our capital expenditures could vary from our expectations if we are unsuccessful in acquiring suitable sites for new stores; development costs vary from those budgeted; our logistics and technology or store projects are not completed on budget or within the time frame projected; or if current operating conditions fail to improve or worsen. We could fail to achieve fuel margins of 11.5¢ per gallon during the second half of the year if the pattern of rapid changes in fuel costs continues. Our ability to pass along product cost increases will depend primarily upon the reactions of our customers and our competitors to those increases. The accuracy of our product cost inflation estimate will depend primarily on weather conditions, supply constraints, unrest in areas of the country in which products are grown or are produced, natural disasters, and the general economic climate. Our ability to use all of the billion dollar authority under our stock repurchase program during 2011 will depend primarily on the price at which our shares trade and our ability to generate cash flow sufficient to make those purchases. Our incremental expense from rising pension and health care costs could exceed our expectations if health care costs continue to rise faster than projected, if unforeseen medical expenses are incurred*

*under our self-insured health benefit plans, or if the assumptions used to estimate pension expenses differ from actual experience. Please refer to Kroger's reports and filings with the Securities and Exchange Commission for a further discussion of these risks and uncertainties.*

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