

# The Kroger Company

## 2018 Investor Conference

October 30, 2018 at 8:00 a.m. Eastern

### **CORPORATE PARTICIPANTS**

**Rebekah Manis** – *Director of Investor Relations*

**Rodney McMullen** – *Chairman and Chief Executive Officer*

**Michael Schlotman** – *EVP and Chief Financial Officer*

**Yael Cosset** – *Group Vice President and Chief Digital Officer*

**Mary Ellen Adcock** – *Group Vice President of Retail Operations*

**Stuart Aitken** – *Group Vice President*

**Michael Donnelly** – *EVP and Chief Operating Officer*

**Timothy Massa** – *Group Vice President, HR & Labor Relations*

**Jessica Adelman** – *Group Vice President, Corporate Affairs*

**Keith Dailey** – *Vice President of Corporate Affairs*

**Alessandro (Alex) Tosolini** – *SVP of New Business Development*

**Robert Clark** – *SVP of Merchandising*

**Gary Millerchip** – *CEO of Personal Finance & Corporate Strategy*

## PRESENTATION

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Ladies and gentlemen, please take your seats. The 2018 Kroger Investors Conference will begin shortly.

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What just happened, guys?

### **Rebekah Manis**

—Manis, Director of Investor Relations, and I'd like to welcome you to the 2018 Annual Investor Conference. For those that were able to attend yesterday evening, I hope you thoroughly enjoyed learning more about how our brand is bringing innovation to our product development. We know that our customers love our brand, and in fact last quarter we posted record share results within that space.

Today we also have a great presentation lined up for you. I know our executive team is excited to share with you the progress that we're making since the launch of Restock Kroger at the beginning of this year as well as how we're transforming our growth model.

So before we begin, I'd like 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 the business on an ongoing basis is contained in our SEC filings. Kroger assumes no obligation to update this information.

I'd like to briefly cover today's agenda before we formally start the presentations. You'll notice that you're going to hear from a variety of our senior executive leadership and we've built in two Q&A sessions to take your questions. One will be half-way through the presentations and another at the end. We will conclude with a store tour, where you will get to experience first-hand how we are executing on our vision to serve America through food inspiration and uplift. With that, I'm thrilled to turn the presentation over to Kroger's Chairman and Chief Executive Officer, Rodney McMullen.

### **Rodney McMullen**

Good morning. Thanks, Rebekah. Thanks for everyone joining us this morning. Last year at this conference we outlined Restock Kroger, our plan to reposition our business by 2020 so we could create value for our customers, associates, and shareholders. We talked about how Kroger has always competed in an ever-changing retail business. Because of our willingness to disrupt and reinvent ourselves, is the key principle for doing that. We said that retailers need to change every 12 to 15 years to remain relevant, and Kroger is in the middle of that transformational process.

If you look at our progress, and see how everything is coming together, we feel good about where we are. We're using our assets, especially our love of people and our love of food, to redefine the grocery customer experience, and we are doing it in ways that drive sustainable advantage. We are proactively investing for the future in our stores, customers, and associates. And we're doing all of this to create shareholder value.

I think you're going to love the presentations today. Kroger's strong team of executive leaders will share the progress updates on executing Restock Kroger after two quarters, and we'll outline where we are headed in the future. We will spend a good amount of time this morning discussing our seamless business and fundamentals. We'll outline how we are redefining the grocery customer experience. And we've also, as Rebekah said, set aside adequate time for Q&A at two different sections.

In the second part of the day, we'll update you on three other drivers of Restock Kroger: Develop Talent, Live Our Purpose, and Partner for Customer Value. We've intentionally placed our discussions on partnership and alternative profit streams last because we wanted to give you insight in terms of where we're headed. By the end of the day, I think you'll agree that we're making great progress and the future has never looked better.

As we share our remarks for the day there are three big ideas that I would encourage you to listen for. And they are, first, we are firstly committed to delivering on Restock Kroger on our financial commitments. Second, we all need to change how we think about Kroger's financial model. Using only the traditional grocery retail business to [ph] value the company will result in some big misses. Both of these together leads me to the third big thing to listen for, which is how we're transforming the Kroger growth model.

So let's go through each one of those with a little bit more depth. The first big idea is we remain committed to delivering our financial commitments through Restock Kroger. We are on track to deliver our free cash flow and FIFO operating profit commitments by the end of 2020. I want to stress to you we have a clear path to the \$400 million. Listen for this today, both in Mike's financial updates and during the second part of the day focused on partnering for customer value and alternative profit streams, you'll hear more detail.

As the senior management team, it is always our job to make sure we clearly explain our purpose and vision plus the underpinning strategy that supports both. This is easier to do this year than last when we announced Restock Kroger because many of the partnerships that we were in conversation on now are public and announced and we can talk more about those. If you remember a year ago, we bluntly informed you, our investor community, that we are well aware of the fact that what got us here isn't going to get us to where we need to go.

Now with the ability to share more about our various partnerships, the second biggest thing I want you to listen for today is how we're re-envisioning our financial model. Most importantly, we want to provide more insight to where we expect new growth and increased profitability to come from. Building Kroger's financial model through traditional supermarket and grocery retail lens is tantamount to looking to the rearview mirror. And of course you always have to use the rearview mirror when driving, but relying solely on it is really not the best approach for driving obviously. And if you're driving on the autobahn it would be a terrible idea to solely depend on it. And I can tell you today, when you look at the retail environment, it's like driving on the autobahn. It's incredibly exciting, but there's a lot going on and it's going on fast. And today we'll share a lot more about how we see the road ahead and our future.

This brings us to the third big thing you should be listening for today, which is Kroger is transforming our growth model. We will grow market share through both strengthening our seamless ecosystem and—that's an important word—and through growing complimentary businesses and partnerships that generate alternative profit streams. Strengthening our overall seamless ecosystem means offering customers an incredible physical and digital experience, great meals—I should really say awesome meals, and after Yael gets up you'll understand why we use the word awesome because Yael is teaching us that—amazing products with friendly and caring associates.

All of this requires significant technology investments. We are supporting those investments by taking costs out of the business and through accelerating alternative profit streams like our personal finance and our media businesses. We've contemplated the costs of new service offerings in our growth model, which is how our savings are helping pay for those. It's a virtuous cycle. It works both from a customer standpoint and from an economic standpoint.

Delivering an exceptional customer experience, an exceptional customer experience, creates incremental new profit streams. And new profit streams drive our economic model to make the seamless

experience possible and special. Both parts are incredibly necessary but neither side alone is sufficient to grow the profitability in the future. These three big ideas rest on the bedrock foundation of our people and our purpose that feed the human spirit.

What you should walk away from today is a much clearer picture of how all of the puzzle pieces fit together. And if you think about each announcement that we've made, it fits together in an overall puzzle that's a beautiful picture. And each person today will talk about a piece of that puzzle. Everything that we're doing supports Restock Kroger, and it supports our vision to serve America through food inspiration and uplift.

We're building a truly seamless shopping experience so we can serve customers anything they want, anytime they want, anywhere they want. We're using our data to provide convenient and personalized food inspiration to help customers to be the hero to their families at mealtime every time. When we do focus groups with our customers, they always tell us they want to be the hero for their family. We're going to let them be the hero for their family when it comes to mealtime.

We are identifying partners that will help us deliver that customer experience value today and the future. If we were depending on us to do all of it, it would take too long to get it done. And as I mentioned before, we're creating incremental profit streams that will also accelerate our core business growth. As always, we are serious about living our purpose to feed the human spirit because associates, customers, and stakeholders are increasingly deciding where to work, where to shop, where to invest, and who to support based on a company's commitment and actual result to making the world a better place.

So with that, let's get the agenda started. And now I would like to welcome Mike Schlotman, Executive Vice President and Chief Financial Officer to review our financial journey under Restock Kroger. Mike?

### **Mike Schlotman**

Thanks, Rodney. It's a pleasure to be here this morning. The good news is the slides are going to be working from the beginning of my presentation not half-way through because I'll be referring to the slides quite often. You can do a lot of rehearsals. You can reread and read again the slides and the words we're going to say, but you can't account for a power surge in the hotel that knocks out the projector that takes five minutes to recycle, so best laid plans. But anyway, we're back in service. I think Sarah's [ph] up there with some squirrels running the projector so it doesn't go down again, but we'll carry on. Unfortunately you didn't get to see the agenda on the screen when Rebekah was up here, but we do have an exciting day.

I'm going to start with space optimization and sales since it's a bit of the elephant in the room. At least it was last night at cocktail hour and dinner. It's what we've talked about. I'm going to dwell on this slide for just a minute. This is the effect of space optimization and space optimization only. It's not the other stores we're touching with minor remodels or perhaps a front entrance transformation were we just put scan, bag, and go or something like that. And it's not just a fresh food destination. This is space optimization stores only. It accounts for the 2017 stores as well as the 2018 stores.

So as you can see in the first quarter, what coincidentally was a 1.9% ID quarter, our strongest of the year, the combination of the 17 stores that we're starting to mature and the handful of stores that we've started to do work on showed a positive contribution to ID sales. You can see the actual results in the second quarter went down. You can see the blue part is through nine periods and the red part—maroon, magenta, whatever color that is. I'm an accountant. I'm not good with colors—is you can see that the third quarter is going to be the peak of it.

And you can see in the fourth quarter, the expectation based on where sales trends are for these stores,

what the maturity patterns have grown to be, we expect a very slight headwind. The effect that we were expecting was for actually quarter 3 to wind up a lot closer to where quarter 2 was as the headwind slowed down, and for quarter 4 to be closer to where quarter 1 was and perhaps a little better. Hopefully this slide does illustrate when you think about the first quarter and we had the 2017 stores contributing, starting to get offset by the 2018 work.

That was a positive contribution and we are predicting a slightly positive contribution when we get into the fourth quarter, which we would certainly expect to carry on into 2019. This will give us, as we start 2019, somewhere between 850 and 900 stores that have had space optimization only, and I'll address the 1,000 stores that we talked about yesterday in a second. So with that number of stores having this work done behind it, even if we do—well when we do more space optimization stores next year, we're going to have nearly 900 stores having positive contribution by these sales, which will significantly overwhelm those new stores that we're working on.

Just a point of a clarification on the 1,000 we'd talked about yesterday, versus the space optimization number of 600, it's become obvious that not only are the 600 space optimization stores having disruption, there's another 400 or so stores, actually probably a little more than 400, where we're doing a different kind of work and not just space ops. Some of it's normal minor remodel work. But all of these stores, whenever you go in and you disrupt the store in any way, it does affect ID sales. So there's actually at least 1,000 stores in the company today that so far this year, or for the year, will have been affected in some way that causes a disruption to sales. So it's not that we went from 600 to 1,000 space op stores. That's the total store count that we're affecting this year.

This is the slide that we showed last year. It's the cornerstone of the Restock Kroger plan. The only change we made to the slide is we did the math for you on each of the columns of Restock Kroger, each pillar of it, to highlight where we expect to generate the shareholder value coming down to the \$400 million. These are exactly the same numbers as last year. So when you look at redefine the customer experience, we continue to expect about an \$800 million investment in that over the course of the three-year program. The partner for customer value is where we're going to generate all of the positive operating profit that we expect to get.

Now to be fair, you see buried in the middle of that cogs. So theoretically we could have moved cogs up to redefine the customer experience, because that does offset some of the smart pricing in the investments that we're making up there. That picture would look a little bit different but internally we try to group all of the buckets where we're generating the operating profit benefit together. The bottom line on there, alternative profit streams, that is probably the biggest unknown that everybody in the audience has. And Stuart Aitken will spend significant time on that later today when he comes up.

As you can see, the Developed Talent we expect to invest the \$500 million. You might say, how do you get incremental operating profit margin growth from develop talent when everybody thinks of investing and wages and things like that? You'll hear from Tim about the positive results of those investments and what it's doing to retention and things like that. And then we do have \$50 million set aside for Live Our Purpose.

This is the biggest thing in our minds affecting the valuation of the company today. So if you look at the consensus estimates today out to 2020 of where those who have an EBIT number that we can grab, they would be predicting that our EBIT is going to go down by \$141 million versus our Restock Kroger plan of a \$400 million increase. I will be honest with you, I use the word consensus on here loosely because this is a range from almost the \$400 million that we have budgeted to some people who are \$400 million to \$500 million down. So there's actually an \$800 million or \$900 million range of estimates from the analyst community out there.

So it feels like more of an average of random numbers, but it's always called consensus. This obviously is a huge valuation gap in the stock. And to the extent we do a better job today of convincing you, or a good job today of convincing you of our ability to generate the \$400 million over the three years, you can see why we're so bullish on where the company is headed and why we're doing what we're doing to try to generate that \$400 million because we are laser focused on doing that.

You'll see this slide a few times. You saw it in Rodney's. This is how we planned to do it. The left side of this is the base supermarket business. It's redefining the customer experience. It's where we're investing that \$800 million. And the right-hand side feeds off of that growing data, the growing traffic, the higher customer count that comes in. We then monetize both that data and that traffic into multiple alternative profit streams. Some of that falls to the bottom line to go to our shareholders. Some of it goes back into redefining the customer experience. And this winds up becoming the virtuous circle of how we plan to generate the \$400 million. Stuart's presentation later today will be very important to help you all understand how we expect to do this.

We also have a unique set of assets that give us the right to win. This is another slide you'll see regularly throughout the day. This is really pulling some key words off the slide. Other folks will have more detail in it. But when you think about the set of assets we sit here with today, let alone the assets we're cobbling together through the partnerships Rodney mentioned about—and Yael will bring all those together when he comes up. And when you think about our stores, and our distribution network, our scale, our data, and customer trust, some of the metrics you will hear later today about customer trust, and how they're willing to share data with us—with a lot of other companies they wouldn't be willing to share the data—it's really quite impressive.

And all four of those give us a right to win in our space because of what we have. You can see the immediacy and the proximity. The data is an interesting one. A lot of people like to do price checks. We like to do price checks. The fact of the matter is, is even when we do price checks they really don't know what Mike Schlotman paid for a product. They don't know how many best customer communication mailings I took advantage of to get a discount. And oh, by the way, there also was a digital coupon out there for that and I wound up being able to use my Best Customer discount and my digital coupon to get a savings that the general marketplace doesn't understand, but our customers understand in a very big way based on their reaction and their commitment to those kinds of offers.

The \$400 million. Where will it come from? How will it get there? You can see 2014 on the left-hand side. \$3.1 billion for 2017 is the anchor number everybody should be using and thinking about. That takes the reported number. It takes the convenience store sale out. We offset the effect of the convenience stores to the bottom line by using that to do an advanced share repurchase so it was no effect on earnings per share. And it also takes out the effect of the 53<sup>rd</sup> week. So \$3.1 billion is what the anchor number should be. And you can see what happens on the right-hand side. The base supermarket business does continue to grow. You can see fuel grows a little bit. It's not growing as fast as it did from '14 to '17 because we're getting maturity on the number of new fuel centers we can get, but we still have very nice gallon growth. But then you can see the growth of the green box on top of the tower of how much alternative profits going to generate. And again, Stuart's going to go into the categories where we would expect to generate that \$400 million.

The capital allocated to support our vision remains unchanged. This is identical to last year. I would look at the \$9 billion as the spend over the three-year timeframe. It was real easy to divide it by three and call it \$3 billion a year. I would guess we will be on either side of \$3 billion over the course of the three-year timeframe. We feel very good about being able to execute the strategy we have within the \$9 billion. I would tell you that when you get to free cash flow, and you take the \$9 billion out of our operating cash

flow projections, and you have \$6.5 billion of free cash flow, I think another misunderstood part of our story is the fact that right now our free cash flow yield is in the 8% to 9% range. And I think a lot of us would like to own a lot of stocks that have that kind of a free cash flow yield.

But when you look at that \$6.5 billion, it will be used for a variety of things. It will be used to make sure that our leverage ratios stays within the range we need it to be to keep our current investment grade rating right where it is. It'll be used to continue to invest in our dividend and continue increasing the dividend over time, like we have since 2006 when we reinstated it. It's grown at a 13% compounded rate since then. Share buybacks are always an opportunity, but some of that will probably wind up getting invested back into the business to keep that virtuous circle going and make smart investments that can grow the business by investing in the business, versus just other ways of using that free cash flow.

We're really excited about the opportunity that bottom right number has about how we decide to spend those dollars in the future. When we get out to 2020 and 2021, how many Ocadors should you need? How many other partnerships can be out there like the ones we've announced in the last year? All of those are an unknown, but we feel we're well positioned from a financial standpoint to take advantage of market opportunities that present themselves.

With that, I'm going to turn it over to Mike Donnelly. I thought his intro slide was next but that's okay. So I'll go back. So Mike Donnelly will come up and head up the next section on redefining the grocery experience. He'll start it off and then he'll wind up bringing up Yael Cosset and he'll bring up Mary Ellen Adcock as well to talk about cost savings. So with that, I'll turn it over to Mike Donnelly.

### **Mike Donnelly**

Alright. Good morning. That's supposed to get you a little excited, right? Alright. So I hope you enjoyed yourself last night. I want to do a shout out to our Our Brands team, Gil and Nichole [ph]. You guys are awesome. You give us the confidence in going forward understanding what we do behind the scenes. So we're going to give you a round of applause. Way to go.

So we're going to talk a little bit about customer trends and get into redefining the grocery experience. So this is what we'll talk about. But I want to kind of level set when you go to the store this afternoon. I want you to think about what we're going to talk about today because this store has actually gone through space op and a lot of different things. So when you're there, you think about this store. A year ago it used to have a segregated natural food section. And you'll see in this store that you look for how we position natural foods, how we positioned Our Brands. You'll see a lot of these segments or these topics, space op pricing, those type of things you'll see in the store. So just for your benefit.

So I'm going to talk a little bit about that. Yael and Mary Ellen are going to come up and talk to you about their respective areas. So let's start with some of the trends. So households. Over the years we've had strong household growth and that continues today. It's driven by our VPS [ph] customer or segments, which actually would give you confidence that our price investments are working, right?

Another good story is the spend per item. When you think about product mix, it's all driven by product mix and not by raising prices. So when you take a look at the bottom down there, it actually shows our active retails are down. So it's a good story and we hope that continues. Digital engagement obviously a big part of what we do. Yael will actually get into a lot more of that in his presentation, but we are adding households and driving visits.

And then lastly, natural foods. Obviously, natural foods has been for the last five years been a double-digit increase for us. It continues that way today. We are obviously well positioned with some of our Simple Truth products. Thank you Gil and team. I will tell you this, I touched on it just a few minutes

ago. Space op has actually helped us grow this category and department more than anything else that we've touched at a pace that actually matters.

So based on that, there's a lot of trends that are changing in this space. And what we'd like to do is show you a quick video of some of those trend changes.

So that's awesome, right? And, Gil, again thanks for you and your team for putting that together. Let me move into the next three topics. One is our price investments. Obviously this year will be our largest price investment. We will continue to invest where it matters most to customers. Has it been a headwind? Yes, but it's absolutely the right thing to do for our business.

So I know Mike likes to be the merchant. So he's already explained this whole slide to you. Thank you, Michael. But I want to cover it because it really is more than just price. It really is about those personal benefits that we give our customers, whether it's fuel rewards, best customer communication, digital coupons. All of those matter to our customers. So when you add it all up, it's a da\*\* good value proposition and it's one that will be a big part of our future.

So also Mike talked about space op. I want to get real clear here. This is really where we're at, if you think about it, overall, you think about we're going to touch over a thousand stores and to date we're probably 80%-plus complete. But we're not going to actually disrupt those stores in the holiday period of time. We may pause and go after the holidays. So we'll make good decisions. So it was an aggressive plan. Has it had an impact? It has, right? But we believe in the process. We believe it's the right thing to do for our customer and the business, and look forward to doing more next year.

And lastly, it really is about Our Brands. And quite honestly, we're having an awesome year. And we expect that to continue. We see strong sales and unit growth, profits are up, and we're growing share. Pretty good combination. I want you to think about it this way also. When you think about Kroger, you think about Our Brands and you think about what they represent to The Kroger Company. And you compare it to the national brands. Our size, our quality, and our offering is unmatched in the industry. We love Our Brands and so do our customers.

So, next up we're going to have Yael come up. He's going to talk to you about redefining the customer experience. He's going to be awesome and then Mary Ellen's going to come up and she's going to talk to you about our cost initiative. So, thank you all.

### **Yael Cosset**

Good morning. Good morning, everybody. 2018 has been a great year. We have invested a lot of energy as we shared last year in New York on our Restock Kroger plan. And what we have accomplished this year whether you're looking at partnerships or some of the performance of that business is a great reflection of where we are on that journey.

Every team in our business, you know, whether you're looking at our talent [ph] team and his team have been doing a fantastic job building the right teams, both here in Cincinnati, but also in all the divisions to support our growing digital business. Operations with Mary Ellen's team, making sure that day in, day out, we deliver on that experience. The divisions, everybody in the organization, is really rallying behind that set of experiences.

And it's paying off. Our customers are rewarding us with the best gift: their loyalty, their engagement. And I will share with you today some of these key accomplishments for the past year and also touch on some of the partnerships and what is coming ahead.

When we met in New York last year we talked about the three key periods of our digital strategy. First, being available; second, being accessible to all of our customers; and third, being more relevant in our experiences.

When it comes to being available, it's about leveraging all of our core assets, all of our stores, our distribution network, the skills that we have, the breadth of assortment, the relevance of that assortment with our customers and making it available to them through digital platform—digital experiences. Leveraging that proximity, leveraging the choice that they have learned to enjoy and making it available to them.

As it stands today, we are covering 92% of our customers, meaning 92% of the customers that shop Kroger in a brick and mortar store also have the ability to shop with us for pick-up or delivery order. By the end of next year, we'll cover not only 100% of our customers, but 100% of the US population. Every family in America will have the ability through our modalities to shop with Kroger, whether they decide to come into a store, use our pick-up or delivery services, or our recently launched Ship service, which is really what is unlocking our ability to reach every family in America. And I will talk a little bit later about how our partnerships with various organizations are contributing to accelerating that journey.

The second pillar is about being accessible. Accessible means bringing a different portfolio, an expanded portfolio of experiences that are more appropriate for how the customers want to engage with us, whether they want to engage through a standard web experience, a mobile experience, or more recently, through a voice-enabled, voice activated experience.

The important thing as we grow that portfolio is to make sure that it remains connected and cohesive, leveraging our data, leveraging what we know about the customer to make that experience seamless, painless for them. And in reality as we see the growth of mobile usage and voice usage, we also see how they complement each other. It's not one or the other. Depending on your time of day, depending on what you're doing in the day, and how you're interacting with us, you will use a different interface. And our responsibility and our focus continues to be how do we make sure it stays connected? How do we make sure that what I do online on a web browser is impacting what I see and how I interact with my mobile application?

The third pillar is about being relevant. And we shared last year, we obviously had a number of announcements in that area earlier this year [ph]. We shared last year that it starts by increasing or expanding our assortment, giving our customers more choice. They're craving for more choice. So we've really expanded in two areas. One is bringing more ready-to-heat, ready-to-eat, or meal kit products to their table. With the partnership with Home Chef, obviously a significant expansion in that field. But it's also the extended hour. How do we make more options, more ingredients, more products available to them on the categories that they are love to engage with us on?

However, as customers want more choice, they also want to spend less time choosing, which is kind of an interesting dilemma, if you think about it. Putting millions of SKUs or products in front of the customer, but also shrinking the time it takes to navigate and make these choices, shortening the time it takes to complete a transaction, which as we know helped us justify and continue to invest in our personalization journey. Leveraging customers' behavior, their data, the science that we've built and continue to innovate on, to further personalize their journey, personalize their experience, and ultimately evolving into the curation [ph] of that experience. Leveraging what matters to them, the time of day, their location, the interface they're using, to really create that relevance.

Are they here to build a bigger basket, their weekly basket for pick-up later this week, or are they here for a quick solution to order a meal or pick up a meal or get a meal delivered to them? Two very different

purposes as a customer, and our responsibility in what we've invested in in the past year is to make that more seamless. You and I may have used the mobile app at the same time of day, but based on our profile and our pattern or consumption behavior, we will see a completely different experience, not just the assortment based on what we've bought before, but also how we typically interact with the Kroger ecosystem.

So, a lot of accomplishment, a lot of progress, winning hearts and minds for our customers, really focusing on what has been the core of our business, that routine basket, that weekly, that monthly trip.

We've also obviously invested heavily in expanding our portfolio to also fulfill what we refer to as the later basket, whether that's the extended [ph] aisle, you know that special spice for that meal that I'm preparing for Thanksgiving or that replenishment, some of that assortment that I constantly and on a regular basis buy at Kroger. How do we simplify that replenishment trip, that replenishment task? And you know we've obviously with the launch of Ship and the ability to subscribe to some of its products and get it delivered directly to your home, a massive expansion in that area.

The next frontier is also continuing our journey in satisfying the now—that trip where I haven't planned properly. I didn't expect something. Something changed in my calendar today and I need a meal. And we talked about some of the accomplishment in the meal kit space, but how do we continue to improve the relevance of our assortment and also the modalities, the options for our customers to engage with them, with us, but I mean to really reduce that timing and make that proximity or make use of that proximity and immediacy in how we bring that to us.

So let me share with you and help bring all the pieces of the puzzle together as Rodney mentioned in his introduction. How do all these pieces fit together? As we continue to innovate on our capabilities, as we continue to bring new modalities, new experiences to life, as we establish partnerships with various companies here in the US and abroad, how does this all fit together? How does this contribute to delivering on the redefinition of the customer experience, but also delivering on our anything, anytime, anywhere strategy?

First, as we mentioned earlier, leveraging our assets we have greatly accelerated how we simplify that shopping trip, whether it's in a store, leveraging digital capabilities to give access to our customers to better planning tools, access to digital offers. That level of engagement is accelerating at a rapid pace and you know the data that is created through that engagement helps us continually feed that personalization capability to make that experience more relevant.

But it's also through partnership with Walgreen's, with Ocado where we are increasing that proximity, shrinking the time between the decision and the delivery or the execution of that order. Think about Walgreens, increasing our reach, getting us closer to the customer, making that last mile less than a mile if that's the right thing to say. But you get the point about really shrinking the time between the order is ready for pick-up or ready for delivery and the time it makes it to the customer.

Ocado is also a huge accelerator in our transformation journey. Ocado helps us not only with the operation in the scaling of our capability and scaling of our business, bringing automation fulfillment capabilities that will make our business even more sustainable, more profitable long term, but also improving the reliability of that experience, making it easier for us to stay true to the commitment of delivering to the customer what they order, making sure that what they order is available and get to them in the right amount of time, really amplifying our coverage extension by making the service pick-up or delivery more available to more customers.

When you think about the later [ph], we have launched Ship earlier this year and a few other modalities

that are really helping us [indiscernible] specific trip purposes that extended hour, making it easier for customers to access a much broader assortment—hundreds of thousands, a million SKUs or products, but also simplifying that replenishment task. Leveraging our science, leveraging the personalization capability, leveraging our ability to curate that engagement, to make replenishment simpler for the customer, more seamless.

We've also invested heavily in improving the relevance of our assortment for what we would call the now moment, where I want to shrink the time it takes for me to put a meal on the table for my family. The investment in the merger with Home Chef is a big step forward, not just in meal kits, not just in meal kits in the e-commerce channel, but also meal kits and other meal solutions in our stores. We're already live in stores with Home Chef, seeing a significant, broader adoption of the service, and that continues to improve the relevance of that assortment for the customer.

We are also looking at partnering and expanding on our partnership with Instacart to expand the coverage of that delivery, which is an important component of the now moment. I may not be in a position where I can drive to the store to pick up my order and that delivery expansion, the partnership with Walgreens which again gets us closer to the customer, as well as the investment in the newer partnership helps us simplify, helps us scale that delivery option.

So as you can see, all of these partnerships and all of our co-assets [ph] come together to really advance our journey, really redefine the customer experience. And none of these partnerships are single-purpose. They all interconnect. They all build on each other. And that probably is one of the most important things you should take away from today, which is, it is not a number of isolated partnerships. These are all capabilities and assets that are building on top of each other, really helping us redefine the customer experience and amplify the journey and the results we have already seen with our customers.

The customer's adoption is fast-paced. As we shared earlier this week, our current run rate or by the end of the year, our run rate will be slightly above \$5 billion. That is the best reflection of how much the customer is adopting our service and how much they appreciate the simplification, the experience we put in front of them. They reward us with incrementality [ph], by bringing baskets and dollars they would otherwise spend with the competition. They reward us with higher frequency. We are earning share of mind. We are becoming a daily destination for our customers. When they shop with us, when they plan their trip, or when they need a quick solution for something that wasn't planned. We're earning their share of mind, which is translating in more share of stomach.

We are becoming more relevant for all of their meal solution, all of their food needs, whether they are specialty, extended hour, or urgent need, ready-to-heat delivery of food that is either a minute away from being ready or 20 minutes if you prefer a meal kit. And that ultimately translates in share of wallet, which is how we are continuing to feed our organization, our success, and reinvesting in making these experiences more and more relevant, more and more meaningful for our customers.

With all that said, I will now have Mary Ellen share with you some of the efforts we have seen in the expense management that are helping us invest in our journey. Thank you.

### **Mary Ellen Adcock**

Thank you, Yael. Good morning. I'm Mary Ellen Adcock and I'm going to provide an update on the cost savings portion of Restock Kroger. It is an important part of the three-year Restock Kroger plan to eliminate costs in areas not relevant to the customer, to invest and fund the investments, and create shareholder value.

For 2018 we are making excellent progress on our Restock Kroger plan. At the end of quarter 2, or

halfway through the year, we're already tracking at 65% achieved savings, exceeding our plan. We are pleased with this progress and ahead of schedule. The savings plan is comprised of targeted areas of the business with strong plans in place for how to achieve. We are executing well against these plans.

I'm going to provide some insight on three key areas that makes up the savings plan.

First is checkout. We are improving the customer experience and increasing productivity in the checkout process. There are several inputs that go into this improvement. One which we have shared, we're implementing our scan, bag, and go, and expanding self-checkout. As a result, we have seen double-digit improvement in utilization, driving productivity in stores when we implement this. This is important because every basis point improvement in expense as a rate to sales is significant because it equates to a penny per share. As we look forward, the checkout experience will continue to evolve. And while we don't see this as a final evolution, we will continue to scale these solutions in 2019.

Next, shrink is another area in our planned delivery in savings. We have delivered consecutive quarters of improvement, which we expect to continue. We are executing our plan through renewed emphasis on best practices and process change. Another way to look at the significance of this is one basis point improvement in shrink equals \$10 million pre-tax to support Kroger Restock and the \$400 million operating profit Mike mentioned. As we go forward, we will continue emphasis in this area as well.

Cost of goods is another critical part of our savings plan. This is also a good example where we have invested in external talent. We hired an individual to lead this area with specific expertise to drive savings.

We are accomplishing this in three ways. First, Our Brands. As Our Brands continue to grow, which you've heard about multiple times, it allows us the ability to not only further leverage our size, but also with more granularity in specific inputs of both our Kroger manufactured products and our third-party produced Kroger labeled products combined.

Also, national brands—we're looking at the entire portfolio in addition to a category-by-category basis with our valued partners. Additionally, indirect sourcing. Given our size and scale, this still is a big area where we have opportunity in standardizing across the organization to maximize our buying power in a number of ways—examples like supplies, plastic containers to continue to lower their cost. There is still room in this area.

In closing, we're making strong progress in 2018, executing the plans to deliver savings, which is enabling us to invest back in the business to redefine the customer experience. We are pleased with our progress and have implemented process improvements that will also lead to future savings in the remaining two years of Restock Kroger. We are committed to delivering the full three-year Restock Kroger plan.

Thank you. So next we're going to move to a question and answer session, and Mike Schlotman is going to be our moderator for this first panel.

## **QUESTIONS AND ANSWERS, Part 1**

**W**

One foot down.

**Mike Schlotman**

We have various people wandering around with microphones, so if you would just raise your hand and we'll come to you in some semblance of an orderly fashion.

**Roof Ashpreek**

Yes, Roof Ashpreek [ph], Oppenheimer. Two questions. On your space optimization slide, what does the one-year impact from space optimization look for Q3 and Q4? I was trying to see how that would change in Q3 versus Q4.

**Mike Donnelly**

When you say one-year, meaning—

**Roof Ashpreek**

The headwind that you're going to see in Q3 and then presuming what the tailwind would look like in Q4.

**Mike Donnelly**

The slide showed that Q3 was—you're asking in dollar terms or—

**Roof Ashpreek**

No. I think—last quarter you may have called out a 50 basis point headwind from space optimization.

**Mike Donnelly**

We called out at 50 basis point headwind for several things. I would say that the third quarter is probably running a little bit higher than that because you saw the third quarter number go down further below the line than the second quarter was.

**Roof Ashpreek**

Okay, great. And then on your slide where you had EBIT growth for a few of your [ph] supermarket business and alternative revenue streams, what percent of your EBIT growth is coming from grocery business as we look out through 2020?

**Mike Donnelly**

Yes, I'm not going to get that granular on the model because it is a prediction out three years. Suffice it to say that we have a solid plan to grow both the base supermarket business, as well as the alternative revenue stream and continue to invest back in the core supermarket business. We're very excited about our ability to grow, but I'm not going to get into the percentage gross of each category.

**M**

Two questions. One, I just want to follow up on that with you, Mike. So the chart looked like the base supermarket business is up a little, I think, over the—am I visually seeing that right?

**Mike Donnelly**

Over the three-year period.

**M**

In that number, is the pressure from digital taking share? Is that in that number? Or is that somewhere else?

**Mike Donnelly**

That would be included in that number.

**M**

So that's included—

**Mike Donnelly**

That's a particularly quick listed as a sale [ph] at the supermarket.

**M**

Got you. So if we frame it, the three buckets you put in, it looked like the fuel contribution profit looks similar as well. So when you look at fuel and base supermarket and then the new bucket that we're learning about, what's—can you frame where the risk—which of the three buckets do you think has the most risk to it? Or how would you rank it?

**Mike Donnelly**

Well, obviously any time you project something out for three years, there's risk to each and every bucket. I would tell you that we have solid plans to achieve all three of the buckets and I don't want to do half of Stuart's presentation like I did some of Mike's earlier, so we'll have another Q&A panel after the sessions later this morning. So let's hold questions and I'll turn to revenue and our view of being able to generate that until after Stuart talks a little bit later.

**M**

And then just one quick—oh, sorry Rodney—

**Rodney McMullen**

I was just going to add one thing on digital. Digital continues to be a significant investment in the business. What we find is it takes about three to five years for us to become indifferent whether somebody shops with us digitally or in store. And one of the reasons for that is you get more of the total household share, so next year will be the first year that we would expect that it will start becoming a tailwind rather than a headwind, but it's still a significant investment in the business, in the repositioning of the business.

**M**

That's helpful. And then just one last one, actually for Mike Donnelly. I thought the commentary on the very price-sensitive customer versus the trading up customer, it just, so your very price-sensitive customer's the fastest growing, but then you called out the trading up customer as driving basket size up. Is there a—can the lines sort of interfere with each other? It's sort of, you've got two going on at the same time. How should we think about that?

**Mike Donnelly**

So you should think about the very price-sensitive customer as a segment, a price-sensitive as a segment, and then least price-sensitive as a segment, okay? Those are the things you could compare against when you talk about the one example you just used.

The second one is the spend per item. And that actually is across all customers. So it's not necessarily just the VPS customer, it's across the entire customer base.

[Audio disruption]

So we're connecting—

**Mike Donnelly**

Wait, wait a second. Let him repeat it so it gets picked up on the webcast.

**M**

Sorry. So if I understand, if you look at just the very price-sensitive customer, you're getting more of them and then they're also on average trading up or spending more—

**Mike Donnelly**

Spending more.

**M**

More items.

**Mike Donnelly**

Spending more, right. Exactly right.

**M**

Got it. Thank you.

**M**

[Audio disruption] from Credit Suisse. Let me just follow up on this base optimization. I think you've been pretty consistent in your comments that the lists expected from space optimization are there, but it sounds like the headwinds are greater than expected, so can you help us with why that's happening and have you turned the corner there?

**Mike Donnelly**

So, let me try to describe it, when we talk about space optimization in general. So we've done this for five years now. So over that period of time, we've seen performance of those stores do this. Okay. So this year we take on more. So what we are seeing is this. So we're seeing a little bit, not a hockey stick this way, but we are seeing the potential of that getting to the point where we feel comfortable there's a return on the investment. You with me? I don't know how to describe it.

Here's the other thing I want you to keep in mind. It's not just space optimization. Think about everything else that's going on and think about what's the impact that we talk about from our investments—whether it's price investments or some of our strategy that actually could be having some of that same headwind. So I don't want to call it out as one single thing.

**M**

Maybe just quickly on [audio disruption]. And then just quickly on digital sales—the ramp from \$5 billion to \$9 billion. That's definitely a faster pace than we've seen over the last couple of quarters. Can you help us with the underlying drivers there and within that, how important is—Ocado is probably not even in there yet, but how are you thinking about Ocado in the context of competitors going more toward robotics in store for click and collect fulfillment and this two-hour delivery window which Ocado doesn't really solve for.

**Yael Cosset**

Yes. No, that's a good question. The ramp, the adoption is coming through, the growth is coming through a number of things. One is we're increasing the coverage, which you know we're adding coverage for our customers and on a run rate basis, you know, between this year, the end of this year and the end of next year will be a significant impact.

We, as you pointed out, there are new modalities and through the partnerships that we've announced with Walgreens, for example, we're also increasing leverage. The customers are continuing to increase their incrementality or the frequency at which they're using the digital platform. So we've shared some of these numbers already in the past, but we're seeing higher than 50% incrementality as customers engage with us. So they are increasing the reach, increasing the coverage, which, you know, Ocado will also help in the future, not between now and the end of next year, and thus increasing the incrementality.

And then the last point is getting more customers engaged. We've seen over 80%, Mike I think shared earlier today, the number of households that are becoming digitally engaged and ultimately moving up through that funnel and digitally transacting with us. And all of these factor combined are creating that accelerated growth.

**M**

Home Chef too.

**Yael Cosset**

And that's a good point. When you start bringing other properties like Home Chef as well which you add not only e-commerce tailwind, but also capabilities in our stores for better experience which you can also leverage for pick-up and delivery [audio disruption].

**W**

Hi, thanks. So just talking about IDs for 3Q and 4Q, obviously space optimization, as you've said, is going to have the biggest negative hit in 3Q, so the first question is, can you give us a sense of how negative or how the IDs are turning in 3Q? And then talk a little bit about 4Q in terms of the recovery and what the greatest risks are to getting the recovery in 4Q. Because obviously achieving your second half IDs is heavily predicated on 4Q.

**Rodney McMullen**

Well, it's predicated on both the third quarter and fourth quarter performing according to our expectations. We're not going to update inter-quarter sales today. There's a lot of things inside the sales that we don't do as regularly as we used to, so we don't have all of it online and some of the other pieces of the business. We continue to be happy with the trend. Our guidance of ID sales in the second half being in the neighborhood of the first half. Obviously, both have to contribute to where ID sales are going to wind up being. It's not like ID sales in the third quarter are negative or anything like that. They continue to perform quite well. In fact, when you look across our geographies, we talked in the second quarter about 20 of our divisions being positive IDs. That continues to be the trend. So there continues to be overall strength in the underlying IDs, just not the level we wanted to.

So don't think about this that the third quarter looks disastrous or something like that. It's just a slower ramp up. And also keep in mind the 50 basis points of price investment that Mike talked about in the second quarter. That doesn't go away overnight in the third quarter either because until we lap that next year, that won't really go away. So both of those are out there affecting the top line.

**W**

Okay, and then my second question is, maybe Mike Donnelly, could you just talk a little bit about what you changed from the early store optimizations to what you're doing today? Because obviously it sounds like you've gotten a model that is [audio disruption] in getting a stronger sales list [ph] so maybe just talk to that a little.

**Mike Donnelly**

So I would say that, when I said it was a large undertaking, it was a large undertaking. And we learned a lot on the early stores that we touched. I would tell you the biggest issue that we had early was bringing it all together in a timeframe that actually was not so disruptive. So what we ended up doing is we were touching a store two or three weeks here, going away and coming back and touching it again and that's what we tightened up. So when we say we're more focused on the execution of the space op and all the elements that go into it. That's how I'd describe it.

**Kelly Bingham**

Thanks. Kelly Bingham of BMO [ph]. I guess the space optimization is still not 100% clear to me why it's taking longer. So I was wondering if you could talk about those early stores that went through it that the first couple of test stores and how those are performing now. And what gives you the confidence that you will start to see that ramp eventually and that we're not going to push that timeline out again when we get to the fourth quarter?

**Mike Schlotman**

So if you look at the 2017 stores we did, the 250 or so stores that we did in '17, they have been a positive contributor to ID sales every quarter, well, the first two quarters so far this quarter and the expectation is for the fourth quarter. And their contribution to ID sales has been relatively consistent. It's the fundamental reason why my slide that I showed, why the first quarter had a net positive contribution. It was those stores being through it, starting to come out of that cycle, but then somewhat offset by the storage, the stores we did start it in the first quarter.

Keep in mind the first quarter is a 16-week quarter, so there were—you can start a lot of stores in our first quarter that eat into some of that, but it was still a strong enough performance of the '17 stores to overwhelm the stores that we started disrupting in the first quarter of this year.

**Rodney McMullen**

And broaden the scope as well.

**Mike Schlotman**

And to Rodney's point, the scope on a lot of them wound up being broadened as well, so it took a little bit longer to get the stores completed. You know, there's things we've learned and in hindsight's always 20/20. Would we do things differently throughout the year than we did so far this year? Absolutely. But to Mike's point, we became aware of what was going on and we're changing the process going forward so we don't have the same unexpected disruption the rest of this year and into next year when we start to do some more next year.

**Kelly Bingham**

Okay. Thanks. And just one more follow-up if I can. In terms of that \$5 billion in digital sales, I would assume a big part of that is the pick-up. So I was curious if you could talk about the fee structure for that because you have a lot of competitors moving forward with a free pick-up service. So why should investors not worry that you eventually have to match that or bring that fee structure down? And maybe you could share with us some metrics on after you have a customer who does the first three orders, which I think are free, what kind of retention rates or repeat rates you have with those customers?

**Yael Cosset**

Yes. I won't share like specific repeat rate or retention rates, but I'll give you one metric, which is the vast majority of our transactional pick-up and delivery transactions today come with a fee, which indicates since the first three are the fee is waived, the vast majority of the transaction are three plus transaction customers.

In term of the fee and the fee structure, we have been testing and we continue to test constantly the willingness for the customer to have that fee and whether it's a \$4.95 or \$3.95, how do we future rate [ph] that? We also have things that maybe fall below the line. We have a lot of offers and investment, either merchandising investment on our side, or through CPGs that are helping alleviate that fee.

So we'll continue to test; we'll continue to monitor the tailwind from an operating profit that Rodney mentioned earlier and our plan moving forward is of course modeling and assuming that there will be ultimately, potentially a change in that fee structure. We're not wanting to build a model that only works

if you maintain that high fee structure. We want to create the optionality moving forward so that as the market evolves or as the customer evolves, we can adjust as well.

The last thing I'll say is our customers tell us the quality and the convenience of the service helps them feel comfortable with that fee. And we're in markets where we do tests, where we twist or adjust that fee, we don't see too significant of a shift. Which, you know, gives us confidence that the value of the service justifies the fee at this point. Good question.

### **Rodney McMullen**

Yael's comment on some of the dollars are below the line in gross and things like that, just like when you shop in the store and you get a personalized shopping experience, people who shop on ClickList can wind up getting orders personalized for a ClickList shopper that wouldn't be known in the marketplace and in many cases customers are willing to pay that fee because of the value they get on that personalization and the discounts on products.

So our regular customers that use the services and interact with us in the different modalities clearly understand the different value propositions that are out there and how we excite them.

### **Ken Goldman**

Hi. Ken Goldman, J.P. Morgan, two from me. Mike Schlotman, on the chart that showed that a little bit of the growth will come from fuel, I'm just trying to get a sense, I know you're not forecasting this, but you obviously have some kind of idea what fuel margins will be. Can you give us an idea, are you assuming fuel margins over that time don't change? In that assumption I assume it has to be somewhat of a forecast in there. So I'm just trying to get an idea.

### **Mike Schlotman**

There is a forecast, yes. Our assumption for fuel margins is, you know, they've obviously been very strong and growing over the last five to seven years and five to seven years ago we would say that historical average, well, that just continues to move up. We believe there's numerous reasons why fuel margins continue to move up. A lot of the players are public. They have to meet the demands of you all, who might be their shareholders as well. A lot of them are MLPs. They need to generate a certain amount of cash flow to pay the dividends to keep that status. And a lot of the big oil companies who got out of, even though it might say Shell or BP on it, it's probably not run by the big oil company anymore. It's probably independently owned or there's two or three stores that that person may own. And that's their livelihood.

So I think all of those have caused margins to stay up where they are and stay higher. So there's a little bit of gallon growth and I would say margins where they've been the last couple of years would be the fundamental thesis.

**M**

[Indiscernible] five year average.

### **Mike Schlotman**

Five year, yes.

### **Ken Goldman**

Okay, that's helpful. And then my follow-up is on the cog side, there were three points mentioned. You mentioned that you're gaining some efficiencies from your own brands, the second thing was national brands, the third was indirect sourcing. I understood the first and second. I didn't quite understand the national brands part of that and I was hoping you could elaborate a little bit on how you're gaining some

efficiencies there. Thank you.

**Rodney McMullen**

I'll go ahead and take that for you. Obviously we're in a dynamic business and time right now when we think about the CPGs and the national brands and what's going on there. I can tell you through our process of CO, which is a process that we take all of our CPGs through. Through that process we've had some, well I would tell you, we're ahead of plan, so we had a very aggressive plan to capture cost savings across the board and we do look at it from national brands, Our Brands, and that kind of thing.

So we're actually, we're very comfortable. The issue with today's world is, you have heard, that there's been many announcements out there around cost increases. Some of those are happening and some of those are not. So I would just tell you that the announcements go out this way and it's really about how do we actually capture costs by working with the CPGs.

And to be quite honest with you, we're a lot more tenacious about our cost of goods today. But we do partner with them. But we do leverage our size and we do try to lead them in the right direction. How about that?

**Mary Ellen Adcock**

And I would also add, [overlapping voices] I'm sorry—I would also add that that is a main point, but don't underestimate the other two components. Because that's why we really emphasize those two, because there is a lot of leverage in both the Our Brands and the, particularly the indirect sourcing.

Sorry, Rodney, did you have something—

**Mike Schlotman**

Rodney brings up a really good point, and it is the leverage that we have with our stores. But if you think about the substitutability of brands and you look at certain categories, and we've done this. And using the insights that we actually have, we may not need to have all the brands on the shelf that we have today. And those are the decisions that we make.

**Vinny Sinisi**

Great, thanks. Vinny Sinisi, Morgan Stanley. So one more on the space optimization and then on your private brands.

**Mike Schlotman**

I didn't think there could be any more.

**Vinny Sinisi**

One last one, I promise, I promise. So as you mentioned, this is not a new concept for you guys. You've been doing this in certain expense [ph] for a few years. So at this point, given that there are still kind of puts and takes, would you say that you're at the stage now where some of the core elements, it's kind of plug and play and that for each type of store, given their own characteristics, that you have the model in place now that it's not going to be—you feel good that one more quarter maybe and then disruptions definitely will get less going forward. Well, that's [ph] the first one first.

**Mike Schlotman**

So, absolutely. So when I said we've learned a lot, we have. We actually reacted quickly to improve the situation and tighten the windows. And to be quite honest with you, they are store-driven projects. So it's not a question of this is what it looks like. We actually look at planograms by store. And then we execute on that.

I've got to tell you, I feel really confident that next year there's going to be a good year. The lights go off, sorry. I think we just had another power surge. So, I just—next year when we do these we'll start and we'll start with a better plan than what we did this year and we'll accelerate from there.

**Vinny Sinisi**

Okay. And then just on your private brands. Obviously, continuing to have real nice traction there. Where can that go? Where are the most opportunities? And then kind of to Ken's question, have there been material changes when you are working with some of your bigger suppliers over the years? Or is that maybe something that is just kind of a continued work in progress?

**Mike Schlotman**

So is that two questions?

**Vinny Sinisi**

Sure.

**Mike Schlotman**

Okay. So the first one is around Our Brands and I would tell you that we are extremely confident based on—you even saw some of it last night. Based on what we do, how we do the research, and where we go with it. I'm not going to tell you that we want to be a 50% share of Our Brands because that's not really our plan. Our plan is to continue to give the customer what they want when they want it and expand where needed. Private Selection and Simple Truth are a great story. And if you think about five years ago, Simple Truth wasn't even part of the arsenal. So it gives us confidence that we can get into areas that actually are meaningful.

And your second question was around the CPGs?

**Vinny Sinisi**

Yes, so basically, that with obviously private brands continuing to have nice traction as an important element of that. As you mentioned you are being mindful of the profitability when you're in some of these discussions. Have the discussions changed in a meaningful way to date?

**Mike Schlotman**

They have changed in a meaningful way at Kroger for the last year. And I will tell you that we are more tenacious today about cost of goods and working with our partners to achieve our ultimate goal.

**Vinny Sinisi**

All right. Thanks, Mike.

**Michael Astor**

Good morning. It's Michael Astor [ph] from UBS. Within your expectation that you're going to get growth over the next couple of years from the core retail business, have you assumed that the overall industry profit pool for groceries is going to grow in light of the fact that it's increasingly going online? There's more cost pressures and there's more price investments. And have you assumed that your share of the profit pool will also grow?

**Rodney McMullen**

Well, I think fundamentally we would have the expectation that we would continue to grow our share of the profit pool in our basic industry. As you listened to Yael's presentation, we are clearly setting ourselves up to meet the customer not only where they are today, but where we think they're going. It

remains to be seen how much of the grocery industry in the US goes online. It's relatively small today compared to a UK or a place like that. I love how we have ourselves set up to be able to address where the customer goes.

But almost every one of our partnerships has something else about it, not just online. Ocada can do other things for us, wherever [ph] Walgreens go; that's obviously an outlet just for selling Simple Truth and Our Brands in that environment because that's in the stores today and the test in northern Kentucky.

So every one of these partnerships that we're doing to address the modalities that Yael talked about, we would have the expectation that our share would grow.

### **Mike Schlotman**

The other thing I think it's important to remember, it's still about 45% of market share in grocery is held by people without economies of scale. And if that operator has a niche of some type, then I think they'll still have some runway in front of them. But there's an awful lot of people in that 45% that really do not have a niche and they do not have economies of scale and if you think about the world getting increasingly complicated with the use of data, a broader ecosystem, and multi-channel, it becomes increasingly painful for some of those. And if you look, you're starting to see some of those, if you look at Supervalu and what they've done with retail and some other transactions that have happened as well.

### **Michael Astor**

Thank you. Can you [ph] put in a better view on the grocery sector than nearly anyone out there? Can you put some perspective around what's happened to the overall grocery profit pool, just in the last couple of years?

### **Mike Schlotman**

Some of it would be opinion-based. If you look at the overall market, it continues to expand slightly. You would have the total market share in the country. Obviously, it's a separate grade of pool. We're looking at the pool not just the supermarket, but restaurants as well. And when you look at supermarkets and food away from home, it's a \$1.5 trillion market that's out there. A lot of the things Yael showed, the instant I need something now, delivering fresh food fast and things like that, we would expect to be able to get some of that share as well.

### **Rodney McMullen**

I like the question, but I would define it a little broader. What's the profit pool on the food that people eat in the United States? And then how do we get our share of that profit pool? And then how do we use the data that we have for the benefit of our customers to help their shopping experience and to create the potential for new income streams as well?

So, if you look at the—we would include CPG profits in the profit pool. We would not just look at other grocery retailers in the potential profit pool. And we still think there's a ton of opportunity there.

### **Ed Kelly**

Hi, guys. It's Ed Kelly at Wells Fargo. So, this question's probably for Mike to start, but you expressed some frustration around the \$400 million and the fact that the consensus number is so far below. I think from the Street's perspective, there's probably some frustration on our part as well around the details around how you get to the number. Could you help us out to some extent? How should we think about things like IDs embedded in your guidance? How should we think about things like the gross margin, where that's going to go over time? How big is this cost savings bucket? I think any help there would potentially help us start to frame how we should be thinking about it.

**Mike Schlotman**

You know historically, we've talked about a model that needs 2% to 3% kind of IDs above inflation over time and I don't think our view of where we need IDs to be over time would be any, really, any different like that. Obviously, with the different modalities, it may come from different streams than just that of the center—out of the supermarket, but overall we know we need the higher IDs than we have today to make the model work long-term.

I think when you look at the overall picture, Rodney talked in his opening comments about looking at Kroger through the traditional lens, which a lot of your questions are the traditional lens of where gross profit's going to go, where operating profit's going to go, and the like. Clearly we need stronger IDs. If you think about the virtuous [ph] circle we talked about, you have the left side that continues to grow strongly, needs to continue to grow strongly with higher customer count, higher transactions. That generates more information, more data. It feeds over the alternative revenue stream. That allows us to invest back into business, to grow ID sales. Some of that investment may come at the expense of gross profit rates, but that virtuous circle, it's both sides have to balance with one another to make the profit picture work.

Hopefully, when we get into the sessions a little bit later and I'm putting all kinds of pressure on Stuart, so I'll add a little more to you, Stuart. He will go into more detail than we've gone into on the alternative revenue streams and what we expect the growth to be in that, that will hopefully help you frame how that adds to the picture of how we expect to get the \$400 million.

**Rodney McMullen**

The other thing I would add, and think about this when Stuart is going through his presentation. In a couple of areas that Stuart's talking about, the potential is much bigger than what's included in the \$400 million, but not relative to the 2020 on Restock Kroger. But a couple of the categories, if you look at health and wellness and if you look at media, not so much in terms of incremental to the 400, because the 400 includes a lot of that, but as you look out, five or ten years, it's massive opportunities. So, if you look at media CPGs spend \$100 billion dollars on media every year. We believe we can help them spend it much more effective than others, especially if you create some partnerships. So, there's some opportunities there that really are the things; do you think we have the skills and the ability to get it and we believe the learnings that we're getting today and the things that we're doing over the next couple of years are the skills that will allow that runway to be even longer and more meaningful.

**Ed Kelly**

Just a follow up on the digital revenue, the \$5 billion at the end of this year, the \$9 billion, I don't know if I missed this, but can you just provide a bit more color of what's exactly in that number? How should we think about the margin implications of that and as we look at the eventual \$9 billion, how much of it is actually new incremental business to Kroger?

**Yael Cosset**

That's like three questions disguised into one. It's like Halloween. The first question, I think on the revenue and what is included in that bucket, obviously today it's all of our pick-up and delivery business. It's also all of the pure e-commerce platforms we have. Think about Vitacost, think about Home Share, think about Murray's Cheese which has a meaningful e-commerce online business. All these modalities are all included in that number. I would say and it ties to the previous question on how do you feel, how good you feel about that growth from \$5 billion to \$9 billion, because the numbers we have shared have not necessarily implied and almost doubled 80%, 90% growth year-on-year.

As the pick-up and delivery business continues to grow and get more mature, that is clearly where the bulk of the growth comes from. A year ago, if you had looked at the growth rate, it probably would not

have been as impressive as it today because the pick-up and delivery business was maybe comparable to the rest of the other e-commerce revenue force. As you go to the end of this year and going into next year, that business is continuing to grow, that adoption from the customers continue to grow at a rapid pace, which is [indiscernible] report that significant growth rates year-on-year.

I think your second question was how much of that is incremental business? We see over 50% incrementality in general for the biggest pull of business which is the pick-up and delivery business. We don't expect that to shrink. We actually continue to see a pretty solid floor in term of the markets that are out there forming others, 50 is really something we feel good with as we bring in new customers, new segments of customers, there is potential of some softness, but in aggregate we are north of 50 and we expect to increase that number as we continue to improve the expense as we get better with personalization, better in curating, and simplifying that journey we expect that incrementality to increase.

If you think about the overall business, in pick-up and deliver, half of that revenue is coming from the competition and we don't expect that to slow down so you can start modeling what that looks like two, three years out.

I think your last point was about gross margin and if I recall correctly?

**M**

Operating. Margin. I would go back to Rodney's comment that he made earlier in the Q&A panel that it's been a headwind, it continues to be a headwind, but we're getting to the point where it's going to turn into a tailwind in the digital business overall. I think that's how you described it a minute ago.

**Yael Cosset**

Yes, if you look at the customer, because of that incrementality, and that increase in frequency, at the customer level, once you engage with us digitally and shop with us digitally, you are driving more. It's a tailwind from the profit perspective. If you start aggregating at the store level, when you open the store there's a significant capital investment to stand up that capability and that's the point Rodney and Mike made. It takes about three to five years before that's [indiscernible]. A unit basis is positive, but then when you look at the aggregate from an enterprise perspective, we have opened over 1,600 stores now for pick-up and also over 1,600 stores for delivery. Even those stores become a little bit of a misleading proxy for coverage because you can deliver from one store to more than one store worth of coverage.

When you start looking at the aggregated impact at the enterprise level, the number of stores or net new stores we are opening which is the biggest impact from a capital expense, it's starting to slow and is smaller than what is considered now a natural [ph] business. That's where you're going to see starting next year and beyond a tailwind in aggregate for the enterprise on the profit side. I hope that answers your question.

**Craig Johnson**

Craig Johnson, Customer Growth Partners. You all mentioned earlier that the very price sensitive segment of your customer base is the fastest growing, given that, can you talk a little bit more about your strategy for addressing the limited assortment players all the Trader Joe's, etc.?

**M**

I would tell you that we don't look at any one competitor to determine what our strategy's going to be. Certainly, there's a handful of competitors that are probably doing fairly well right now. We would look at some of those competitors, when we think about our brand, we would look at those as when we look at our brands compared to some of theirs, that's how we'd probably look at it.

**Bill Kirk**

Hi, Bill Kirk from RBC. You're projecting a lot of e-commerce growth. I think last quarter you said 80% of the top brands online are your own. With that in mind, CBG companies seem a bit left out. So, how do you expect them to try to participate in that growth and that opportunity that you're providing?

**Yael Cosset**

I think that may be a bit of misleading indicator. The top brands purchased online and are properties are Kroger brands. However, if you look in aggregate in total dollar sales then it gets diluted. So, I think it's just a reflection of how much our customers are loving our brand and the frequency with which they engage with our brands online. It doesn't mean that they are not purchasing a national brands when they shop with us.

**M**

The comment that we made was in context of Ship versus overall.

**Yael Cosset**

That's correct. One single modality. I would say if you think about the pick-up and delivery which is the more mature established service, the mix of products and therefore brand attachment of our [ph] transaction is very comparable to the store transaction.

**Joe Feldman**

Joe Feldman, Telsey Advisory Group. I think, Mike Donnelly, you mentioned early in your prepared remarks, or maybe in a response that you're not seeing the list that you saw when you did the initial ones a few years ago from space optimization. It's not quite the hockey stick. I'm curious can you explain why you think that is?

**Mike Donnelly**

I tried to, actually, before. I honestly believe it has to do with a lot of the things that we're doing. It has to do with our pricing initiative, it has to do with the disruption we've seen across some of the space optimization. It has to do with, potentially, it could be our brand. It could be a lot of different things. The thing that I want to set at ease here, is that we see progress. It's just not like it was a few years ago. I don't know what the gap is there, but I can only assume some of the things I just described are a part of that.

**M**

Also keep in mind when you do the calculus, it's a record number of stores that we've ever touched in our history that touched the number of stores we did this year. In Mike's presentation, he also talked that it's the most investment we've ever made in price in a particular year as well. It actually causes some internal debate about, is this store that got remodeled, is the effect of that the fact that it was a space optimization and it's going through the recovery period, or did we make an incremental investment in price in that store as well so it's from price.

All of these collide to come together and we understand what the total impact is, we're trying to get as granular as we can with you to tell you what the effect of each one is, but I can tell you the team up here and the rest of the team in the room continue to be very excited about where we're heading with all of these efforts.

**Yael Cosset**

You're too close to the front.

**M**

Tara [ph] didn't want to be seen by the whole room.

**M**

Thank you. So, first for Mike Donnelly, when you think about this year's price investments versus past, what's the demand response been? If it's been slower, is that just the environment, is it some of the disruption on top of that? When you think about shelf pricing versus personalization, was there a change in mix of investment versus prior years?

**Mike Donnelly**

I won't go into our strategy because I'm not going to do that, but I will tell you that based on our data, based on what we put into play this year with our price investment, we've seen good unit lift, but we've created deflation. So, from a dollar standpoint, as I explained to some of you earlier, it's very difficult when you start to look at certain items that customers buy most, you don't necessarily get to see that retail inflation or units drive as more units that can get you across the lines.

Second part of your question?

**M**

When you think about the impact, any change in mix of shelf pricing versus personalization?

**Mike Donnelly**

I would tell you that there is no change. I would tell you we're also very focused on the personalization side and in today's environment, we're trying a lot of things. We're probably doing more test and learns on the backside of the business as you'll see on the front side of the business today when you go to the store.

**M**

Secondly, maybe for Schlotman. If you think about the impact of alternative revenue streams in the PNL out to 2020, clearly there is a margin benefit. Is it right that that's going to flow through the most pronounced in x-fuel [ph] gross profit dollars and x-fuel gross margin? That's where you'll see it. Does the maturation of that effort, does that create any backend loaded nature to '19 and '20 as you progress toward the \$400 million?

**Mike Schlotman**

To answer the last part of your question first, we talked this time last year that 2018 was going to be an investment year, and while we expect to grow operating profit margin dollars by \$400 million over the three years, it was going to come down this year. Then in March we talked about it was going to go down further because we were pulling some 2019 investments into 2018 and I can tell you the way the business model plan is being set up for next year, is it's very clear which buckets we move to '18 and where we're reducing those in '19 so we don't spend them again just because that was the original plan.

We're very upfront with the teams on what they can and can't invest in 2019. It was set up to be a hockey stick in nature in '19 and '20, and I get that's part of the disconnect of we're sitting here with what was going to be a down year, we now pulled investments forward which makes it even more of a down year and it's a big number to generate in 2019 and '20, but when you look at all the things we have going on and maybe we should've led off with you Stuart. When we get Stuart up here to talk about alternative revenues later after the break and then we'll have another Q&A after that so we can quiz him on some of that. Hopefully the overall profit picture starts to become a little clearer.

**M**

Stuart and Gary, both.

**M**

I just meant when '19 and '20 taken together, is that sort of—it's not a backend loaded meaning now it's more than \$400 million, it's over \$500 million. It's not '19 is a couple of hundred million and '20 is much bigger—

**Mike Schlotman**

We're not waiting for everything to happen in '20, if that's your question; '19 has to have some decent operating profit margin dollars growth.

**M**

Okay, thank you.

**Mike Schlotman**

Let's go over here to Scott.

**Scott Mushkin**

Hi guys, Scott Mushkin from Wolfe Research. I had two questions for you.

**M**

You're not going to ask the TV question this year?

**Scott Mushkin**

I know the TVs are now available at Fred Meyers. Everyone should know that, e-commerce online, that's great.

The question really goes to volumes, we've seen a pretty significant volume shift over about probably the last year, year and a half away from traditional supermarkets to mass and discounters, those competitors are using price as a lever—and I'm talking volume specifically here—are using price as a measure to get their businesses moving. I'm just trying to understand from your perspective why that competition would stop that strategy which seems to be working, especially since they're some of your top competitors. And then I had a follow-up.

**M**

Overall, our market share continues to grow, our units continue to grow, so when you look at shift that you're describing, it doesn't necessarily affect everybody the same way it does. Rodney talked earlier about the 45% share in a lot of markets that don't have economies of scale that us and the people in the 55% of that would have, and a lot of those people wind up becoming the donors of share out of the way we go to market and it's not necessarily—it's not just the, if this went up then it must've come from Kroger. There are a lot of other people and weaker players out there who are donating share, not only to us but to some of the outlets that you talked about.

**Scott Mushkin**

My follow-up question is we've seen across retail, especially in staples retailing, and even out of Amazon, the digital sales, tend to be quite dilutive. I think your largest competitor actually loses about \$2 billion on theirs. I'm just trying to understand a little bit why you guys are having such a materially different experience and expected to be a profit tailwind as we move forward when everybody else seems to talk about it as a profit headwind in this significant one [ph]. Thanks.

**Yael Cosset**

This is a good question and I can't really comment on the challenges some of our competitors may face.

What I would say is what seems to be a big sort of support for that profitable tailwind if you will, is the fact that as customers are transacting with us through channels that may be more expensive to fulfill, there is additional costs associated with fulfilling a pick-up or delivery order. They expend their engagement, they increase their engagement with us across all the modalities. So, we're not seeing a significant—back to the incrementality point, because we are seeing 50% incrementality, you obviously see some channels shift and my guess would be that the competition may see a bigger share of their e-commerce business as a channel share.

For us leveraging our asset, the proximity to the customer, the personalization capability we have we're creating a relevant experience that is driving that incremental sales, that is driving that frequency of engagement and is translating in the metrics we see today, which is obviously accelerated growth of the business from a top-line perspective, and about three years in-ish [ph] plus or minus where we start getting a tailwind at the store level but for an enterprise because of the maturity of these two businesses in particular it becomes an aggregated tailwind.

**M**

Yes, and remember the tailwind doesn't mean it's profitable, it just means the investments aren't as much as what they were in '18.

**Scott Mushkin**

I said two, but I actually had a quick follow-up. I think you mentioned 1,600 pick-up stores. Is that about as high as you guys can get or can you slip in a few more? Can we go to 2,000, 2,500? Now I'll yield. Thank you.

**Yael Cosset**

Yes. I think the 1,600 is not the end of the road, but as we are looking ahead we definitely still have a few hundred that are already identified and in the pipeline for opening. You'll see that slow down for the balance of the year for an obvious reason, which is we want to minimize the disruption of the physical stores. As you go into next year you'll see that pick up again for a few more hundreds.

I would just also emphasize the fact that the Ocado partnership and the partnership with Walgreens and others is helping us increase that coverage without necessarily relying on one physical store to be opened for pick-up, if you will. The store may still be open for pick-up as in the orders will be staged in the store but may not be picked up in that store. So when we talk about the 1,600 and the next few hundreds, we're talking about full end-to-end operations of pick-up in that facility, but moving forward you'll see a few more hundreds of these, maybe not to 2,500, but we'll increase the coverage through the Walgreens, through the Ocado partnership which allows us to move the operation outside of the physical store so we can maintain better and high-quality experiences for our brick and mortar customers.

**M**

One of the things that Walgreens will help teach us is what is the ability to have pick-up points different than a traditional location. Learnings from that will open up a whole new avenue assuming that we can do it effectively and efficiently and profitably, it just opens up a lot of additional pick-up points.

**M**

I appreciate everybody's questions and time. Rebekah's going to come back up for a brief second. I thank my fellow panelists.

**Rebekah Manis**

Thank you, guys. Those were great Q&A questions. We'll have an opportunity for another round of questions too, so if you have more we'll save that for the end of our meeting time. Before we break I did

want to take a minute to have our Senior Team introduce themselves. If we have a couple more Kroger executives you can join us on the stage at this time, and that way you'll put names and faces together and when we go to break you'll have an opportunity to speak to everyone again. Thank you.

**Mary Ellen Adcock**

Mary Ellen Adcock, Group Vice President of Retail Operations.

**Yael Cosset**

Yael Cosset, Digital.

**Mike Donnelly**

Mike Donnelly. I think you know me.

**Rodney McMullen**

Rodney McMullen.

**Chris Hjelm**

Chris Hjelm, Executive Vice President and CIO.

**Jessica Adelman**

Hi, everybody. Jessica Adelman, Group Vice President of Corporate Affairs.

**Christine Wheatley**

Hi. I'm Christine Wheatley. I'm the General Counsel.

**Tim Massa**

Good morning. Tim Massa. I lead our People function.

**Alex Tosolini**

Alex Tosolini, New Business Development.

**Robert Clark**

Robert Clark, Senior Vice President of Merchandising.

**Stuart Aitken**

Stuart Aitken, 84.51 and Marketing.

**Gary Millerchip**

Good morning. Gary Millerchip, CEO Kroger Personal Finance and Strategy Integration.

**Rebekah Manis**

Great. Thank you. We'll go ahead and take a break. Let's come back at 10:20, and we'll start the second half of our day. Thank you.

**Operator**

Ladies and gentlemen, please take your seats. We'll return from break shortly.

**Rebekah Manis**

May I have your attention please? If you could find your seats? Okay. Thank you. We're getting ready to start the second half of our day. Tim Massa, our Chief People Officer, is here to start our next round of presentations.

Tim, welcome.

### **Tim Massa**

Thanks, Rebekah. Good morning, everybody. I hope you enjoyed your break. I wanted to spend a few minutes to talk about the third pillar of Restock Kroger and that's Develop Talent. A year ago in New York because we introduced the plan we talked about this pillar. It contains three components: a focus on the associate experience; a focus on high-performance leaders and teams; and importantly investing in and retaining our store associates.

I wanted to give a brief highlight over the past year of what we've done in this space to support our business and to support our associates. We're 460,000 strong in terms of associates that work for us across the country, and one of the big areas in ensuring that we deliver on the customer experience that you heard earlier about and have heard about on an ongoing basis, is ensuring that we are retaining our associates and having fully-staffed stores as well as capable leaders. A big component of how we measure the Develop Talent section is really retention. Since we introduced the Develop Talent section of Restock Kroger a year ago, we've reduced our turnover 9.4%, and we're very proud of that.

At the same time the individuals who choose to leave us actually are staying longer with us before they choose to pursue something else, and we see that as positive. So both on our improving retention and folks staying with us longer both of those lead to improving our customer experience as we have nine, or if you call it as Mike Schlotman says 11 million customers a day with fuel and pharmacy interfacing with us. That associate is much more knowledgeable, much more engaged, knows their department, knows their category, and that improves that customer experience for our customers. Importantly, we see a cost to serve being lower and a return on investment being better by reducing our turnover costs.

I'd like to talk a little bit more about the three areas that make up Develop Talent. The first one as I mentioned is about improving the associate experience. With the tax savings we took a third of those savings and actually invested significantly in our associates, and in a minute we'll talk more about those investments really hallmarked by our focus on education that we call Feed Your Future. Before I get to that, we put a lot of emphasis on continuing to differentiate ourselves with the culture, the Kroger way.

Rodney's talked to you about in the past how our associates and many of our executive team have come for a job and have stayed for a career. We've rebranded our recruiting strategy that's out there today called Careers with Promise. Our research and our consumer insight and our applicant insight is telling us that that's resonating with the Gen Z and the millennials in our work force. It's also resonating with external talent. We're beginning to bring in more and more external talent with skills that we need to help us continue to serve our customers.

We also are happy and proud that we outpaced the retail industry in associate engagement. From day one when an associate joins us with a consistent onboarding experience, whether you're in Utah at Smiths or in Atlanta, Georgia all the way to their ongoing performance career and learning development, we believe that engagement is key to cultivating the culture that we strive for.

A little more on the long-term benefits that were connected with the tax savings that we put toward associates. I'd like now to show you a brief video that internally we created that highlights some of those significant investments.

[Audio-visual presentation]

Again as I mentioned, that investment in our associates has really played well for us and for our

customers. On April 16<sup>th</sup> Rodney was able to be on *CNBC* to talk a bit about our program. You've heard about those investments in previous sessions. We continued to see both local and national coverage that day. The conversation continued in July. *NBC Nightly News* did a piece on what companies are doing on new perks and benefits to attract talent, and our program Feed Your Future was highlighted as one of the hallmarks in the industry in what companies are doing to support associates. Then earlier this month *Wall Street Journal* did a piece on how companies are coming up with new benefits to attract talent. So really from April through October we've seen a good tailwind of the extreme support of what we're doing to invest in our associates, and we're very proud of that.

Introducing the Feed Your Future program in May we've been around five months now with the program, we've had over 2,000 of our associates already apply. Again, this is all associates, part-time and full-time, \$3,500 a year, \$21,000 over a lifetime and it can be for a high school equivalency exam all the way up to a degree, a certification, etc. We find that flexibility for our associates is really resonating with them.

The second component of our Develop Talent area is around developing high-performing leaders and teams. And really the hallmark is our Kroger Leadership Academy, where every associate, whether you're a new hire coming on with a consistent onboarding approach, through a high-volume store leader, to a district manager, through executive, all of our training and development, our learning and development, is based off an academy of role-based curriculum and leadership curriculum.

As I mentioned earlier, we continue to emphasize how we grow talent and create jobs. We announced recently our holiday hiring of 10,000 associates that we're looking for across the country. We continue to put more emphasis on external talent, both at the store level as well as the executive level. Many of the executives that you've seen today come from different backgrounds beyond the Kroger experience.

I believe this visual does a great job of depicting what we mean by high performance at Kroger. Rodney's talked a bit about our purpose of feed the human spirit, and Jessica will talk more about that in a second but that is our why. That's why we exist. That's our North Star. Our people, our 460,000 individuals, are using our promised behaviors of everyone friendly and caring, everything fresh, improving every day, uplifting someone, as well as our values and our leadership behaviors to really be the how we bring our purpose to life. We believe if we do that right day in and day out with our associates, we get the results that Mike and Rodney have talked to you about. We believe now as we get into more of a digital age, an e-commerce age, that's ever more important in a seamless fashion of how we create growth opportunities to really feed the human spirit for our customers and for our associates. So this really is our framework that we use in driving that component of high performance.

The third, and not to say least important, but very important component of developing your talent is what we're doing to invest in and retain our store associates. We're very proud of the progress we've made on retention but we're nowhere done. We want to continue to retain talent to serve our customers and the importance of continuity in role and the importance of knowledgeable associates to serve our customers has never been more important. The \$500 million investment that we announced last October really was a significant component of our investment as well as in talent development areas.

We're also able to leverage the associate insights, and we annually do engagement surveys and throughout the year are doing pulse surveys with our associates to understand what's on their mind, how to simplify their work. That's important as well, and those insights are helping us enable better business results.

Beyond our focus in year two and three to continue this investment on wages, and as we look ahead I'll talk more about some other areas, but the \$500 million investment has really been broken out this way over our three-year Restock Kroger plan. 56% of our retail hourly associates have already seen an

adjustment or an enhancement to their wages, and that will happen by the end of 2018 when we finish our fiscal year. Another 33% through our collective bargaining agreements will see another impact on wages and the remaining 11% by 2020. So that's how we'll spread the \$500 million investment to our associates.

All of that today leads to a current average hourly retail rate of \$14.47. That's up from \$14.01 last year when we provided that detail. This number is significantly higher when you look at benefits and pension that we offer to our associates. We continue to rebalance benefits and pension to provide even more on wages and also provide flexibility for our associates to meet them where they are. Again, in addition to the wages the things we're looking forward over 2019 and into '20 is how we continue to upskill our workforce and provide a more flexible workforce. Paramount in that is really looking at our leaders of others as teachers and coaches to teach, coach, and celebrate with our associates.

Over to my left on those banners you see some of the phrases of hands-on leading change, lifting expectations, and directing the workforce. We're teaching and coaching our leaders of others to teach our workforce how to operate in that framework to serve our customers so that we are friendly and caring, that we are everything fresh, and that we are working on ensuring that what we have is in-stock for our associates day in and day out.

Yael talked a bit about digitally enabled, and we need to make sure that we have the skills and the talent, and we need to upskill our entire workforce including our leadership team on being digitally enabled to serve our customers. We want to also call on certifications and performance-based incentives and skill-based incentives as our associates become more knowledgeable in their area of expertise in serving you. We want to be able to reward them on top of their average hourly rate.

Importantly, this demand for talent has never been greater. Several of us talked about this last night over dinner and one of the key things we're looking at across our stores is on-demand scheduling. How you can be in one store, like Bellevue, which you won't be at today, but is a stones' throw from Newport, and how we can have associates be able to sign up for hours between stores to give them more hours for their schedule, as an example. As we look at, also, the gig economy and on demand talent to serve our needs as we talk more about being digitally enabled.

We're also trying to simplify the store. Mike Donnelly, as the chief operating officer, is really stressing we have to make it easy for our associates to serve you, the customer. Our recent contract, that we brought out in Cincinnati and Dayton, talked more about a wall-to-wall clerk or a wall-to-wall associate having operational flexibility to work across the store and serve you better versus having multiple roles.

At the same time, we believe this Careers with Promise recruiting message showing a career path and showing what's possible inside the store and then beyond the store is really resonating with our associates, and we'll continue to look at third party relationships, as appropriate, to help us in serving you and provide the flexibility that we need. These two areas, along with our wage investment continue to be the hallmarks of what we want to do to develop talent to support Restock Kroger.

We're also hearing from our associates that it's beyond what we do in the store, it's beyond how we interface with you on an app or digitally enabled. It's what we do in our communities and how we give back is what really resonates as well with the men and women who join Kroger.

It gives me sincere pleasure and honor to introduce Jessica Adelman, who's going to talk about the fourth pillar of Restock Kroger and that's live our purpose. Jessica?

**Jessica Adelman**

Thank you, Tim. Hello, everybody. I'm Jessica Adelman and I'm Kroger's Chief Corporate Affairs Officer and Chief Sustainability Officer. Let me get right down to the essential question, which is why in today's environment would Kroger bother with an ambitious social impact plan?

Well, we've been talking all day about how we are going to create shareholder value as a result of Restock Kroger, by redefining the grocery customer experience, partnering for customer value, and developing talent. The foundational Restock Kroger pillar, in support of creating shareholder value, is to live our purpose. Our customers, our associates, like Tim just so brilliantly mentioned, and you, our investors, expect big companies like Kroger to contribute to communities, support their people, and to protect the planet.

This ability to live our purpose translates directly into our ability to grow the business and to create shareholder value. Our stakeholders are hungry for purpose and employees want to work in a purpose-driven company. In fact, recent studies show that employees would take a paycheck at \$0.67 on the dollar to work at a company whose cultures and value they believe in, and increasingly the investment community is moving rapidly in this direction, although I realize that the math isn't quite the same yet today.

BlackRock is Kroger's largest shareholder. All of [ph] you know how closely the business world reads the CEO's annual letter, scanning it for clues and information about the firm's investment direction. This year, the letter sent off minor shock waves through the ESG investment world when BlackRock explicitly called for CEOs to articulate their companies' social purpose.

The ultimate conclusion: lack of purpose results in subpar returns for you, investors. Kroger has been at this since day one, in 1883, when Barney Kroger was known for donating day-old bread to neighbors in need. We've been at this since day one, of feeding America, as a founding member. Now, as a company, we are defining what day one looks like in the social impact space by being at the forefront of shaping the national discussion around hunger, and food waste in America primarily through Zero Hunger Zero Waste, our ambitious social impact plan designed to end hunger in our communities and to eliminate waste across the entire company by 2025.

Zero Hunger Zero Waste is predicated upon addressing a fundamental absurdity and that is that 1 in 8 people go hungry, yet 40% of the food produced in America is thrown away today. We have decided that that makes absolutely zero sense. We, at Kroger, are going to use our expertise and our scale to try and do something about it, especially because we know that in today's crazy world, our customers expect us to throw our weight around. They expect us to use our scale for good.

What have we done? Well, it turns out, quite a lot. In 2017, Kroger directed a total of \$358 million in charitable giving to our communities. Of that, about half of those donations focused on ending hunger. This total giving translates into 325 million meals for families in need, or more than 6 million meals a week, and this puts us on track to meet our goal of donating 1 billion meals by 2020.

On the green side, let's be clear. Our main objective is always sales and preventing waste in the first place. But, when we do have waste, we focus on keeping it out of the landfill. In 2017, Kroger achieved a companywide waste diversion rate of 77%, on our way to achieving zero waste of 90%-plus diversion by 2020. In all, we diverted 2.2 million tons away from a landfill last year. For full results, check out our 2017 sustainability report at [sustainability.kroger.com](https://sustainability.kroger.com). More on that in a few minutes.

What are we focused on in 2018? Like everything in Restock Kroger, we are driving execution. Our top priority is in-store focus on our Zero Hunger Zero Waste Food Rescue Program. We've also synced up with Mary Ellen's successful expense management initiative to reboot our efforts on first avoiding waste

but then eliminating it properly in order to contribute to the company's bottom line.

Hopefully, you've heard the announcement that Kroger is the world's first major retailer to commit to getting entirely out of single use plastic bags as part of our Zero Hunger Zero Waste commitment. Now, there was a bit of a collective gasp when the world's largest grocery store announced it would be getting out of the plastic grocery bags, but those are the kind of moves that customers expect today and ultimately reward.

In another major vote of confidence, we even got a shout out from Oprah Winfrey herself on our plastic bag move when she joined us for a packing event to celebrate our first-year anniversary of Zero Hunger Zero Waste.

As investors, we know that you are very focused on how to measure sustainability and compare activities across firms. You want to know that it isn't merely green washing from PR chiefs like me. Camberview, ISF, and Glass Lewis will all tell you that 2018 is the year ESG topics have gone mainstream, and as a result, we wanted to make sure to get our sustainability reporting fully aligned with the global reporting initiative standards, so that your ESG teams know where to find the information that they are looking for in order to make accurate comparisons to other firms under evaluation.

We've also ensured that several of our Zero Hunger Zero Waste commitments are aligned with the U.N.'s sustainable development goals, which is another important benchmark that helps provide industry standards and harmonization across the previously fuzzy field. Kroger was also invited directly by the Sustainability Accounting Standards Board, or SASB, to submit a nomination for their food and beverage sector advisory group, which will help set sustainability standards that shape SASB reporting and metrics going forward.

While early in our Zero Hunger Zero Waste journey, the lift to our reputation has been incredibly encouraging. As you can see here, Zero Hunger Zero Waste is already being recognized as substantive and tied to our business model since it's authentic to who we are as a company. Customers are choosing Kroger because of our values and our efforts and you heard last night, from Nicole and Gil, about Zero Waste eating and values-based shopping.

We are right in the sweet spot of that and a lot of other mega food trends plus, as Tim mentioned, our purpose and social impact is helping us to recruit top talent. All of this culminated in Kroger being named in the top ten of *Fortune's* Change the World 2018 list, debuting for the very first time at number six.

*Fortune's* list identifies the top companies around the world who are tackling public health, environmental, economic or other societal challenges as part of their everyday operations. The list isn't about charity dollars that companies give nor is it about assessing who's good or bad. *Fortune's* Change the World list, rather, is about solving problems through sustainable and scalable problem-solving machines that we know as business.

Debuting among companies Changing the World, at number six, is pretty good. We were pretty jazzed about that. We're also pretty excited about the fact that there are five more spots left to climb on the list, so challenge accepted. The same goes for you, as our investor audience, in concert with our customers and our associates. Challenge accepted to navigate today's polarized and divided society and to use our scale for good. Challenge accepted to live our purpose and authentically share what we're really passionate about knowing that we're not going to get it right every single time. Challenge accepted to be crystal clear about what Kroger stands for.

Our Zero Hunger Zero Waste initiative gives us a simple and forward-looking way to ensure our

customers, associates, and you, as our investors understand how our commitment to do good is a key point of differentiation for Kroger and together, we can change the world. Thank you.

[Audio-visual presentation]

### **Keith Dailey**

Thank you, Jessica. Nice job. It's a big reason why I work for this company, something I'm incredibly proud of. Shortly after my presentation, I'm going to bring up a number of our colleagues to talk about a number of the other partnerships we have at Kroger. But, I'm extremely excited to talk to you today about something we really haven't talked to you about in the past.

Alternative profit streams speaks to how we're leveraging our unique assets to drive value, both for customers as well as our shareholders. Today, these would include media, insights for CPGs, our Kroger personal finance division and our portfolio continues to grow within those pillars as well as additional pillars. By the end of this presentation you should have a much better idea of what the potential is for us as a business. We have unique assets and strategic assets that give us advantages and the right to win. You saw the slide earlier. A lot more detail here.

So our store and distribution network. Today we have 2,800 stores, 42 distribution centers, 38 plants around the country, not to mention the 460,000 associates we have at Kroger. This provides immediacy, proximity and instant gratification for our customers. Our scale allows us to partner with companies in ways others can't. It allows us to be far more efficient than many and the ability to uniquely talk to customers in ways no other can. It allows us to extend partnerships to those who want and need our scale.

Our data. We have 60 million households worth of behavioral information. This next piece is critical. With 96% of all transactions tied to a plus card, this is the most robust data set in the industry and allows us to precisely personalize experiences to customers that are meaningful and just as importantly measurable.

We have data on what you eat. This allows us to create the op top [ph] score. This means we can get into new verticals. So imagine the op top score is extendable into the healthcare space and the opportunities that that opened for us. Rodney talked a little about that earlier. But more importantly than all of these is customer trust. Our customers trust us.

If you look at active shoppers over the last eight weeks, 74% of them have given us a valid email address, name and address. And then 94% of them have said they want to get communications from Kroger be that sales promotions, Start My Cart, etc. These are staggering numbers and numbers we are incredibly proud of. Customers sharing this level of personal information only do so because of the value they get for the trust they give.

We are transforming the growth model at Kroger and it starts with redefining the grocery customer experience. You heard that from Rodney. You heard that from both Mikes. We have incredible assets including a large audience, 9.5 million customers shopping us every day and if you include our pharmacies and our fuel stations, we're at eleven million transactions a day. Think about that.

Let's pretend you have a TV show and every night you get 11 million people watching your TV show. You think you could sell some advertising? So do we. We are investing in the core to keep customers in our ecosystem, therefore our investments in price, our investments in technology, our investments in digital, our investments in space optimization. Tim just talked about our investments in our associates. They are all vital to keep our customers in our ecosystem.

We are increasing the modalities that customers can interact with us. Yael talked a lot about that and you saw how that ecosystem and those puzzle pieces are coming together. More interactions allows us to again leverage this and create a stronger customer experience that ultimately allows us to better deliver on the alternative profit streams.

This is an attractive area for investment for us. It is asset light and margin rich, media being a great example of that and I'll talk more about that shortly. I want to be very clear. None of this exists without a strong core. It truly is a symbiotic relationship between the two, but this symbiotic relationship is what will transform our growth model at Kroger. Let me give you some examples of our track record and what's happening in recent years.

I'll start with KPF [ph]. KPF's growth from '15 to '16 was 8%, '16 to '17 13%. This year they'll hit a 20% growth rate. Media: In '15-'16 our growth rate was 6%, '16 to '17 was 10%. This year we'll be just shy of a 30% growth rate and we have launched 16 new products. I'll talk about them in a moment, but throughout the year, so you can imagine our trajectory just gets stronger.

We've been very deliberate in our media growth. Our media is differentiated. The data we have allows us to be more targeted and provide a greater ROI for our clients. We will be the most transparent media company in the media industry, showing our clients what the value of awareness is of targeting of all of the pieces they are investing with us across the portfolio.

Today's advertisers measure significant portion of their digital media against recall and consideration surveys. We measure exposure all the way through to purchase and provide that visibility back to the clients who are investing with us. The most transparent company out there. The industry paradigm of valuing media will change. The time is now and we want to be in the center of this disruption.

In the last year as I mentioned earlier we have launched 16 new products. We have an inventory unlock [ph] plan that will further accelerate the position we're in today. Let me just give you a few highlights. On property advertising are properties that we control. That might be our website, our app, emails and we're averaging more than a 50% growth rate in visits on each of our properties every period. Yael and Mike earlier talked about the 82% growth in ecommerce households.

We use our personalization science to offer relevant engaging experiences. A couple of examples of those, Start My Cart or My Sale Items. Again, Yael spoke about those earlier. But this summer we released our boosted [ph] search platform, where advertisers can influence where their product shows up on the site.

What am I talking about? Think about Google search. When you search for something, you will see sponsored ads. That's what we're talking about and we have suppliers bidding against one another for key words, key categories and key customers in real time live today.

Our off property advertising is led by our rich first party data understanding, which essentially allows us to tie relevant audiences with relevant content in the open web. What am I talking about? Think about ads you might see on ESPN. That would be an example of where we can tie and find households in the open web and leverage that.

We're incredibly proud of the numbers we are seeing there. The industry average for viewable impressions is 50%. We're north of 70%. And a viewable impression is one where you will see an ad that's at least half the page that you're looking at for at least one second. We're at 70. The industry average is at 50.

Now think about this: Customers are getting inundated with marketing messages; approximately 5,000 a day with the average attention span on that message of about 8 seconds. Relevancy matters to create memorable brand moments. Our loyalty marketing assets are a mature business for us. Frequently you'll hear us talk about our best customer communications and this is a productive investment to drive loyalty both for Kroger and its suppliers. And campaigns deliver a phenomenal return on ad spend across each one of the vehicles we have in loyalty marketing.

Finally in-store. The big Kahuna if you like. Our store asset is one of our biggest assets. The 11 million shoppers we have today we can leverage from a marketing and advertising standpoint. This month we started our first commercialization of shelf edge end caps in the Cincinnati market. You'll see this on your store visit today. This is where advertisers can flight rich media on screens to create engaging content that can disrupt the trip in an entertaining way.

We are currently evaluating more disruptive in-store advertising opportunities for brands to influence at shelf where more than half the decisions on what to buy are made. This should give you a good idea of what we're thinking about within this vertical, our media vertical in the suite of alternative profit verticals we have.

Our compound annual growth rate for the last four years has been 16%, but I made it clear how every single year that number is increasing. It's why we have confidence. Media and KPF are examples in the 20% to 30% range this year. It's why the rest of Restock Kroger we feel confident in a CAGR of 28%. And as Rodney mentioned earlier, in our outer years we see greater potential. For us, the pillar of alternative profit streams provides that glide path through the \$400 million by 2020.

Mike Schlotman showed this earlier. Net operating profit mix will continue to transform and alternative profit will be a bigger component of our total profit. Our objective is to deliver on that \$400 million and transform the growth model we have at Kroger. Kroger has a long history of alternative profit streams. We are focused on this now and our operating profit mix is now transforming. Our unique assets, our repeatable stage-grade rigorous process allows us the right to win and enables scalable profitability. We're reinventing the model for retail growth. We have unique assets as well as a track record to deliver on this transformation in the retail space.

With that, I will ask my colleagues to come join me on stage to talk about our broader partnerships.

## **M**

Thank you, Keith. How's everybody doing? Hopefully this last session gave you a little bit more insight into why we're excited about both our immediate and long-term future. A lot of exciting things going on. We're going to spend a little bit of time talking about the partnerships but I want to go back through some of the slides that we've used today. This is the fourth or fifth time you've seen this slide. It's obviously fundamental what we're trying to do relative to growing, redefining a grocery shopping experience and the alternative profit streams is a huge piece of that.

As Stuart said in his presentation, it's not growth and one and the expense of the other. It's growth of one to invest in the other to grow which spits off more information, more data to be able to generate more profit stream to keep the grocery experience continuing to grow, very important piece.

Unique assets gives us the right to win. Clearly our fundamental strengths and why we are able to cobble together the partnerships that we've done because of our unique assets, other people don't have it. I can tell you a lot of the partnerships we have done. Other people would love to have been in our position to be three of their executives up here in a minute to talk about the different partnerships. But because

of this slide, it's why all these folks have chosen to partner with us.

This was close to the concluding slide that Yael had. I'm going to ask the individuals on stage that are directly responsible for some of these partnerships to give us a little bit of update where each one of them stands. I'm going to start with Yael on Home Chef.

### **Yael Cosset**

Sure. So Home Chef we closed the merger in June this year. Their e-commerce continues to grow. We have introduced our customers to their e-commerce offering so think about mail kits subscription helping them to grow their business both of their property as well as introducing our customers on our direct properties; think for pick-up and delivery as well. I think important as well to mention is their impact on our store experience. Home Chef mail kits are now available in several hundred of our stores. We'll continue to grow that rollout, accelerate that rollout in the traditional mail kit offering and they're also working with our preliminary team to develop further assortment in the mail solution space. So think about the e-commerce and then the in-store experience already benefitting from the Home Chef merger from June.

In term of long-term impact, they are working on innovation as I just mentioned and also improving the financial performance of that mail kit mail solution segment in our store. We have very good alignment between our incentives as a business. They bring a superior experience to our customer with financial metrics that are positive and positively impacting our overall company. Their earn outs obviously align with these objectives which create the perfect alignment between the two organizations.

### **Mike**

Thanks, Yael. Very informative. Alex, do you want to spend a few minutes on Ocado?

### **Alex**

Sure. Thanks, Mike. Ocado was mentioned a few times this morning already, but let me give you a quick recap on why we are with them and what are the next steps. Obviously we are extremely excited to partnering exclusively with Ocado to design and deliver the best customer experience in the US.

Why is Ocado such an important partner? For various reasons. First of all, they do understand grocery. They have been in business since 2000 and they are the biggest online grocery retailer in the UK up against some formidable competitors like Tesco and Sainsbury. So they understand grocery.

They've obviously a very, very knowledgeable supply chain expert. As you heard this morning, our needs on supply chain are big and we look forward to partnering and designing the best solutions and capturing the best opportunities in the US. At heart, they are a technology company. They are digital. They are technology-enabled. They are investing a lot of resources in becoming a very, very well-established company in the world, because almost 2,000 software engineers who as we speak are really looking forward to come to the US or to work in the US to help us crack this market.

The fourth reason for Ocado themselves, the US is a big bet. So we have a big need. They have a big need and together our resources are really committed to do well in the most important and probably biggest market in the world in this space. So very, very excited about the future and even more excited about starting as we speak.

This morning you read there's been an official announcement of a contract being signed. So I think it was UK time this morning. So we are now up and running. Lot of work has been happening before, but we are now in a position to officially communicate the—the engagement has been signed. We are now married.

We want to make sure that we are going to move as fast as possible. I have lots of questions from some of you. We are very, very close to announce the specific locations of the first three sites. We know internally already the first seven sites. As you can imagine, mapping out the US is a wonderful mathematical problem. We want to make sure that we use all the data to place the shed [ph], not just the first three but all of them in the most strategic possible places to really serve the customers in the best possible way.

Maybe the final point I want to make is as you heard this morning, Ocado is a very important component but it's just one piece of a much broader ecosystem that we are trying to develop to really become a relevant force for the next 50 or 100 years.

**Mike**

Alex, thanks a lot. Gary, would you update us on Walgreens?

**Gary Millerchip**

Yes. Thank, Mike. So we're in a slightly different position compared to the first two partnerships that Yael and Alex talked about. We're literally only a few weeks into an exploratory pilot with Walgreens. So it's very early days to paint a picture of what the long-term future would look like there.

That being said, we're really excited about the Walgreens partnership. We think it has the potential to significantly accelerate our vision for serving America through food inspiration and uplift. The principles of the partnership that we have established so far are really about how do we take the unique capabilities that Kroger has? So think about obviously our core strength and expertise and passion for food, our loyalty and our data, the proprietary brands that are obviously exclusive to Kroger and then some of the seamless capabilities that Yael and Alex have both talked about this morning.

Then of course when you think about Walgreens', tremendous expertise in global health and beauty, have their own significant loyalty database as well and then of course phenomenal real estate within that last [indiscernible] as Yael mentioned earlier for the customer. So when you combine those two sets of unique assets, we believe we truly have an opportunity to create a shopping experience and even more importantly a level of convenience that's really hard for anybody in the US to replicate.

So we have dipped our toe in the water. Our first pilot is now in the market. We are live in 13 stores in Walgreens' northern Kentucky market. We have stood up all those 13 stores with the Kroger order online and pick-up at store. So we literally more than doubled the capacity and the coverage that we have in the northern Kentucky market almost overnight when we added the Walgreens stores to our assortment. And then we're also now selling a select range of Kroger exclusive products in the Walgreens stores as well.

Still very early days obviously as I mentioned with the pilot. We're really pleased with the progress so far. We're adopting a very robust test and learn approach so we expect to continue to monitor closely the customer insights, the shopping data, and we'll be evolving that test quickly as we learn more. But so far very excited and we believe if we can deliver on the vision that we have, then we think this could be significant value for both partners.

**Mike**

Thanks, Gary. Hopefully that gives you a little bit more insight into not only the why but where we are in the process with each one of these. At this point, I'm assuming folks are out there ready with microphones. Oh there's Tara. I didn't see you. So we'll go to our second Q&A.

## QUESTIONS AND ANSWERS, Part 2

### Paul Trussell

Hi. Good morning. Paul Trussell, Deutsche Bank. Thanks for the color. Two questions. First, you're already generating it seems pretty healthy profits from some of the alternative profit streams from media, etc. Just help us understand all the places and waves that it shows up in the model. Can you quantify these impacts to total company margins similar to how you report operations x-fuel, perhaps you can help us understand operating profits, x-media [ph].

### Mike

Yes. I wouldn't hold your breath on that.

### Paul Trussell

Fair enough.

### Mike

Nobody usually leaves a meeting with me wondering what's on my mind.

### Paul Trussell

Then the second question is just going back to the slide on the \$3.5 billion. Obviously we see the components there of fuel, the media and the base supermarket business. Just want to make sure we understand the contrast versus one of the prior slides of the \$800 million investment taking place in the stores and the digital operations. And just if you can help talk a little bit more and clarify what some of those offsets are of that \$800 million business. Is it just growth of the overall base, lower cogs? How should we think about that base supermarket business growing through 2020?

### Mike

Sarah, I don't know if they can put up that early slide of mine that had the four pillars of Restock program with the numbers on it. It's probably like slide 15 or 16-ish. I could go in reverse, but I'd make people dizzy. So while they're doing that, if you remember the four pillars of Restock Kroger, the first one of redefining the customer experience, that is a net investment. And as I said when I talked about that again today, arguably some of the dollars in the second bucket, our partner for customer value from the cost-of-goods standpoint, arguably could be flopped up top so it's really not as big of an investment as it looks.

What we try to do is to capture all those things where we have cost-savings work going on for alternative profit stream work going on where we're trying to capture that so we know exactly what we have to invest back in the business. It's really that particular category that's going to drive our ability to invest that \$800 million back in the business to continue to grow it. It's one of the reasons when you look at the 3.1—and maybe a light bulb just went on—when you look at the 3.1 compared to the 3.5, some of you may be wondering, well Mike's saying that it's going to go down \$800 million and redefine the customer experience. So how is that blue bar actually going to grow if it's going to go down \$800 million? There are aspects of things like cost of goods would fall under that supermarket category when we show that blue bar, because those dollars are getting invested in pricing at the shelf edge and things like that. There it is on the screen. So that's the \$800 million investment.

When you look at the partner for customer value and one of the things that Stuart talked about is a lot of what we're doing in his particular world is asset light. So when you look at we're expecting to generate in total nearly \$1.8 billion in that handful of categories now, we didn't list out everything we have going on in there. There are more than just those three work streams. There are multiple work streams. These are clearly the most important. But we're really only investing \$400 million to be able to drive that growth which demonstrates why this is asset light. The other two wind up being the net investments and Tim

spoke about the improvement we have had in retention. That's one of the things that improves the developed talent and the fact that the incremental operating profit margin goes up by that.

There are a lot of moving parts going back to one of your early questions about exactly where do some of these things fall on the income statement. I'm not going to—Todd Foley's [ph] in the back. He can get out his GAAP guide or did he run for the doors? But suffice it to say, they're all going to wind up on the operating profit margin line. This is one of the reasons why we're all going to have to go on a bit of a journey here as these dollars come to fruition and certain lines of our income statement improve differently than we have historically.

Rodney made the comment earlier today. If you're looking through our income statement and Kroger through the lens of a traditional supermarket operator, you're going to miss some of the picture because some of the lines are going to show outsized benefit when you don't expect it based on a particular ID number. Or we said we invested in price but gross margin may have been different because Stuart talked about the gross margin rates being significantly higher in some of his world.

So we'll get as transparent as we can. We don't want to hand our playbook to our competitors. So we'll try to have a lot of transparency so you can understand how you should build models going forward, but we do want to protect a lot of the proprietary stuff going on.

#### **Chris Mandeville**

Yes, thanks. Chris Mandeville from Jefferies. Alex, can you speak to where you believe the Ocado business model can actually work within the United States just broadly in terms of the geographies in markets that it's able to service? Then in areas where you're initially thinking it may not work, how do you plan on approaching or attacking those areas with maybe some additional services? Specifically I was curious if you've explored if at all the idea of micro-fulfillment where certain service providers are arguing that it's a far more scalable practice and one that can actually provide margin accretion relative to in-store.

#### **Alex Tosolini**

Let's start by saying we are confident we'll try to find a solution for all the needs of the customers in the US. To your point and as you know, the rest of the world, clearly the US is a very unique market because it's catching up to some other geographies in the world and the US is a very diverse and big country. So probably we are expecting to see various modalities by region and by sub-region. And this is why I said before, as we speak, lots of people are trying to model the best possible solution for an end-to-end supply design that is going to put the customer in the center.

Probably the key words we are keeping internally with Ocado is that we need to stay as flexible and as responsive as possible because the customer behavior are still evolving. Today even through our pick up from stores, we see different dynamics within our own stores. So we just want to become much more responsive and flexible and study the customers and keeping them at the center of our solutions.

You mentioned micro-fulfillment centers. This could be absolutely one possibility on how we are going to fulfill some of the total ecosystem. We don't have all the answers yet and that's why I said both companies are frankly looking forward to try to crack this market. I can tell you that we will not have one solution that fits them all because the market is too wide and too broad and too diverse.

#### **Mike**

Alex, talk for a second about their spoke process that they have in the UK that you and I visited and watched how that actually works.

**Alex Tosolini**

Yes. The UK which is a relatively easier market compared to the US to serve, they serve it through four major locations and tens of other micro locations that are going to be closer to a certain density of the population in the UK. So if you heard before what they're going to do there, you heard from Gary what we are thinking about partnership with Walgreen's and you think about where else the customer is going to go, all of those solutions we need to scale them up and make sure they are profitable for the company. So the challenge is extremely exciting. I can tell you Ocado is dying to try to bring some of their technology innovation to this market.

**Chris Mandeville**

Thanks. And just a follow up for Stuart. When it comes to media spend and convincing the vendor community to work with you as opposed to a Google or Wal-Mart or whomever for that matter, is there any one element of the Kroger strategy that you find is most effective today? What's really the argument to work with you as opposed to them?

Then Mike, as you think about media becoming a larger component of the P&L, how should we think about CPG and their vendor allowances on a go-forward? Can you sustain the same level of allowances while also accruing incremental media spend?

**Mike**

Yes. Stuart can probably handle both of those.

**Stuart Aitken**

So the first one, we as we think about media and how media is spent today, one of the things you've all heard before, 50% of my marketing is wasted. The problem is I don't know which 50%. Because we can actually tie and tether awareness to a transaction, we know the value of each one of those components. So imagine if you were a CPG who let's say invested in TV, addressable TV now is here where I could target you with awareness to a transaction, we know the value of each one of those components. So, imagine if you were a CPG who, let's say invested in TV, addressable TV now is here, where I could target you with a commercial for 30 seconds on DIRECTV, or what have you, a cable satellite box, every cable satellite box is an IP address. I can now address that commercial to you. The issue is, today you can close that loop. We can close that loop. When you have 96% of transactions tethered to a household, and you target that household, and now you can close a loop, I can tell you the value of that advertising.

Now, imagine being able to do that across every single media outlet you're using. How can we help CPGs better invest their dollars? It's the same way as, I was having a discussion last night around selling data. We don't sell data, I want to be very clear, we sell insights. And as a CPG, a CPG, for example, is looking for insights around products. And we have one metric that will tell you whether or not your product will be successful or not, and the metric is repeat purchase rate. No brainer, right? Again, we see the households who buy them, and then we see repeat purchase rate. That repeat purchase rate is a clear signal on whether or not a product's going to be successful. So, how do you provide insights and value to CPGs that they could leverage across their ecosystem, and then how do we provide them media opportunities that they don't have today?

Across the Kroger ecosystem. Be it digital, so on property, off property, so the ESPN type examples, loyalty marketing, as well as in store, which is a monstrous opportunity to unlock. So we see that as our biggest strategic advantage in the media space, but also, closing the loop, not just on the digital perspective, but also brick and mortar. No one's doing that, and that's where we see we have a clear advantage, and we have a number of CPGs who are partnering with us in an incredibly deep way, to better understand their media spend, too.

What was the second question?

**Mike**

The second part is, why would this not eat into trade dollars. And I don't know if you want to do it, or if Mike or Robert want to speak to that.

**Stuart Aitken**

Mike or Robert?

**Mike**

We'll phone a friend out in the audience.

**Stuart Aitken**

I could start while the microphone goes over to Robert. But, one of the conversations we're having is, how do we take those brand dollars that are there for awareness. And an awareness campaign on ESPN through somebody else, is no different than an awareness campaign you run with us on households, where we can tell you the value of that. And that's a brand dollar, not a trade dollar.

But, Robert, please.

**Robert Clark**

So, I would say that CPGs, obviously, have buckets of how they fund, and how they measure the returns on each of those. Stuart is giving an example and a representation of how I think CPGs are wanting to increase the return that they get on their brand dollars, and be able to measure them in ways that are much more discreet than they ever have before. He started the comment with 50% of my brand dollars spent incorrectly or inefficiently, I just don't know which 50, and I think that this vision is very intriguing to the trade in how they think about those dollars. And how easy it is to measure it against the reports and the insights that we give back. And that, I think is probably the most revealing piece of this is, those insights give you a great sense of security in how you're spending those and getting a return.

**Stuart Aitken**

The media industry is going through massive disruption right now, we're at the center of that. And we believe, as Rodney said earlier, we should be getting our fair share because of the assets we have that no one else has.

**W**

Thanks. Just want to check some math on the alternative revenue stream. You showed the slide that showed it was going to grow 28% through the Kroger Restock period, and the comment that that's driving the majority of the \$400 million operating—no, that's not correct. So, what is the base—I guess the question is, what is the base of the alternative revenue stream operating profit today, or last year?

**M**

As Mike said, we're not—

**M**

[Audio disruption] lower than it's going to be at the end of the—

**Stuart Aitken**

Sorry, my exact words were, this is a glide path to the 400, versus it is the majority of the 400. So it's a glide path to it, I didn't say majority.

**W**

Well, the chart that you showed in the beginning, though, was supermarket kind of flat, fuel up a little bit, and then the other components, it seemed like that was the majority of the \$400 million.

**Mike**

That would be true, because it's actually more than the \$400 million. And if you think about the slide I had him go back to a minute ago, that section is going to generate almost \$1.4 billion in that operating profit, and \$800 million of that will get invested back in the business associates and live our purpose. So, it clearly is going to be a big driver. But now, keep in mind, cost of goods is in that bucket as well, not just alternative revenue services. The things like Mary Ellen talked about, a cost savings and things like that, are scattered throughout the slide as well.

It's all going to contribute, but alternative revenue streams are already pretty significant. We purposely took the dollars off, and it's a meaningful contributor today, and it's going to be more meaningful going forward.

**W**

Okay, thanks. And then, just two on Ocado. You talked about the 50% incrementality rate for pick-up orders. I'm just curious what your assumption is with Ocado in terms of incrementality versus cannibalization and how that affects the stores. And then, how will the last mile solution work with Ocado? I'm sensing that it might be a refrigerated truck, but I'd love to hear kind of what the thought is in terms of that last mile approach.

**Alex Tosolini**

On the first one, and I'm sure Yael can also jump in. We got some data point that we compare and cross-reference between countries. So, if you look at the UK customer Ocado order, compared to a current pick-up order from Kroger, not that dissimilar. So it really depends on how much the US customer behavior will change, and whether [indiscernible] deliver, they receive orders at home, whether [indiscernible] significantly or not. So, the map is pretty similar to what happened in the UK, and this is only assumption we are using. Yael, I don't know if you want to [ph]—

**Yael Cosset**

We would expect the incrementality to remain or improve, as opposed to reduce the quality—I don't know if you can—the quality of the experience, and this is just based on the data we have for the Ocado existing markets, particularly in the UK. The quality of the experience actually shows it slightly higher frequency of engagement for online orders, than what we see currently with our customers. So that would indicate that that stickiness, that quality of experience is driving additional trips of frequency, which translates, overall, at the customer level and higher incrementality. So we would expect to either stay constant or improve.

**Alex Tosolini**

So big baskets, more loyalty, through frequency. On the last mile, as I said before, we are looking, as we speak, at all possible options to really deliver where the customer wants. As you know, in the US our trends were, people are starting to get a lot of parcels, not even at home. So we could [ph] be super flexible and provide delivery points wherever the customers want to be served. And the last mile could be delivered in also the modalities from human beings to robots.

**Greg Melich**

Greg Melich with MoffettNathanson, two questions. One, I think, is first for Yael on voice commerce and how important you think it is. I think right now it's a small number, maybe a mid-single digit percent of Americans that actually practice it. But, as you go from \$5 billion to \$9 billion, how are you thinking about

voice commerce as an enabler, or potentially a risk, given the Amazon and Google platforms that are sort of there driving that today?

And then the second question, I think, is for Stuart. Thanks for outlining, very well, the media opportunity. How are you thinking about the media opportunity outside of CPG, given the fact that a lot of that [indiscernible] comes from everything from [indiscernible] to banks, you name it? And where's that balance of sort of trust with the customer that if you went too far down that path, that those great trust numbers you showed could actually start to slip? Just want to know how you were thinking about it. Thank you.

### **Yael Cosset**

Yes, very good question, Greg. I think it's still early on in terms of both the overall technology adoption from the various platforms that exist in the industry, and it's also early on for us in terms of learning. So we have a tests in market today, where we are testing and measuring with customers how comfortable they are interacting via voice for shopping. And what we see is, as it stands right now, it's acting more as a complementary experience, as opposed to a substitute for web or mobile. There is still a lot of sensory, like visual, and detailed information, a confidence in the shopping experience that are not easy to translate via voice. What we see our customers do is check on the status of an order, add one single or two items to an existing order for pick-up or delivery, change the time of pick-up, or inquire about a specific promotion.

Where we expect voice to potentially increase, in terms of adoption and share of total traffic, including transaction, is as we get closer to a true full spectrum of meal and full solution. Because these are less complex, from a consumer perspective, in terms of interaction. You're asking for one solution, one meal, one dinner, likely to be delivered or picked up, and with our trip or shopping trips that are more likely, more prone to be fulfilled through a voice interaction, than say a 40 or 50 item basket which will require a lot more visual clues as you navigate. So, I hope that answers your question.

Complementary today, certainly see and monitor the adoption of the technology as a base, not just within Kroger ecosystem and broader, and continue to innovate to make sure that we offer that flexibility as a complementary experience.

### **Stuart Aitken**

Greg, great question. When you walk the store today, you'll see our shelf edge, which we've just rolled out to the entire Cincinnati market. When you walk in there, I want you to envisage full-motion video, and who could play in full-motion video. Think about, you're releasing a movie, and on the front end of the store, across the entire store, you have your animation, your movie, running across the store in an exciting awareness driven way. Where customers aren't going to walk away in 30 seconds, they'll see it time and time again. What's the value for that? This gets back to the question Robert answered around trade versus brand. These are dollars, clearly, outside of trade, and a huge opportunity for us.

Mike Donnelly, earlier, talked about test and learn. In the test and learn space, we are doing just that in the open web with other advertisers, but at a small scale, to ensure we do not, and will never damage that trust we have with customers. It's not worth it for us, so for us that's critical, and that's paramount to this ecosystem staying in place.

### **M**

Just maybe one thing to add to that [indiscernible] as an example, and today we sell a lot of gift cards in our stores, and we reward customers with fuel points for buying gift cards there. A lot of our customers actually self-use, they buy gift cards themselves to use in other places. So we actually have a lot more data out of our ecosystem, as well, around customers that might be shopping at a home improvement

store, or maybe using cards to go to a theme park somewhere, for example. So, we'd even tested some of those examples where we've used that knowledge off a customer to say, we know more about you do more broadly, and here's the way we'd like you to reward you for doing that. And we've had great response to that, too. So, I think we're already seeing examples where we've actually tested into, it's outside of, specifically, a grocery that you're buying in Kroger, but we're able to demonstrate we know you, and use that information in a powerful way to help the customer. We're getting great responses to those.

### **Stuart Aitken**

And just think about the value of doing that, because I love the example, both from a media perspective, as well as from the KPF perspective on the profit we get from those gift cards.

### **Michael Astor**

It's Michael Astor again from UBS. So, Mike, on the slide aligning all the different buckets, there is \$1.775 billion of incremental operating margin growth over the next few years coming from alternative revenue sources, cost of goods, and then infrastructure and technology upgrades. So, a lot of that is going to come from the CPG space, either selling them insights and data, and also getting better cost of goods.

So, how do you send a message to those partners, we need both better buying from you, and we also want to sell you more, at a time when those partners are under a lot of pressure? And then one follow-up.

### **Mike Schlotman**

Yes, I think when you think about the two or three comments we've had around that question between Stuart and Mike Donnelly when he was up here, and Robert, when they talked about the CCO process that we go through, the robust process, when we sit down every year with vendors and understand how many dollars they give us, where they're applied, what the reaction to that particular promotional spend is, versus if you wound up spending it in a different way on something. Because, look, they aren't just giving us promotional dollars to lower our cost of goods, they're trying to drive their business as well.

So, when you think about a trade dollar being to drive their business inside Kroger, that's entirely different than their ability to run a media kind of campaign with Stuart and his team, to both brand awareness broadly. They're entirely different efforts and entirely different missions when they would look at a consumer. So, they're totally separate. At this point, I think when Robert talked about how the vendors come to market and the various opportunity they have [ph], when you think about the coupons and our best customer communications, those aren't necessarily trade dollars either. They have buckets called direct to consumer.

I think it was on Stuart's or Mike's slide when he talked about a 50% engagement rate when we do that kind of a communication to the customer. Imagine the value to the trade when they put a coupon out with Kroger, or a group of coupons out with Kroger, where you have a 50% engagement rate and that offer to your customers, versus, what, an under 1% and an FSI today. It's tremendous value. They spend more with us because of that, and they actually have the opportunity to spend less overall, and drive their business to the same level.

### **Michael Astor**

Thanks for that, Mike. My follow-up question is, on that same chart you have \$4.45 billion of incremental operating profit, and \$4.05 billion of investment. You were kind enough to share that 56% of the labor investment of that \$500 million has spent this year. So, we can better calibrate our models, and more align it with the longer term guidance that you've provided, can you give us the percentage of investment that is spent across these other lines as well?

### **Mike Schlotman**

I wouldn't be prepared to do that today. We've talked about—Mike Donnelly talked about price being the biggest year we invested in price. Keep in mind, we already had in year one of Restock Kroger healthy price investment, and when the Tax Act got passed, we talked in March about moving a big chunk of '19s up to '18s. You should assume that '19 is a very heavy investment year, because operating profit margin is going down. We made it even heavier in March when we accelerated some of the investment to develop our talent, and some of the investments in price. So both of those categories would have less incremental investment next year. It's part of the reason that EBIT starts to recover next year as, not only did Mike move those price investments up, he talked about the length of time for the lines to cross.

Well, what we do know is, the first period after you've made that investment, you have—when you lap that, the lines do start to cross, even if it takes that long. So, we moved it up for two reasons. One, use some of the tax dollars, two, start to get the benefit in future years even earlier. I don't know that we'll go to that level of detail because there's—like I said, we gave you, really, three big illustrations, or two, depending on the category of where we're investing and generating dollars. There's a lot more than just the ones on that screen.

I think we have time for one more question. I see my colleagues sneaking up on the left here. Barry [ph], you get to decide who gets to get the last one. Oh, Tara's beating you.

### **Karen Short**

Thanks. Karen Short from Barclays. So, I have just two clarification questions. In '19, what tax rate should we be using, and is Ocado included in '19—well, '19 and '20 guidance? And then I had another bigger question on Ocado.

### **Mike Schlotman**

Yes, generally speaking, where we are with Ocado today, we can pretty well handle the fees that we would wind up being paid. Keep in mind, we won't even get the first shed open until sometime in 2020, it could even be 2021. So it could wind up being out of the scope. [Indiscernible] my guess on the tax rate would be the statutory rate, at this point would be our guidance for 2019. Keep in mind where we are today, there was some unusual adjustments, as well as some tax settlements that drove it down to where it is today, and you can never predict those.

### **Karen Short**

And then on Ocado, wondering if you could just give a little more color on the fee structure overall when Ocado is up and running, versus Instacart. And then wondering if you could give a little bit more detail on the characteristics of the seven markets or locations that you've identified.

### **Alex Tosolini**

So, on the fee, we are not giving all the details of the fee structure. What I said at the beginning is that, just think about a slightly different partnership and collaboration in the US than what they sign in some of the other markets. As you know, they sign in Canada, [indiscernible], ITA in Sweden, which by the way, all markets we are going to learn from, because this is a learning game for every single company involved. So, for us, think about a partnership where both companies really want to—there's going to be, of course, an exchange of money, but the key point is, we really want to maximize value creation for both companies, and win in the biggest market of all. So, there's a clear understanding for both companies over finding a base solution and create the most value end-to-end.

In terms of the seven locations, again, I would love to tell you every single detail, I'm told I cannot. And I'd love to describe the beautiful cities where we can go together and [indiscernible], but you're going to

get the three locations really in the next two weeks, and then you'll be able to get an idea on where we are going to start to play. And then we hope to be in a situation to announce the next four really as soon as possible. We're working on the land, we're working all the details, we're working on the legislation. The US is a big country and every state has its own dynamics on attractive investments.

**M**

When you ask about the, what is it about the cities, this has been, as Alex said earlier, an interesting mathematical exercise, because you don't want to be off by 50 or 60 miles in where you place sheds. So, it'd been very to say a shed here, a shed here, and a shed there for our first three. But if you've put it north of a city instead of south of a city, what does it do from a traffic pattern standpoint, what does it do with your ability to cover more Kroger customers? If you're on the wrong side of the city, can you get to the next city? So all of that plays into it. And then if you're off by any significant amount, it could mess up where shed 12 goes, from a logical standpoint. So, it's really not just the first three or the first seven, it's really trying to figure out where we think they all should go within some range of certainty.

**Alex Tosolini**

That's why, Karen, really flexibility and the responsiveness is so important how we approach this. The question before on micro-fulfillment, just think about the total end-to-end supply chain, and we cannot tell you exactly every single location, every modality, because we are going to adopt it to how the—even demographics will play a role. Nobody can predict ten years from now the demographics. So, every single variable has been inputted. And, frankly, as you could imagine, machine learning is helping a lot.

**CONCLUSION****M**

So, with that, we'll end our Q&A panel at this point. Thanks, gentlemen, appreciate you coming up with me. We're going to have Mike Donnelly come up to talk about what you're going to see at the store in the store tour, and Rebekah with some directions on how we're going to make that happen. And thanks for getting my chair.

**Rebekah Manis**

Thank you. We hope you enjoyed the presentations, and we are so pleased that you decided to join us today. Before Rodney closes out the evening, or the morning, I should say, Mike is going to join us to talk about some things that you should expect to see at the Newport store tour. Mike.

**Mike Donnelly**

Thank you, Rebekah. So, we talked a little bit about the tour and where we're going. Let me give you a little bit of lowdown on it. It's a marketplace store, 120,000 square feet. The weekly sales are average \$2.3 million a week. What will you see? You'll see a lot. I talked about some of the elements in our Restock program. But what you will see is fresh, fresh, and fresh. A big store, it has a little bit more fresh areas. You'll see meal solutions throughout the fresh areas. We're going to take you on a little tour of some of that. You'll go through rotations that Rebekah, or somebody will explain. You're going to see Kroger pick-up. You're going to see shelf-edge technology on the perimeter of the store. So as you're walking around the store, you can take a look at what, I think Stuart referred to, or Robert referred to, was shelf edge.

So, it'll be exciting, it's a fun store. It happens to get a lot of help. I happen to shop there. So, they are gracious and awesome. We do a lot of test and learns at this store. But today is what? The day before Halloween. So guess what? It's going to be busy, right? So, all I would ask you to do is just kind of help our customers, or just be aware. So, have fun, enjoy it, we'll see you over at the store.

**Rebekah Manis**

Thank you, Mike. So, from a logistics standpoint, after Rodney comes up and concludes the meetings, you will go out these doors, take the elevator to the SL, or street level. There'll be people directing you to where the buses are. Once you get on the bus, you will go to the store, it's about a 15 drive, and then you're going to be visiting five different stations. So the back of your name badge should tell you which station that you're assigned to. So we ask that you stick with those stations to help with the flow of traffic within the store. You will also receive a store brochure, and we're excited to have you see one of our top performing stores in the division.

The other piece of information that I wanted to point to is laying on your table. It's a progressive grocer edition, and if you remember, or recall in Mike Donnelly's presentation, Kroger was named the 2018 Progressive Grocer Retailer of the Year due to Restock Kroger. So this is a good pamphlet for you to take with you, and has some great things about what Kroger is doing. So please take that with you on your way out, and we'll see you at the stores after I welcome Rodney McMullen, CEO and Chairman. Thank you.

**Rodney McMullen**

Thanks, Rebekah. I don't know if Julie's in the room, but Julie, Angela, and Quinn [ph], thank you, as well, plus all the audio folks and [indiscernible]. As you know, it takes a village to put on a meeting like this, and it's an amazing team, between Rebekah, Mike Schlotman's team, and Jessica's team, that makes everything pull off in an incredible, smooth, and just a world class way.

Also, thank you for spending your valuable time with us. I hope you can see, from last night and today, why we're so excited about our business, and even more excited about where we're headed. We have a clear vision, it's to serve America through food, inspiration, and uplift. Everything that we're doing today is creating a truly seamless shopping experience, so we can serve customers anything they want, anytime they want, and anywhere they want. You can see it in our launch of Ship, and our expansion of delivery, our merger with Home Chef, our continued emphasis on Our Brands. Our Brands has been a competitive advantage for years, and under Gil's leadership and his team, we continue to even accelerate what we've done. And our relationships with Alibaba, Walgreens, and Ocado, it's creating new partnerships that makes the sum of all bigger than individual parts.

I hope today you can begin to see how all the parts fit together, and how you can see how a customer sees all the parts fitting together, in a unique experience that truly is inspirational, that brings out our love of people and our love of food, so that our whole team can serve those customers.

We are committed to delivering shareholder value, and we have a clear path to achieve the \$400 million in operating profit by 2020, set out as part of Restock Kroger. We are clearly changing our financial model, and looking forward, not backward, to drive growth. Driving growth in the future will be different than the way growth was created in the past. We are fundamentally transforming our growth model, by both redefining the grocery customer experience, and growing complementary businesses and partnerships to generate alternative profit streams.

Thank you very much. Let's go have a fabulous store visit. Hopefully you haven't been eating too much, because I guarantee you the store will have plenty to eat. So let's go see the store. Thanks again.