Stocked Up for an Attractive Future

This company owns a fast-growing consumer products business that is likely to keep growing even in a recession. The company's extensive distribution network and digital strategy position it to take market share while competitors fumble with outdated supply chains. The Kroger Company (KR: $47/share) is this week's Long Idea.

Not surprisingly, some argue that Kroger is just another grocery store waiting to be squeezed out of the market by the likes of Walmart (WMT), Amazon (AMZN), or Costco (COST). However, we view Kroger's business as a peer to these competitors, rather than prey. KR presents quality risk/reward given the company's:

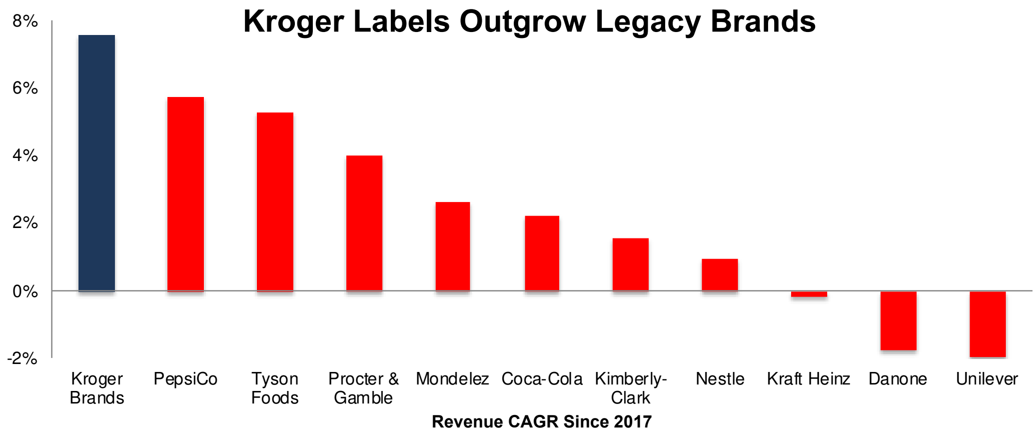
- strong growth from its consumer products business that generated $28 billion of revenue in fiscal 2021
- strong data science capabilities
- large physical footprint of 2,700+ stores
- strategy to improve digital sales
- improving profitability
- shares are priced for profits to permanently fall 30% below pre-pandemic levels

Strong Private-Label Business Taking Share from Legacy Brands

Kroger, more commonly known for its grocery retail business, operates some of the largest and fastest growing food brands in the world, with sales from its private-label brands reaching nearly $28 billion (23% of sales excluding fuel) in fiscal 2021. In fiscal 2021, Kroger brands'[1] revenue was 1.1x greater than The Kraft Heinz Co.'s (KHC), 1.5x General Mills' (GIS), and 2x Kellogg Company's (K) revenue.

Kroger brands are also taking market share away from the largest, most established food and beverage[2] companies in the world. Per Figure 1, Kroger brands grew at an 8% CAGR from fiscal 2017 through fiscal 2021, a much faster rate than the 10 largest (by revenue) consumer products companies under coverage. As consumers look to offset inflation Kroger brands are positioned to meet increased demand for low-priced alternatives. In its fiscal 1Q22 earnings call, management noted, "…when the economy is tight, Our Brands always gains share…"

Figure 1: Kroger Brands Vs. 10 Largest Food and Beverage Brands: Revenue CAGR Since 2017



Sources: New Constructs, LLC and company filings

[1] Some of Kroger's most popular brands include Kroger, Private Selection, Simple Truth, Simple Truth Organic, Big K, Check This Out…, Home Chef, and Heritage Farms.
[2] This analysis excludes Anheuser-Busch Inbev SA (BUD) since Kroger does not compete in the beer market with private-label beer.

Kroger's Data Advantage

Kroger's data analytics team leverages the vast amount of data the second largest grocer in the U.S. has acquired over decades to identify trends and create private-label brands that are able to compete with longstanding brands and take market share. Kroger's strategy to build its brands mirrors Amazon's, which also utilizes data from its marketplace to grow its private-label business.

Kroger uses data to drive revenue growth by (1) identifying new private-label product opportunities and creating special offers for existing products that target specific buying behaviors.

We think these data-driven strategies position Kroger brands for continued growth as the company only gets better at tailoring its offerings to fit the needs of its customers.

Network Is Difficult to Replicate…

Kroger operates an extensive network of more than 2,700 stores and the company enjoys the number one or number two share of the food at home market in the "vast majority" of the markets in which it operates.

Kroger's store network provides a structural advantage over legacy food and beverage brands, which do not own their own stores. Kroger leverages the benefits of owning the customer relationship by marketing Kroger brands in the most ideal locations in its stores and with the optimal amount of shelf space. Having ultimate control over who gets shelf space is one of the reasons why we argue that Beyond Meat (BYND) is a zombie stock.

Per Figure 2, Kroger has the second most locations in the U.S. among grocers. Kroger's large-scale store and distribution operation enables the company to offer competitive pricing, extensive product variety, and numerous services which draw customers to its stores, and have made the company the second-largest grocer (by revenue), the largest floral retailer, and fifth largest pharmacy in the U.S.

Figure 2: Number of Stores of Top Grocers: 2021

Company	Ticker	U.S. Stores
Walmart	WMT	5,342
Kroger	**KR**	**2,726**
Albertsons Companies	ACI	2,276
Aldi*	N/A*	2,186
Target	TGT	1,926
Food Lion	ADRNY	1,104
Publix	N/A*	1,271
Costco	COST	564
Trader Joe's	N/A*	530
Whole Foods	AMZN	~500**

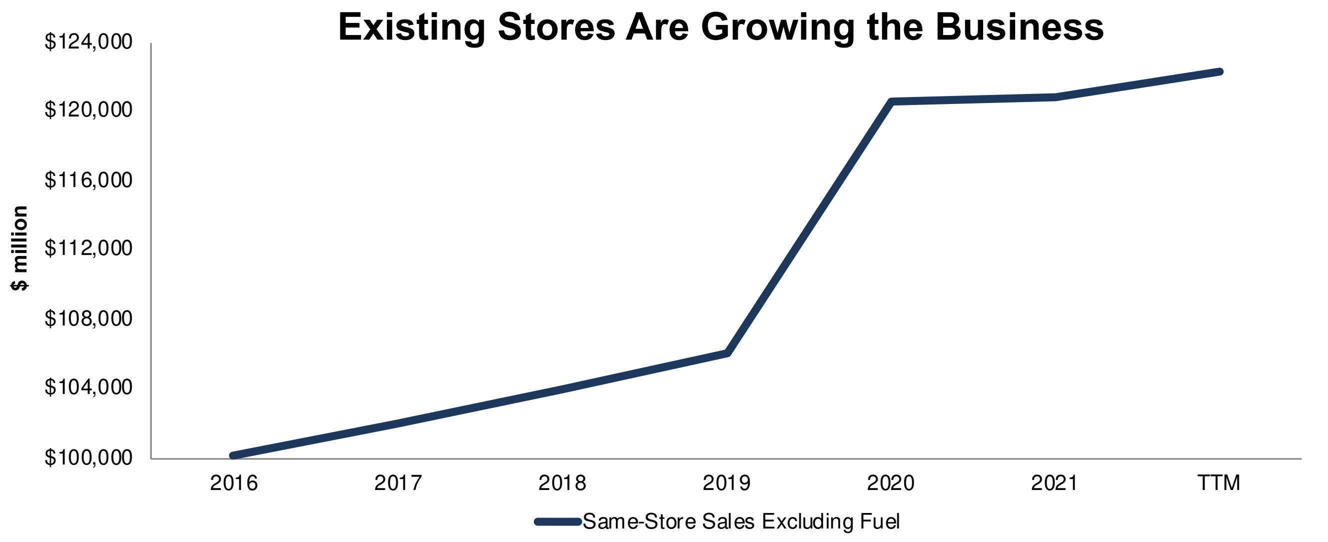
Sources: New Constructs, LLC and company filings
*privately held
**Includes U.S., Canada, and U.K.

…and Drives Sales Growth

While its store count fell from 2,796 in fiscal 2016 to 2,726 in fiscal 2021, Kroger's high-quality physical store and distribution network equips the company with persistent advantages that contribute to consistent revenue growth. The company's same-store sales excluding fuel rose from $100 billion in fiscal 2016 to $122 billion TTM.

The company's fuel points program serves as an example of how its physical network drives customer engagement and sales. Customers that redeem fuel rewards spend 4x more at Kroger and visit 4x more often than customers that don't. In the face of soaring gas prices, Kroger is positioned to add new customers and more deeply engage with existing customers looking for relief at the pump. Indeed, in fiscal 1Q22, 600,000 incremental households engaged with Kroger's fuel rewards program for the first time.

Figure 3: Same-Store Sales Excluding Fuel: 2016 – TTM



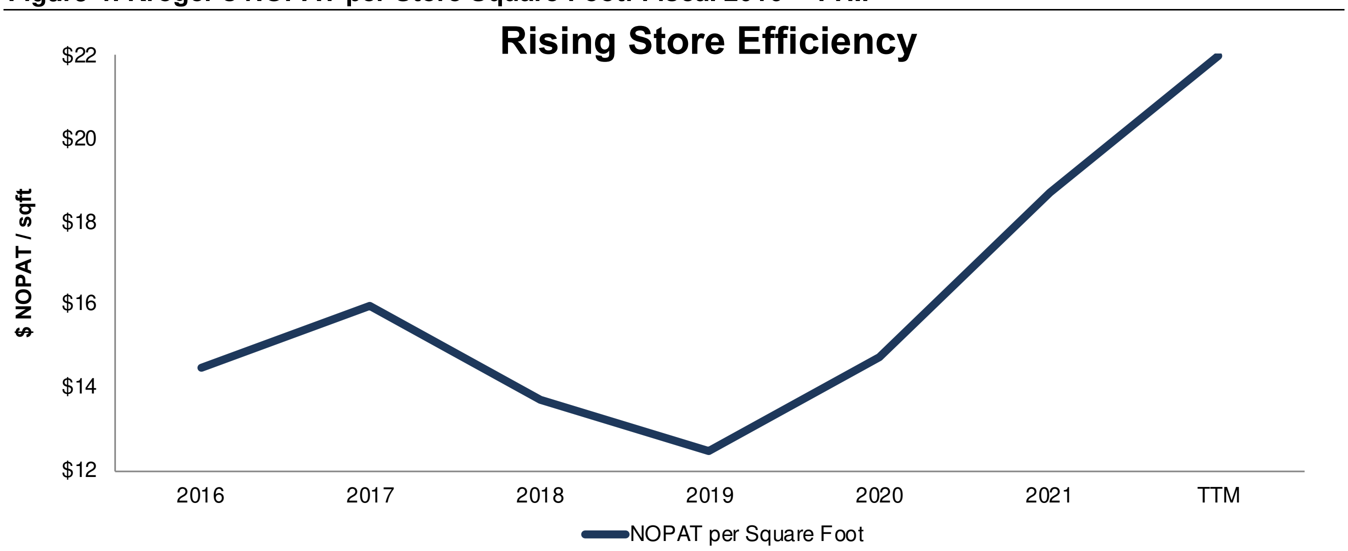
Source: New Constructs, LLC and company filings

Creating Value By Improving Stores' Efficiency

Kroger launched its "Restock Kroger" imitative in 2017, which leverages company data to revamp the customer shopping experience through an overhaul of its product assortment, data-driven pricing, and personalized customer communication. The company's investment in its Restock Kroger initiative appears to have paid off.

Per Figure 4, Kroger's net operating profit (NOPAT) per square foot of store space improved from $14 in 2016 to $22 over the TTM. The improved efficiency of Kroger's stores is indicative of the company's improved competitive position since 2016.

Figure 4: Kroger's NOPAT per Store Square Foot: Fiscal 2016 – TTM



Source: New Constructs, LLC and company filings

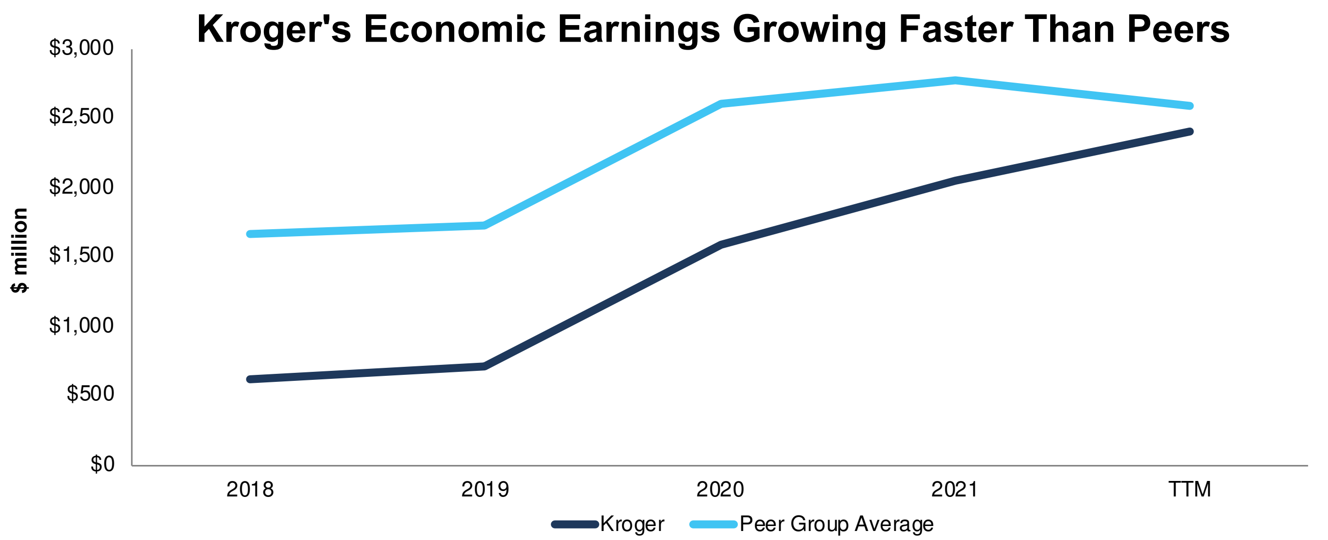
And Creating Value by Improving Balance Sheet Efficiency

From fiscal 2018 through fiscal 2021, Kroger's executives' long-term incentive plans were tied to the performance of a target return on invested capital (ROIC). With management focused on ROIC, the company has improved its ROIC each year since fiscal 2018. Kroger's NOPAT margin has risen from 2% in fiscal 2018 to 3% TTM, while invested capital turns rose from 2.8 to 3.0 over the same time. Rising margins and invested capital turns have driven Kroger's ROIC from 6% in fiscal 2018 to 8% TTM.

The company's improving ROIC has driven its economic earnings to grow faster than its peers. Kroger's economic earnings, the true cash flows of the business, rose from $622 million in fiscal 2018 to $2.4 billion over the TTM, while the average economic earnings of its peer group rose at a slower rate from $1.7 billion to $2.6 billion over the same time. See Figure 5.

Peers include Walmart (WMT), CVS Health (CVS), Target (TGT), Costco (COST), Albertsons Companies (ACI), Walgreens (WBA), BJ's Wholesale Club (BJ), Ingles Markets (IMKTA), Sprouts Farmers Market (SFM), Weis Markets (WMK), Grocery Outlet (GO), and Rite Aid (RAD).

Figure 5: Economic Earnings: Kroger Vs. Peer Group Average: Fiscal 2018 – TTM



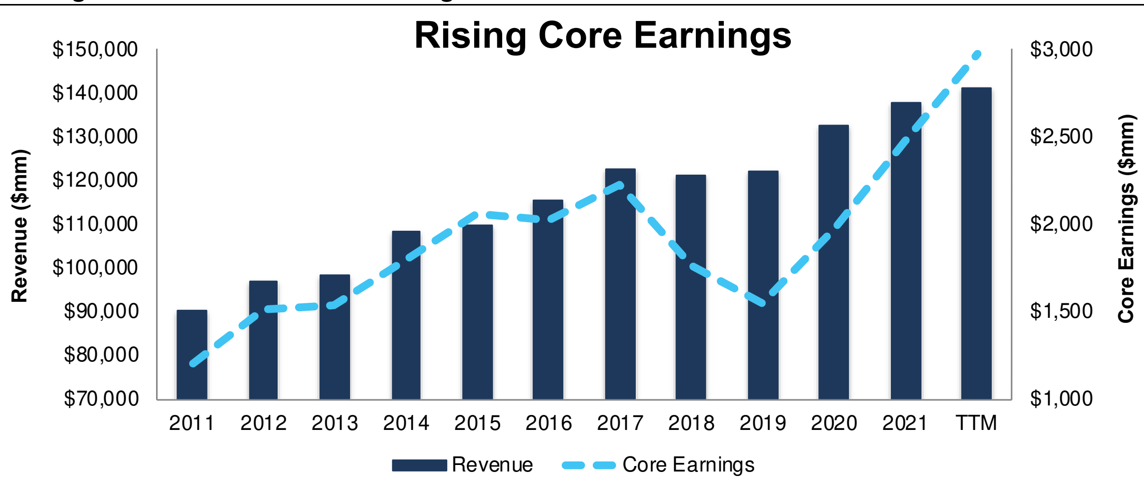
Sources: New Constructs, LLC and company filings

Core Earnings Are Rising

Kroger clearly saw a boost to its Core Earnings during the pandemic. However, unlike other retailers that have seen Core Earnings fall from pandemic highs, Kroger's Core Earnings growth has persisted. Longer-term, Kroger's Core Earnings have grown from $1.2 billion in fiscal 2011 to $3.0 billion TTM.

Investors may not realize just how profitable Kroger is either. Kroger receives a Beat Earnings Distortion Score, which indicates the company is more likely to beat its next quarterly earnings estimates than others. Kroger's TTM Core Earnings of $3.0 billion are significantly higher than its TTM GAAP earnings of $2.2 billion, which means Kroger's GAAP earnings are understated by $1.07/share.

Figure 6: Kroger's Revenue & Core Earnings Since Fiscal 2011



Sources: New Constructs, LLC and company filings.

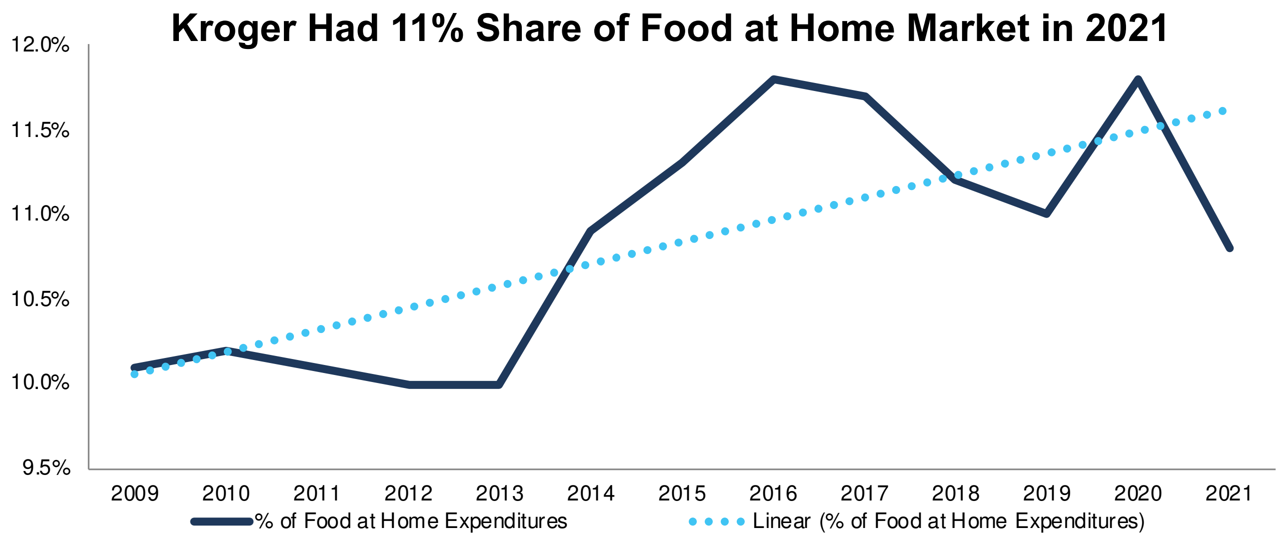
Kroger Can "Boost" Market Share

Though Kroger improved its share of the food at home market in 2020, it was unable to sustain those gains in 2021. Kroger's share of the food at home market in 2021 of 10.8% is 20 basis points below pre-pandemic levels in 2019.

Kroger looks to address its recent lackluster market share performance through the launch of its Boost membership program, which offers free next day delivery, 2x fuel points, and exclusive offers on Kroger brands for $59/year. Customers can sign up for free 2hr delivery for $99/year.

This program will help the company reclaim recent market share losses by encouraging existing customers to spend more at Kroger. Membership programs can give more pricing power by creating a more loyal customer base. The competitors listed above have enjoyed great success with membership-driven business models. Should Kroger succeed with this initiative, not only will the company grow its top line, but it will also see improved margins as well.

Figure 7: Kroger's Share of U.S. Food at Home Expenditures: 2009 – 2021



Sources: New Constructs, LLC and USDA

Positioned to Meet Popularity of Organic and Natural Foods

The fastest growing segment of the U.S. food industry is organic food. Organic food sales rose from $29 billion in 2012 to $57.5 billion in 2021, or 7% compounded annually. Looking ahead, BlueWeave Consulting expects the U.S. organic food market to continue growing at an 8.7% CAGR through 2027.

Kroger is not a company associated with being "cutting edge", but on close inspection that seems to be a marketing issue. The company has capitalized on the strong growth in the organic food market and has grown its Simple Truth brand into the largest natural and organic brand in the world. Kroger's ability to execute its organic food strategy positions the company for continued sales growth.

Amazon and Costco Threat Is Overhyped…

Given the growth of digital grocery channels during the COVID-19 pandemic and Amazon's ecommerce dominance, investors could be forgiven for believing Amazon is positioned to grow market share at the expense of more traditional grocers such as Kroger. Amazon purchased Whole Foods in 2017 with the goal of dominating the high-end grocery market, but research firm Numerator estimates the combined businesses had just 2% share of the U.S. grocery retail market in 2021.

Meanwhile, Kroger doubled its digital channel from ~$5 billion in fiscal 2018 to $10 billion in fiscal 2021. The company's large physical footprint and investment in digital fulfillment centers position Kroger to further grow digital sales.

Wholesale clubs such as Costco (COST), Sam's Club (owned by Walmart), and BJ's Wholesale Club (BJ) have competed against traditional grocery stores for decades. Nevertheless, Kroger has improved its share of the food at home market (which includes wholesale clubs) from 10.0% in 2012 to 10.8% in 2021. Membership Clubs do not offer a full range of grocery needs for most households, which means grocery stores such as Kroger are still essential. Furthermore, should Kroger successfully execute its digital fulfillment center strategy, the company's digital channel could be better positioned to offer discounts on online bulk items with fast delivery options.

…as Kroger Builds a Unique Digital Fulfillment Infrastructure

Most successful "ecommerce" retailers are brick-and mortar-businesses that build their digital strategies on pre-existing local physical stores and large warehouses. Kroger is no exception. By leveraging its existing footprint, the company has grown to be the eighth largest digital retailer in the U.S.

Kroger's digital ambitions reach beyond a local store fulfillment model. Kroger is investing in larger, centralized fulfillment centers designed to optimize digital order fulfillment that will complement its existing network. This local and centralized model is unique in the industry and could help Kroger drive more digital sales growth.

To help the company deliver on its digital fulfillment ambitions, Kroger has partnered with Ocado Group to build 20 robotic customer fulfillment centers. The partnership is quickly delivering results. At the end of fiscal 1Q22, Kroger had already opened five customer fulfillment centers and six smaller "spoke" locations which are capable of reaching customers within a 90-mile radius with refrigerated delivery service.

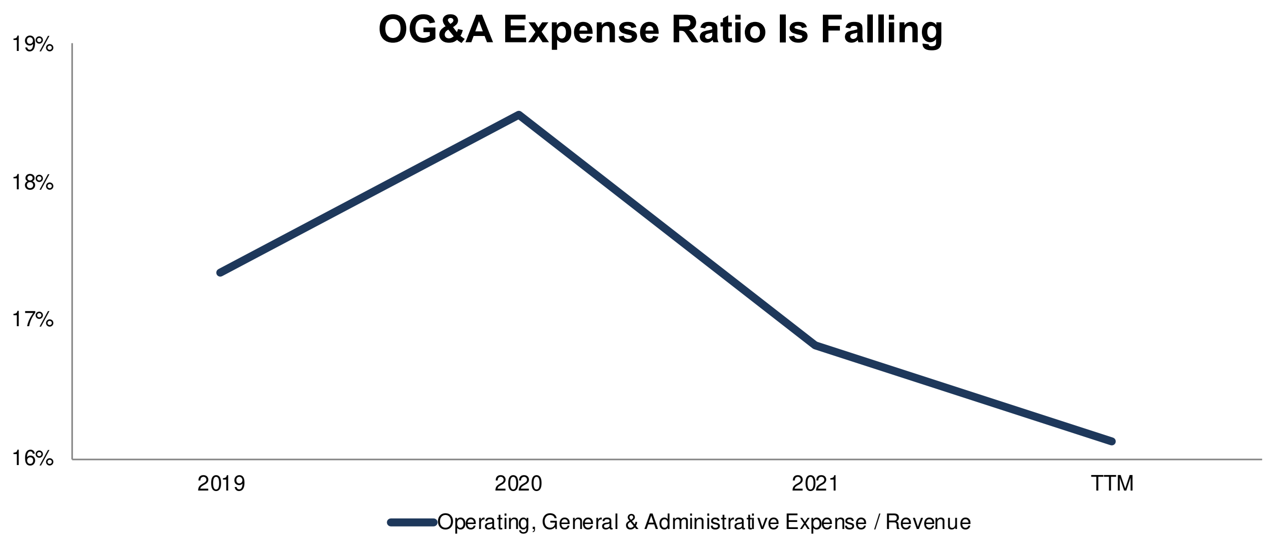
Scale and Technology Help Kroger Overcome Labor Challenges, Too

Unionized labor presents Kroger with long-term challenges that could hinder the company's ability to execute on its goals and profitability. Though Kroger has a smaller percentage of unionized employees than Albertsons (ACI), Amazon and Walmart have notably (mostly) avoided unionization in the U.S. and Costco only has 6% of its employees represented by unions.

Nonetheless, Kroger's strong store and distribution network have enabled the company to overcome challenges that unions can pose to the company's operational flexibility and operating efficiency.

After rising during the COVID pandemic, Kroger's operating, general, and administrative (OG&A) expense fell to 16% of revenue, well below 17% pre-pandemic level in 2019. See Figure 8. If the company successfully utilizes its growing number of robotic-driven digital fulfillment centers, the company should continue to drive overhead expenses lower as a percent of revenue.

Figure 8: Kroger's Operating, General & Administrative Exp / Revenue: Fiscal 2020 – TTM



Sources: New Constructs, LLC and company filings

A Growing Company Priced for Profit Decline

Despite the company's history of profit growth and its strong competitive position, Kroger's normalized price-to-economic book value (PEBV) ratio is 0.7[3], which means the market expects profits to permanently fall 30%

[3] We calculated Kroger's normalized economic book value using its pre-pandemic average NOPAT from fiscal 2015 – 2019.

below pre-pandemic levels. Below, we use our reverse discounted cash flow (DCF) model to further quantify the expectations baked into Kroger's stock price, as well as the upside potential in the stock should the company grow revenue below historic GDP growth rates.

DCF Scenario 1: to Justify the Current Stock Price.

We assume Kroger's:

- NOPAT margin falls to its ten-year average of 2.2% (vs. TTM of 2.8%) in fiscal 2022 through 2031 and
- revenue falls at a 1% CAGR from fiscal 2021 - 2031

In this scenario, Kroger's NOPAT in fiscal 2031 would be $2.7 billion, or 31% below TTM levels, and the stock would be worth $48/share today – nearly equal to the current price. For reference, Kroger's NOPAT has grown 6% compounded annually over the past decade.

DCF Scenario 2: Shares Would Be Worth $70+ at Moderate Growth.

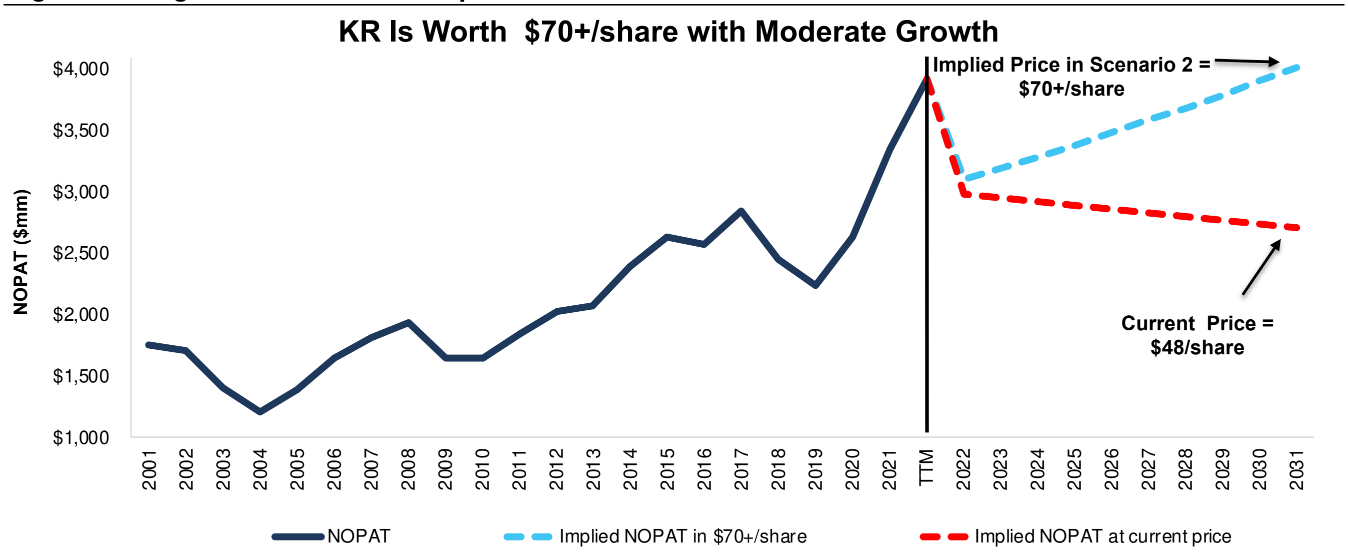
If we assume Kroger's:

- NOPAT margin falls to 2.2% and
- revenue grows at a 3% CAGR through fiscal 2031(below the average annual global GDP growth rate of 3.5% since 1961), then

KR would be worth at least $70+/share today – a 49% upside to the current price. In this scenario, Kroger's NOPAT in fiscal 2031 would be just 2% higher than TTM levels. In this scenario, Kroger's invested capital turns in fiscal 2031 would be 3.0, equal to TTM levels. Should Kroger's digital fulfillment centers improve the company's invested capital turns from current levels, the stock has even more upside.

Figure 9 compares Kroger's historical NOPAT to the NOPAT implied in each of the above DCF scenarios.

Figure 9: Kroger's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings.

Each of these scenarios assumes Kroger's weighted average cost of capital (WACC) will rise to 4.5%, or 100 basis points higher than its current WACC of 3.5% and above its 20-year average WACC of 3.7%. For comparison, a WACC of 4.5% is significantly higher than the TTM WACC of Albertsons Companies at 3.2%, Walmart at 3.8%, and the consumer non-cyclicals sector at 4.1%. Should our assumption around Kroger's WACC prove overly conservative, the stock has even more upside.

Sustainable Competitive Advantages Will Drive Shareholder Value Creation

Here's a summary of why we think the moat around Kroger's business will enable it to continue to generate higher NOPAT than the current market valuation implies. The following competitive advantages also help Kroger generate strong cash flows for decades to come:

- sizable and fast-growing consumer product brands
- large physical store network
- leadership in organic foods
- high profitability compared to peers

What Noise Traders Miss with Kroger

These days, fewer investors focus on finding quality capital allocators with shareholder friendly corporate governance. Instead, due to the proliferation of noise traders, the focus is on short-term technical trading trends while more reliable fundamental research is overlooked. Here's a quick summary of what noise traders are missing:

- proven-successful, data-driven growth strategies
- growth opportunities from investments in digital fulfillment centers
- Kroger's improving profitability
- valuation implies Kroger's profits will fall from current levels

Earnings Beats or Strong Results Could Send Shares Higher

Kroger has beaten earnings estimates in eleven of the past 12 quarters and doing so again could send shares higher.

Kroger's market share falling to pre-pandemic levels and the year-over-year decline in digital sales in fiscal 1Q22 have caused many to be skeptical about the company's ability to grow profits going forward. However, should the company's new Boost initiative show early signs of success, investors may more favorably view the company's future growth and send the stock higher.

Dividends and Share Repurchases Provide 2.7% Yield

Kroger has paid a dividend every year since fiscal 2006. Since fiscal 2017, Kroger has paid $2.5 billion (7% of market cap) in cumulative dividends. The company's current dividend, when annualized provides a 1.8% yield.

Kroger also returns capital to shareholders through share repurchases. From fiscal 2017 – 2021, the company repurchased $7.1 billion (21% of market cap) worth of stock. Over the TTM, the company has repurchased $1.9 billion worth of shares. Should the company use the remaining repurchase authorization of $301 million in fiscal 2022, the buybacks would provide an additional yield of 0.9% at its current market cap. Combined with a dividend yield of 1.8%, investors would see a 2.7% yield on their shares.

Executive Compensation Could Be Improved

No matter the macro environment, investors should look for companies with executive compensation plans that directly align executives' interests with shareholders' interests. Quality corporate governance holds executives accountable to shareholders by incentivizing them to allocate capital prudently.

The company compensates executives through base salaries, cash bonuses, performance-based equity awards, and time-based equity awards.

For fiscal 2022, executives' long-term incentive plan is tied to total sales without fuel plus fuel measured in gallons, growth in Adjusted FIFO Operating Profit including fuel, cumulative adjusted free cash flow, and "Fresh Equity" metric.

While we commend the company for incentivizing management for not just achieving top-line growth, but on reaching profitability and free cash flow targets, tying the company's executive compensation plan to growth in ROIC, as it did from fiscal 2018–2020, would better align shareholder interests with executives. We also think tying compensation would boost investors' confidence in the company. After all, ensuring that executives' interests are directly aligned with shareholders' interests tends to drive more shareholder value creation.

Insider Trading and Short Interest Trends

Over the past 12 months, insiders have purchased 5 thousand shares and have sold 255 thousand shares for a net effect of 255 thousand shares sold. These sales represent less than 1% of shares outstanding.

There are currently 23.1 million shares sold short, which equates to 3% of shares outstanding and under four days to cover. Short interest is up 10% from the prior month. Even with increased short interest, not many are willing to bet against this business well positioned to deliver strong profits even in the current macroenvironment.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

Fact: we provide more reliable fundamental data and earnings models – unrivaled in the world.
Proof: Core Earnings: New Data & Evidence, forthcoming in The Journal of Financial Economics.

Below are specifics on the adjustments we make based on Robo-Analyst findings in Kroger's 10-K and 10-Qs:

Income Statement: we made $2.7 billion of adjustments, with a net effect of removing $1.7 billion in non-operating expenses (1% of revenue). Clients can see all adjustments made to Kroger's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $12.9 billion of adjustments to calculate invested capital all of which increase invested capital. One of the largest adjustments was $6.6 billion related to goodwill. This adjustment represented 20% of reported net assets. Clients can see all adjustments made to Kroger's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $24.8 billion of adjustments to shareholder value for a net effect of decreasing shareholder value by $24.7 billion. Apart from total debt, one of the most notable adjustments to shareholder value was $1.5 billion in net deferred tax liabilities. This adjustment represents 4% of Kroger's market cap. Clients can see all adjustments to Kroger's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

Attractive Funds That Hold KR

The following funds receive our Attractive rating and allocate significantly to KR:

1. Brown Advisory - Beutel Goodman Large-Cap Value Fund (BVALX, BIAVX) – 4.5% allocation
2. DWS CROCI Equity Dividend Fund (KDHIX, KDHTX, KDHCX, KDHUX, KDHSX, KDHRX) – 2.5% allocation

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Disclosure: David Trainer, Kyle Guske II, Matt Shuler, and Brian Pellegrini receive no compensation to write about any specific stock, style, or theme.

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It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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