



CAIRN
INVESTMENT
GROUP

COMPANY SPOTLIGHT:

Kroger Co.

COMPANY DESCRIPTION

Headquartered in Cincinnati, Ohio, Kroger Co. is the largest U.S. grocer. It operates multi-department stores, jewelry stores, and convenience stores throughout the United States. Kroger also offers its own private label that it produces from its 38 food production plants.

William McMullen has been the CEO since 2014, spending over 37 years with Kroger.

COMPANY HIGHLIGHTS AND FINANCIALS

Kroger operates, either directly or through its subsidiaries, approximately 2,800 supermarkets and multi-department stores, approximately 1,400 of which have fuel centers. Kroger operates under 21 banners that include Fred Meyer, QFC, Kroger, City Market, Dillons, Food 4 Less, Fry's, Harris Teeter, Jay C, King Soopers, Ralphs, and Smith's. Kroger also operates over 700 convenience stores, either directly or through franchisees. Kroger has an additional 319 fine jewelry stores, which alone account for \$345 million in annual revenues, making it one of the largest fine jewelers in the U.S. Kroger is the fifth largest pharmacy operator in the U.S. by number of locations. It offers pharmacy services in over 2,200 of its stores, which accounts for close to 10% of its revenue.

Kroger operates one of the broadest footprints in grocery with a vast majority of its supermarkets within 2-2.5 miles of its customers' homes. Their size and scale puts them in an enviable position to compete through digital platforms for home delivery or curbside pick-up services. This is a key differentiator when comparing Kroger to competitors, and a big asset moving forward as the grocery business adapts to new competition. Kroger recently opened its newest store concept, "Fresh Eats MKT," which is a combination convenience store, pharmacy, and gas station, focused on higher quality food offerings.

Kroger has demonstrated consistent operating performance across many financial metrics. Though the grocery business is fiercely competitive, Kroger manages to generate high returns on capital (averaging over 12% during that last 5 years) and free cash flow generation. This allows the company to continue to invest in future

KEY POINTS

- :: Largest U.S. grocer, operating close to 2,800 locations.
- :: Strong private label brand and organic offering.
- :: Strong real estate portfolio, owning 48% of their properties nationwide.
- :: Above average financial health with high interest coverage ratios and cash flow generation.
- :: 5% average annual growth rate in sales over the previous five years, as of the most recent company filing.

growth initiatives (e-commerce and small store formats) while rewarding shareholders via an increasing dividend and timely share repurchases.

VALUATION AND RISKS

Kroger is trading at attractive valuations compared to historical operating performance and peer group. As of the date of this report, Kroger traded at over a 25% discount to its historical five year sales and cash flow multiples. Based on numerous free cash flow growth assumptions, we assume an overall compound annual growth rate (CAGR) in free cash flow of 4.5% over the long-term. This blended growth rate assumption is well below the growth rate achieved historically. This reflects conservative assumptions based on increasing competition from new entrants into the market (Amazon) and pricing pressures from existing competitors like Walmart and German-based Lidl. If our conservative estimates turn out to be overly optimistic, we feel there is a margin of safety built into the current price.

These risk factors will be monitored, but at current valuations combined with the company's financial strength, we feel the risks are represented in the current price and that future growth potential remains strong.

—Patrick Mason, Investment Analyst, Cairn Investment Group



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503.241.4901 :: 877.241.4901 :: cairninvestment.com

121 SW Morrison, Suite 1060 :: Portland, Oregon 97204

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