

Weekday Trader ■ by Alexander Eule

Thriving in Wal-Mart's World

BARRON'S ONLINE

A version of this article appeared Jan. 2 in Barron's Online (www.barrons.com).

Kroger at a Glance

Recent Stock Price:	\$25.67
52-Week High:	\$31.94
52-Week Low:	\$22.94
Stock-Market Value:	\$18.6 bil
Revenue:	\$70 bil
EPS (Est. FY2009):	\$1.89
P/E (Est. FY2009):	13.6
Est. LT EPS Growth:	11%

Sources: Barron's Online, Yahoo! Finance, Thomson Financial

KROGER HAS GOTTEN SHORTCHANGED in recent months but its sales growth amid a looming slowdown could help the supermarket giant rise from the pack.

After falling 20% since June on margin pressures in its gasoline business, Kroger shares (ticker: KR) look attractive, including to insiders at the Cincinnati-based company.

The volatile fuel business has clouded Kroger's impressive sales growth. In December, the company's food business posted its 10th straight quarter of 3%+ identical-store sales increases. For the third quarter, identical sales, excluding fuel, grew 5.7%.

Kroger dominates the food-retailing business, which looks attractive in an uncertain economic environment.

James Gibson, chief investment officer of Valley Forge Asset Management, likes grocery stores as a "hedge against rising food costs."

"In a food-inflation environment, these companies offer some pricing-power protection against that phenomenon," he says.

Gibson calls Kroger the industry's "premier operator," citing its strong management, impressive free cash flow and recently implemented dividend.

Having learned to survive and thrive in a retail environment shaped by **Wal-Mart Stores (WMT)**, Kroger has managed to pass on rising costs to customers while offering shrewd promotions to keep those customers loyal.

"They were taking it on the chin because of Wal-Mart's expansion," Lehman Brothers analyst Meredith Adler says of Kroger in the early part of the decade. "They stood up, dusted themselves off, and they're out there hitting."

Citigroup Global Markets analyst Deborah Weinswig adds that Kroger learned to be the midweek destination while Wal-Mart filled families' needs on the weekend.

"They got that during-the-week trip because they were convenient," Weinswig says of Kroger. With gas prices up, she notes that more consumers are also now choosing Kroger on the weekend instead of making the longer trek to Wal-Mart.

Between 2001 and 2006, Kroger's U.S. market share grew from 11% to 12.8%, according to Weinswig. **Safeway (SWY)**, on the other hand, has grown at a slower rate—from 8.2% to 8.4%. **Supervalu (SVU)**, the other major player, has gone from 5% to 7.7%, largely as the result of its 2006 acquisition of Albertson's for \$11.4 billion.

Weinswig says the gap is likely to widen. By 2010, she estimates Kroger will have 15% of the market, compared with 10% for Safeway and 9% for Supervalu.

Investors, meanwhile, can play Kroger's dominant position at a relative discount. Kroger trades at 13.9 times estimated earnings per-share for the next four quarters, compared with a 15.4 multiple for Safeway, according to Thomson Financial data.

Analysts surveyed by Thomson see Kroger shares gaining 27% over the next 12 to 18 months, versus 17% for Safeway.

Kroger currently operates nearly 2,500 retail grocery stores in 31 states under brands including Kroger, Ralphs and King Soopers, plus 782 convenience stores.

In addition to fuel sales at most of the convenience stores, 678 supermarkets have gas stations attached. The company also runs a retail jewelry business, which accounted for 0.7% of 2006 sales.

Kroger executives declined to comment for this article, but one insider's actions spoke louder than any words about the company's outlook. Director Robert Beyer, a board member since 1999, bought \$1.1 million in Kroger stock in mid-December, a day after shares slumped on fiscal third-quarter earnings news.

The purchase was the first by any Kroger insider since March 2006 and the largest in over five years, according to InsiderScore.com.

Citi's Weinswig gives partial credit for Kroger's growing market share to the sophisticated data mining that Kroger uses in conjunction with its customer loyalty cards. The program, run by British firm Dunnhumby, has helped drive traffic and purchases by optimizing marketing programs.

If a customer has a new baby, Weinswig says, retailers traditionally provide coupons for items like baby wipes or diapers. Kroger, with Dunnhumby's help, "will suggest beer coupons because dad's at home more," Weinswig says.

And while gas has added a degree of volatility to Kroger's quarter-by-quarter earnings, the convenience of fuel centers has further helped boost traffic for the company's traditional food outlets.

"I believe the very first reason people shop at a store is convenient location," says Lehman's Adler, noting Kroger's neighborhood locations in contrast to the strip mall, off-the-highway homes of retailers like Wal-Mart and **Costco Wholesale (COST)**.

Of course, the fuel strategy poses risks for Kroger and was largely responsible for sending shares down 9% in the week following its Dec. 11 third-quarter report. For the quarter, the company's gross margins fell by more than 1%; nearly three-quarters of that decrease came from lower fuel margins. The fuel news overshadowed a 10% jump in total revenue and an 18% increase in profit.

Lehman's Adler believes the drop in margins spooked many investors. "They own it for absolute stability of earnings, and they didn't get that," she says. Such volatility on a quarter-to-quarter basis could continue to stand out at a company that otherwise produces consistent results.

Adler maintains that, volatility aside, fuel remains a net positive for Kroger, by driving traffic into its stores. Additionally, year over year, those fuel margins are still relatively stable, Adler says.

And as gas prices stay high, the convenience of its full-service neighborhood locations could give Kroger an edge over more distant, big-box competitors.

For investors, that should be food for thought. ■

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