The Kroger Co. (KR)

Sector: Consumer staples

Price: 31.19$

Market Cap: 24.15B$

P/E ratio: 8.1

Dividend: 0.72$ yearly – 2.30%

KEY INFORMATIONS

Founded in 1883, one of the oldest and most experienced in the sector

It is the United States' largest supermarket by revenue ($121.16 billion for fiscal year 2019), and the second-largest general retailer (behind Walmart). Kroger is also the fifth-largest retailer in the world and the fourth largest American-owned private employer in the United States.

435k employees, nearly 2800 supermarkets, 2250 of them have their own pharmacy and 1585 has a gas station

Beside selling goods, they have also 35 plants where they make their own products, 16 of the are diaries plants, 9 bakery, 5 grocery, 2 beverage, 2 cheese and 1 meat.

They have huge potential growth, they are just discovering now the potential of online sales, which had a growth of 110% in last twelve months, and their sale system, made of in store pickup or home delivery is very well implemented because they make deep customers habits and data studies.

Their custom branded products are very popular, both for the convenient price and for their good quality, and the integration of the whole system allows them to control all supply chain (production - distribution - sale). This also will allow them to raise the margin in the future, which is a little low right now especially due to the huge employees number

Exclusive partnership with Ocado for the United States is helping them turn from manual labor to a more efficient and fast system, automatic warehouses.

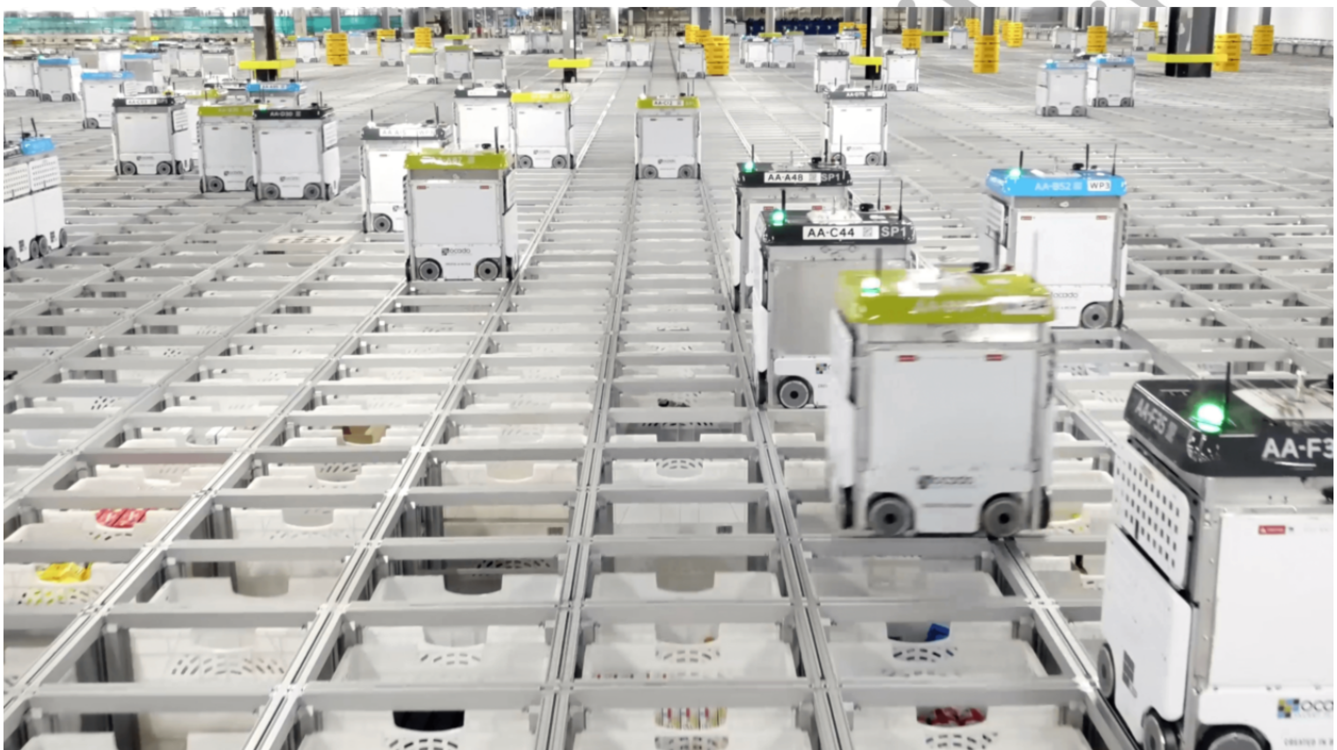
STRENGHT POINTS

The company is very old and very experienced, they have grown their business during 140 years, survived 2 worldwide wars, and all the crisis in modern history. A company that survives for so long time it's a force to reckon with for its competitors.

Very focused on real estate, they own 54% of their supermarkets, other are owned buildings and leased land, they always try to find the best solution for the long term opportunities, even for the leased part of the company they usually have buy options.

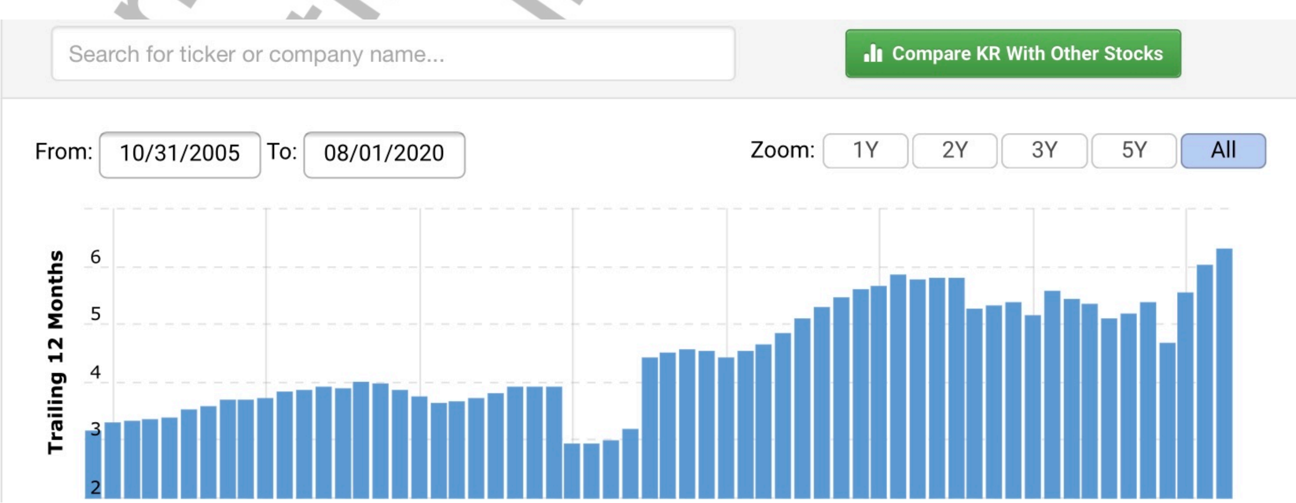
A great focus and unique talents development boosts their management, a good part of their managers worked in lower tier jobs, so they passed part of their life inside the supermarkets, allowing them to understand better all the business system and giving them a good advantage to understand better the areas that must be improved and how. Even their CEO was a part time stock clerk in a Kroger supermarket. Most of managers have worked for Kroger for decades, some of them for their whole career, boosting their knowledge and expertise on the field.

The partnership with Ocado is probably one of the most interesting and promising agreements in US right now, and having the exclusive rights on the project for US zone gives Kroger a huge opportunity and advantage to use against his biggest competitors (Amazon, Walmart, CostCo. Below you can see an image of a fully automatized grocery warehouse. They already have warehouses operating this system, and are implementing new ones to reach a number of 20 in 2021 and 2022. When they signed this deal they also bought 6% of Ocado, a great long term investment that already 4Xed the money they put in the deal.

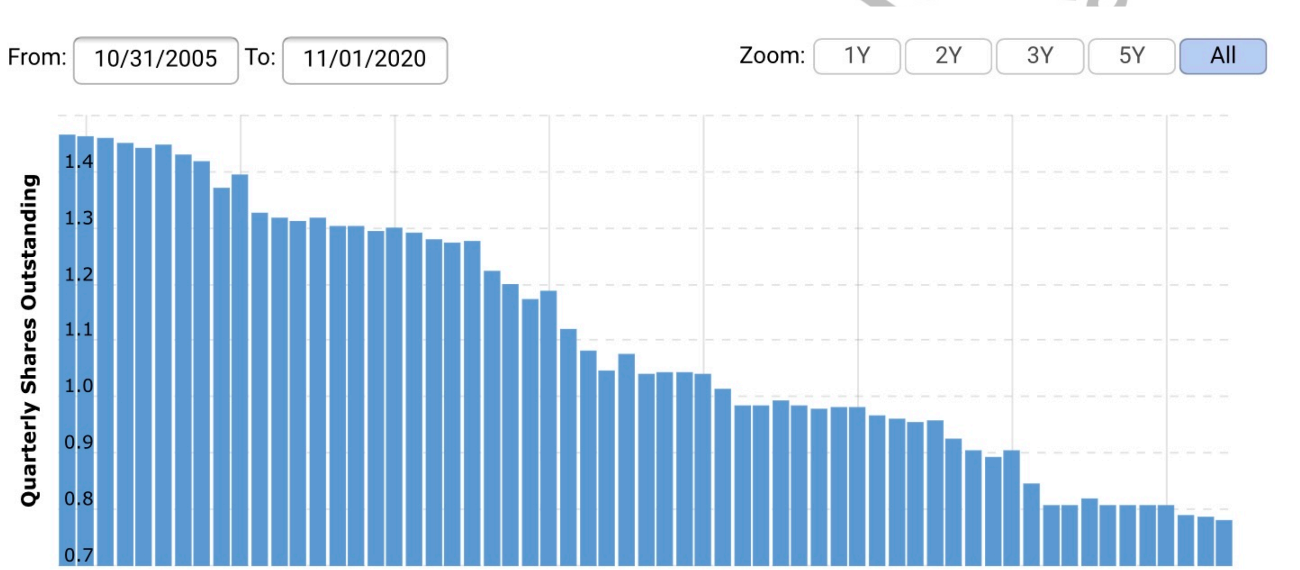


The growth of digital sales was helped by the store pickup or home delivery system, boosted by their huge database and data analysis which helped them to optimize the distribution and cut costs while still covering 98% of the households.

They had an good growth during last 10 years, and made investments to keep leading the sector and gaining market share. The overall management was fine, not great but fine, they are trying to innovate with interesting projects while cutting the less profitable parts of the company, like the sale of the convenience stores in 2018, a good move because the margin was close to 0 so they sold them and used the profits to grow their main business. Below you can see EBITDA growth during last 15 years.



Dividend is not bad at all, it’s not huge but the payout is so low (less than 18%) that there’s no chance they could cut the dividend or stop raising it. The most likely future is that they’ll still raise it year by year since they started focusing very well during last 15 years on giving back value to shareholders by raising dividends and buying back their shares. 10 year compounded annual growth rate (CAGR) of the dividend is 8.6%, very good looking for a timeline so long, the latest dividend growth announcement has been in August, 12.5% dividend raise.

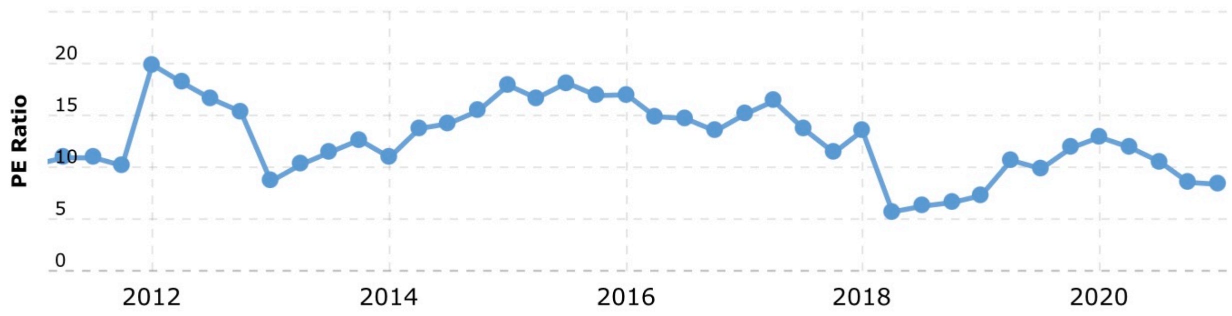


FINANCIALS

2.18B$ cash - 2.85$ per share, I don’t consider this a mitigation because they have a good amount of current liabilities, they will probably just refinance the debt to pay for it like any intelligent manager would do, but we don’t really know what can happen so better be a little more careful.

A very nice looking 22.7B$ retained earning and 17.5B$ treasury stock gives them a good looking financial situation for the future, they can easily cover the debt (11.9B$) and the huge cash flowing in the company, considering the very low dividend payout, and the fact they’re working on raising the margin, gives us a good safety margin and the certain of making a good investment for the long term. Never forget that using other people’s money to grow your business is the best strategy to use, and the treasury stock look like an expense on the books, but they are great for investors.

Price/earnings ratio is looking very good now, 8.1 is a good one considering the 5 years average and 10 years average are 12.3 and 13.6, this helps us calculating a fair value between 37$ and 40$. Buying at the actual price of 31.3$ is at least 20% less than the fair value. Below you can see how the P/E moved in last 10 years.



The inventory is well calculated, considering that most of their sales are made from fresh groceries and food, they sell and renew the inventory very fast so it doesn't need any reconciliation. As for properties, plant and equipment, considering they have a lot of supermarkets, they need constant improvements and investments to keep them operating and attract customers, the depreciation is fine. The only point I'd consider is that the company is very old and has some interesting locations, and they bought some of the properties decades ago, while the building needs Capex, they also appreciated during the years, especially the land so I would raise the PP&E value by a good 50% to have a more realistic value.

POTENTIAL THREATS

They are facing competition from the biggest and baddest competitors out there. Amazon, Walmart, CostCo, Target are some of them, and they must be careful to not lose market share or net margin.

Having food plants expose them to food safety rules and risk, if they face a food safety issue on one of their customized brands this could make them lose customer's loyalty and trust and lose market share.

In the last 3 years the growth slowed down, and net profit has been very variable, but I'm confident the management will success in raising margins and keep the company growing.

The huge employees number exposes them to labor relations problems, like pension plans, union relationship and all kinds of problems related to human relations. Recently they have announced they will pay 1B$ for a new pension plan for the employees. While this is a risk right now, in my opinion they are working on reducing this exposure and to reduce employees complaints.

FINAL THOUGHTS

The company is a very interesting one, and while the whole stock market looks pumped, this is one of the few that makes sense investing into. It's not perfect, no company is, but the advantages are good and the threats are under control for now.

The price is not very low if we look at the chart, but the earnings justify a long position, especially if we want to keep the stock for long long time. Very interesting as a long term dividend investment, we could keep this company forever and gain with the dividends, which have huge potential and low to no risk.

Being not at the cheapest moment I'm expecting the price to have the a little higher downside risk, but I don't think the price could drop under 26.5$ so the maximum risk is 15%, the price will probably never go under 27$ but let's take a little higher margin. The expected profit is 25% in the first year, so somewhere near 39$, dividends included. The price could also go higher, but let's be conservative and have a more realistic expectation.

Timeline goes from long to very long term, if we want to fully enjoy the potential of the company we must go for 10+ years long investment, so the company can achieve all his goals, complete its transformation and let the dividend mature. During this time we must constantly be careful at labor relations and see if they have any other problems with that, at the dividend growth and at the shares buyback program. If these keep going fine we'll make a lot of money out of Kroger. During the investment we must also look at the financials to be sure they don't deteriorate, but in my opinion its an event that's not very likely to happen.

The buy price is not bad, I'd use a steps buy strategy, I'd buy 33% of the money I want to invest at this price, 33% if it drops 5% (so 29.6$ the 2nd buy price) and the other 33% if the price drops 10% (so around 28$). If after you buy the price goes up, don't buy at higher prices, keep the risk low and enjoy the gain, don't get into the trap of greed. Personally I have bought 10 days ago at 30.5$, and after I bought I found out that also Warren Buffett opened a position in Kroger recently.