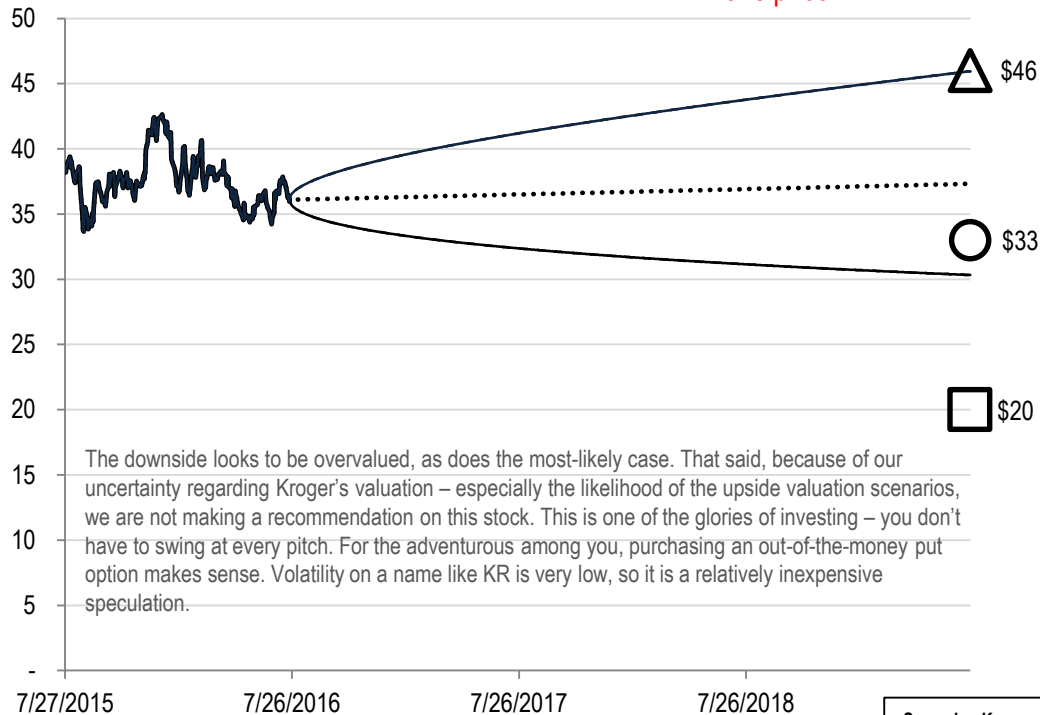


High valuation uncertainty and a valuation range not that different from option market price projection means we are not making an investment recommendation on this stock at this price.

IOI Tear Sheet : Kroger (KR)

Valuation Only

Data as of 21 July 2016



IOI's Take

All generalist investors think they understand retail. As some HF managers have found (SHLD, TGT, JCP), investing successfully in retail is not as straightforward as retail business models (buy inventory, sell it at a higher price). Kroger is changing. The way people buy everything, including food and home goods is changing. On one hand, restaurants report lower traffic due to competition from supermarket deli sections. KR's profit margins are shooting up to historic highs. We cannot be sure these profitability increases aren't durable, especially given KR's scale and operating efficiencies. On the other hand, low-end competitors, online competitors may drive profits down.

Drivers

| | |
|--------------------------------|--|
| S-T Revenue Growth | Inc. at a brisk pace due to grocery roll-up strategy and "infilling" New organic focus pulls in WFM shoppers. Proj: +7% (Best), +5% (Worst) |
| S-T Profitability | Shooting up due to operational efficiencies and inc. sales of high margin items. Proj: +3% (B), +2% (W) |
| Investment Level / Eff. | Half of profits spent on investments. Highly effective over last 5 years. Proj (med-term growth): +10% (B), -1% (W) |
| Balance Sheet | \$1 billion write-down of So. Cal. Ralphs chain should probably be added back to co. Ralphs is doing fine again, but acctg. rules only allow for write-downs, not gross-ups. |

Valuation & Return

Valuation Uncertainty: High

| | Low | Likely | High |
|---------------------------------|-----|--------|------|
| Stock Fair Value (\$) | 20 | 33 | 46 |
| Stock Return (%) | -45 | -8 | 28 |
| Option Period Return (%) | NA | NA | NA |
| Option Annual Return (%) | NA | NA | NA |

Historical Metrics

| | Historical Median | |
|--------------------|-------------------|---------|
| | 5-year | 10-year |
| Revenue Growth (%) | 7 | 7 |
| Profit Margin (%) | 2 | 2 |
| Med-term Growth | High | High |

Market Risk

As profit margins improve, PS Ratios go higher. If we're right that KR profits are resetting higher, low end of PSR range gets shifted up. However, to me, this co. is more uncertain than option market thinks.

Scenarios Key
ST Rev Growth | ST OCP Margin | Med-Term Growth

| Case / Scenario | Value |
|------------------|-------|
| 5% 2% -1% | 20 |
| 7% 2% -1% | 22 |
| PSR Implied Low | 24 |
| 5% 2% 10% | 29 |
| 5% 3% -1% | 29 |
| 7% 3% -1% | 32 |
| 7% 2% 10% | 32 |
| 252-day Low | 34 |
| PSR Implied High | 40 |
| 5% 3% 10% | 42 |
| 252-day High | 43 |
| 7% 3% 10% | 46 |

