

Company Name: Kellogg
Company Ticker: K US
Date: 2016-02-11
Event Description: Q4 2015 Earnings Call

Market Cap: 26,151.01
Current PX: 73.79
YTD Change(\$): +1.52
YTD Change(%): +2.103

Bloomberg Estimates - EPS
Current Quarter: 0.983
Current Year: 3.672
Bloomberg Estimates - Sales
Current Quarter: 3443.375
Current Year: 13420.118

Q4 2015 Earnings Call

Company Participants

- Simon D. Burton
- John A. Bryant
- Ronald L. Dissinger

Other Participants

- David Cristopher Driscoll
- Alexia J. Howard
- Jason English
- Kenneth B. Goldman
- Rob Dickerson
- Bryan D. Spillane
- Vishal Bhailal Patel
- Eric R. Katzman
- Eric Larson

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Full Year and Fourth Quarter 2015 Earnings Call. All the lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer period. [Operation Instructions] Please note that this event is being recorded.

At this time, I would like to turn the call over to Simon Burton, Vice President of Investor Relations for the Kellogg Company. Mr. Burton, you may begin, sir.

Simon D. Burton

Thanks, Dan, and good morning, everyone, and thank you too for joining us today for a review of our fourth quarter and full year 2015 results. I'm joined here by John Bryant, CEO and Chairman; and by Ron Dissinger, Chief Financial Officer.

The press release and slides that support our remarks this morning are posted on our website at www.kelloggcompany.com. And as you're aware, certain statements made today such as projections for Kellogg Company's future performance, including earnings per share, net sales, margin, operating profit, interest expense, tax rate, cash flow, brand building, upfront costs, investments and inflation are forward-looking statements. Actual results could be materially different from those projected.

For further information concerning factors that could cause these results to differ, please refer to the second slide of this presentation, as well as to our public SEC filings.

As a reminder, a replay of today's conference call will be available by phone through Monday, February 15. The call will also be available via webcast, which will be archived for at least 90 days.

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And now, I'll turn it over to John.

John A. Bryant

Thanks, Simon, and thank you, everyone, for joining us. We are pleased to have reported results that have met our expectations in the fourth quarter of 2015. We saw good growth in both currency neutral comparable net sales and operating profit and the individual performances of many of our businesses were strong, with currency neutral comparable sales growth in U.S. Cereal, U.S. Specialty Channels, Europe, Latin America, and Asia Pacific. We continue to build momentum and trends continue to improve. And importantly, as you've seen in the public data, our consumption increased in the U.S. Cereal business in the fourth quarter and we gained share. Obviously, this continued momentum had a positive impact on overall results in both the fourth quarter and for the full year.

The broad-based quarterly performance led to the underlying full-year currency neutral comparable net sales and operating profit results that were in line with our expectation. 2015's performance represented an improvement from 2014's results and we're continuing to build momentum in 2016.

Comparable currency neutral earnings were \$3.81 per share, at the high end of our guidance range, and full year cash flow of \$1.1 billion was also in line with our recently increased estimates and we have excellent earnings visibility as we continue to make great progress, executing Project K and implementing zero-based budgeting. So we met or exceeded our targets for 2015, and the performance we achieved set a great base for growth and the momentum we've built provides us with confidence as we enter the year.

So now let's turn to slide four and more detail on our expectations for 2016. The momentum we built in 2015 was the result of a better innovation, better support, better execution, and some of the visibility provided by our cost savings programs and we expect this level of execution and the momentum to continue in 2016. Specifically, we're very pleased with the momentum that we built in the U.S. Cereal business. We ended the year with fourth quarter consumption growth of more than 2% for the Kellogg brand and a share gain of 70 basis points, and results in December were even better. I'll talk about this in more detail in a few minutes.

The Project K and zero-based budgeting programs will each generate \$100 million in savings in 2016. That's \$200 million in total flexibility that we'll use to continue to drive top-line growth and increased margins.

Importantly, as you heard at the Investor Day a couple of months ago, we're excited about the plans we have to drive growth in North America and in each of the international regions, and we will remain focused on executing those plans throughout 2016.

We're investing in the top line by improving our food by introducing great new innovation across categories and businesses, by increasing the geographic expansion of Pringles, by improving sales capabilities, and by focusing on other activities designed to help us win where the shopper shops.

So we're pleased that all this has put us back on our long-term growth algorithm in 2016. Specifically, we still expect low-single-digit revenue growth, mid-single-digit operating profit growth and earnings per share growth of 6% to 8%, all on a currency neutral comparable basis. Ron will discuss this in a minute. We're excited about our plans across all the areas of our business and are very encouraged by the impact our actions are making.

And with that, I'll turn it over to Ron for a discussion of our financial results.

Ronald L. Dissinger

Thanks, John, and good morning. Slide five shows financial results for the fourth quarter and the full year. Fourth quarter currency neutral comparable net sales increased by 4.2%. This was ahead of our expectations and included the impact of pricing actions in Venezuela. We also saw improving trends and sales growth in our business, excluding the impact of Venezuela. We always had anticipated approximately 1 point of sales growth benefit from Venezuela in our

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guidance for the full year. The accelerated pricing drove an additional point and resulted in full year sales growth of 1.2%.

Currency neutral comparable operating profit increased by 2.8% in the fourth quarter. This included a headwind from the rebasing of incentive compensation of 4%. So growth in operating profit in the fourth quarter would have been approximately 7% excluding the rebasing of incentive comp.

Full year currency neutral comparable operating profit decreased by 2.3% at the high end of our guidance range of between down 2% to 4%. Full year operating profit would have also increased by approximately 1%, excluding the impact of rebasing incentive comp.

Reported operating profit for the full year was \$1.1 billion and for the quarter was a loss of \$39 million, including a non-cash mark-to-market charge for pensions of \$393 million. This was primarily driven by the impact that asset returns had on our pension plans, but it is worth noting that even at historically low discount rates, our pension plans are almost 90% funded. You will see more detail regarding items affecting comparability in the Appendices to the presentation.

Comparable earnings were \$0.79 per share in the quarter, and these results include \$0.06 of currency headwind. Currency neutral comparable earnings were \$0.85 per share for the quarter, an increase of 1.2%. Full year comparable earnings were \$3.53 per share including \$0.28 of impact from currencies. So as a result, full year currency neutral comparable earnings were \$3.81 per share at the high end of our guidance range and flat to last year.

Slide six shows the components of the full year and quarterly sales growth. Overall, currency neutral comparable net sales increased by 1.2% for the full year. We delivered double-digit growth in Asia and strong growth in Latin America. Pringles also delivered another strong year of growth across the globe, and our U.S. Cereal business continues to see improving trends and posted good growth in the fourth quarter.

Price mix increased by 1.9% as a result of growth in Latin America, which was driven primarily by the impact of Venezuela. We also saw price mix improvement in several North American businesses and in European Snacks.

While volume declined for the year, driven by developed Cereal [ph] and (8:50) U.S. Snacks, we saw good growth in the global Pringles business and in the Emerging Market Cereal business. And as you can see on the chart, impact of 2014's 53rd week reduced reported sales growth by 1.3% and the impact of foreign exchange lowered reported sales growth by 7.5%, more than half of which was due to the midyear re-measurement in Venezuela.

As a reminder, our joint ventures in China and Africa aren't included in these numbers; however, we saw very good rates of growth from them in the fourth quarter.

Slide seven shows details regarding our fourth quarter and full year currency neutral comparable gross profit and gross margin. Comparable gross margin for the full year was down slightly and in line with our expectations. It is important to note that gross margin for the quarter and the full year has been impacted by accelerating levels of inflation in Venezuela. Of course, we were able to price to manage the profit of the business to our plan but gross margin deteriorated. Excluding the impact of Venezuela, gross margin increased by 20 basis points for the full year and by 30 basis points for the fourth quarter.

Slide eight shows the fourth quarter operating profit performance for each of the regions. North America's currency neutral comparable operating profit increased by 3%. This was due to gross margin expansion resulting from lower input costs and savings from the Project K initiative in the region. This is partially offset by the impact of rebasing incentive compensation, which lowered North America's operating profit growth by more than 5% in the quarter.

We're pleased with the full year operating profit growth of 4% in Europe. Results for the fourth quarter were due to the timing of investment in brand building and some discrete costs. Without these discrete costs, operating profit would have increased by approximately 5%.

Operating profit in Latin America increased by 46%, due to the impact of Venezuela on the region's results. In addition, we saw good results in Mexico, good overhead management, and a favorable impact from the timing of investment.

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Operating profit decreased by 13% in the Asia Pacific region. We do continue to invest in sales growth in Cereal and Snacks in this region. This includes investment in our brands and our people. In addition, we saw higher cost of goods in the quarter due to the timing of spend across the year.

Slide nine shows our full year cash flow. Full year operating cash flow after capital expenditure was approximately \$1.1 billion, \$100 million higher than our estimate as we began 2015. We're very pleased with this result as it includes the cash required for Project K of approximately \$330 million. We offset this use of cash with the excellent execution of our payables initiative. And importantly, in 2015 we returned more than \$1.4 billion to share owners through dividends and share repurchases.

Slide 10 shows our industry leading core working capital as a percentage of net sales, and the improvement we've made over the last year. You can see that we ended the year with rolling 12-month core working capital as a percentage of sales of 6.2%. The significant year-over-year improvement is the result of excellent work that we've done on our payables initiative and we'll continue our efforts to free up cash from our balance sheet as we proceed through 2016.

Slide 11 shows our currency neutral comparable guidance for the full year 2016, which has not changed. We continue to expect that net sales will increase at a rate between 1% and 3%. Now while our original guidance always included approximately 1% of sales growth from the impact of inflation in Venezuela, our latest outlook includes more pricing to offset inflation in the country. Obviously, this is hard to predict, but it is possible that full year comparable net sales growth could exceed our guidance range due to these changes in Venezuela. It's worth noting that even excluding the total impact of Venezuela, we still expect to be in our original guidance range of between 1% and 3%.

We anticipate deflation in cost of goods sold driven by material costs, in combination with savings from Project K and zero-based budgeting, we expect improved gross margin. Of course, this excludes the impact of Venezuela, given the inflation-driven volatility. Our material input costs are approximately 70% covered at this time.

Operating profit is still expected to grow at between 4% and 6% and we also still expect that currency neutral comparable earnings per share will increase between 6% and 8%.

Our outlook includes a higher tax rate due to comparisons in 2015 and slightly higher interest expense. Specifically, we expect interest expense to be in a range between \$235 million and \$245 million, reflecting an anticipated increase in rates and slightly higher levels of debt. The comparable tax rate is expected to be between 27% and 28%.

Our board has approved a share repurchase program of \$1.5 billion, which will run through 2017 and we still expect to repurchase approximately \$700 million to \$750 million of shares in 2016.

As always, our expectations for sales, operating profit and earnings per share exclude the impact of items affecting comparability. We expect that full year operating cash flow will be approximately \$1.1 billion. This includes our expectation that full year capital spending will be in a range between 4% and 5% of sales to support growth in our Pringles business and Project K.

Slide 12 shows our full year earnings per share [ph] walk (15:33). We currently expect that currency translation could have an impact of as much as \$0.10 per share in 2016. This includes approximately \$0.04 for the translation of Venezuela results impacting the first half 2016. We expect that integration costs from the transactions we did in Egypt and Nigeria in 2015 will be between \$0.02 and \$0.03 per share for the full year and we expect that incremental savings from Project K will be approximately \$100 million for the full year, approximately 75% to 80% of which will come through cost of goods.

We estimate that pre-tax P&L costs for Project K and our zero-based budgeting implementation will be between \$200 million and \$250 million or approximately \$0.40 to \$0.50 per share. Approximately half of this will be in cost of goods and it's important to note that both Project K and our zero-based budgeting initiative remain on track.

Finally, our currency headwind is much more significant in the first quarter and the first half of the year and the increases in tax and interest expense also impact Q1 in the first half of the year. So a simple way to think about our comparable earnings per share delivery, including currency, is that it will be delivered relatively evenly across the year.

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And now I'll turn it back over to John for more detail regarding the operating segments.

John A. Bryant

Thanks, Ron. And now let's turn to slide 13 and the U.S. Morning Foods business. We saw good results from the business in the fourth quarter, with sales growth of 1.5%. This was driven by very good results in our U.S. Cereal business.

As you can see on the chart, we gained share in 2015 and in the fourth quarter, and had a great ending to the year in December. As you saw last quarter, our base sales performance was even better, with growth all year and growth of 4% in the fourth quarter. Importantly, our Core Six brands led this growth: Raisin Bran, Rice Krispies, Frosted Flakes, Mini-Wheats and Special K all saw consumption growth in the quarter with Special K posting high-single-digit growth. This was driven primarily by changes to messaging and the renovation work we did last year on Red Berries and the good growth we saw all year on Raisin Bran as the result of the introduction of Raisin Bran with cranberries, which showed good results for the entire franchise.

So we saw a lot of improvement across the year in the Morning Foods business. We invested where we needed to and worked hard to improve the fundamentals. We improved our brand building and the new products we launched; we invested in our foods; we put fun back in the box with Avengers and Disney Frozen-themed Cereals and we've quickly taken these learnings to other regions of the world, as I'll discuss in a minute.

I'd like to thank Paul Norman, who began this transformation, and Craig Bahner, who has continued it, and the entire Morning Foods team. The hard work is having significant impact. And we're optimistic about this business as we enter 2016. We said last year that we would improve the performance of Special K, and we have, as you can see on the graph on the slide. And we're going to continue to drive sales in 2016 with the introduction of much new products like Special K Nourish, which you can also see pictured on the slide. Special K Nourish is a cereal with positive nutrition and ingredients the consumer can see and the food includes fruits, nuts and on-trend grains like quinoa. It's early but the initial response has been encouraging and we will continue to focus on all our Core Six brands, as Craig discussed at the Investor Day in November.

We have a range of new products launching in 2016. Some are on-trend foods such as Special K Nourish and Harvest Delights Mini-Wheats, and some are fun additions, including S'mores, Disney Dory-themed Cereal and Orange Crushed Pop-Tarts.

So we saw improvement throughout 2015. The Cereal business continued to improve as the year progressed, and we saw the results of the investments and changes we made. We're excited about the plans we have for 2016, and expect continued improvement.

Let's turn to slide 15 and our U.S. Snacks business. We again saw sequential improvement in consumption in the cookie, cracker, Wholesome Snack and Pringles businesses in the quarter. We gained distribution in the overall cracker category as a result of innovation and Cheez-It continued to post good consumption growth and share gains in the fourth quarter as it has all year. This was driven by contributions from new products, including Cheez-It Extra Toasty and Grooves. And as Deanie Elsner said at Day of K, we will increase our focus and our investment on core brands in 2016, including Cheez-It.

We restaged Special K cracker chips during the year and we saw improved consumption performance as the year progressed due to renovations we made to the packaging and the food. We did see continued declines in consumption of popcorn chips in the fourth quarter, which had an impact on results. However, we expect the impact of the remaining SKUs to lessen as we progress through 2016.

We also gained distribution in the cookie business in the fourth quarter. The sequential improvement in consumption I mentioned continued the trend we saw last quarter and was driven by Chips Deluxe, Fudge Shoppe and Famous Amos. These brands benefited from expanded distribution, new products, and increased in-store activity. We have great brands

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in the category and we have some exciting new introductions planned for 2016 and we're also going to give the brands new support, including the relaunch of advertising, featuring the Keebler Elves.

We continue to see very good rates of consumption growth in Rice Krispies Treats in the Wholesome Snack category in the fourth quarter. In addition, the performance of our Special K bars has improved due to new products and renovation, especially our new Special K Chewy Nut Bars.

The overall Pringles business posted good underlying growth in the Grocery and Convenience channels. We continue to expand our global capacity and we have good plans across all our customers in 2016. As a result, we expect this business to post strong rates of growth for the year.

We are making progress in the Snacks business. We are increasing investment and focusing it on our largest brands. We're making sure that we have the right offerings in the right channels and we're expanding our offerings for the On-The-Go segment. And as in all of the North American region, we're using the flexibility we have to fund these changes and drive improving profitability. Deanie and the whole team are making a real difference and we expect modest sales growth in the business in 2016 with sequential improvement across the year.

So let's turn to slide 16 and highlights from the U.S. Specialty segment. Comparable net sales in the Specialty Channels business increased in the quarter. We saw growth in the Vending and Convenience Channels with net sales in the Convenience Channel increasing at a high-single-digit rate. We saw strong growth in Rice Krispies Treats in the Vending Channel and from Cheez-It and Pringles in the Convenience Channel, and we gained or maintained share in the Cereal, cracker, Wholesome Snack and salty snack categories within the channel for the full year. We also gained share in the Foodservice Channel in the cereal, cracker and cookie categories in the fourth quarter. The Specialty business also built a solid base in 2015, and our expectations are the team will drive good results in 2016.

Slide 17 shows the North America Other segment, which includes the U.S. Frozen Foods, Kashi and Canadian businesses. The Frozen Foods business saw continued growth from Eggo handheld sandwiches in the quarter. Consumption increased at a double-digit rate as it did all year. Overall sales declined at a low-single digit rate for the quarter, driven by the impact of egg prices, network improvements, the timing of activity, and the drawing down of inventories due to changes in packaging from boxes to bags. This veggie food packaging conversion is going well, but we expect sales to continue to be impacted in the first quarter of 2016 and for performance to improve over the balance of the year.

We saw continued sequential improvement in the Kashi business in the fourth quarter, and the performance improved within the quarter. The Cereal business improved due to the stabilization of distribution and the impact of introduction of new products in the second half of 2016, and the Bare Naked Granola brand posted double-digit consumption growth in the quarter.

The overall Kashi business. The overall Kashi business sales were down at a low-single-digit rate in the quarter. However, we expect continued improvement in 2016 due to further improvement in distribution and the impact of a new focus, our new products, high implant protein.

The Canadian business posted sales growth in the Cereal and Wholesome Snack businesses in the quarter. For 2016, the Canadian team is planning introductions of new products or programs, much like the rest of North American region. But we'll continue to see an adverse impact from transactional foreign exchange.

Let's turn to slide 18 and our European business. Sales growth across the region was 1.6% in the quarter, with strong growth in the Emerging Markets. The Pringles business also posted double-digit sales growth in the fourth quarter. We grew share in both the UK and Germany in both the fourth quarter and for the full year. Germany's performance were due to the introduction of Tortilla Pringles, and the strong results we saw in the UK due to some great activity, including a successful Halloween themed promotion.

As you might imagine, we had some exciting activity planned for Pringles in 2016 as well, including soccer-themed activity, planned to coincide with the EURO soccer tournament in the summer and the continued rollout of Tortilla Pringles in the region.

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The Wholesome Snack business also posted sales growth in the fourth quarter. This was due to better results in the UK, driven in part by Disney branded Snacks, Mini Biscuits, Crunchy Nut and Rice Krispies Squares. In addition, the Russian business did well, and we have new foods coming out across the region in 2016.

The Cereal business in Europe declined in the fourth quarter due to challenges in the category in many of the countries. However, we improved our plans for Special K and Crunchy Nut in the UK. So good performance from Extra in Italy and invested behind Kellogg's branded granola in Germany and we recently launched the Ancient Legends brand in the region. These are great products, which include on-trend ingredients like spelt, apples, sultanas and chia seeds.

And we're also applying earnings from other parts of the world, including the renovation of Special K Red Berries, the launch of Special K Nourish and we're also adding more fun in the box. So, the fourth quarter was a successful one for the European business, and we expect improvement to continue in 2016, as we launch great new products, invest for growth and continue to focus on execution.

Slide 19 shows highlights from our Latin America business in the fourth quarter. Total currency neutral comparable net sales again increased the double-digit rate primarily due to the impact of Venezuela. We saw sales growth in Mexico of approximately 4%, driven by great performance in the Cereal business. We gained share in the Cereal category in the latest public data and we saw improved performance from our adult-oriented cereals. We also gained share in Brazil in the quarter and for the year. These gains were partially the result of parent brand innovation and support. We launched Ancient Grains in Brazil in Q4, and in the first quarter of 2016 in the Andean region, and we also have Special K protein and granola with quinoa planned for introduction.

Sales in the region's Snack business also increased in the quarter. This growth resulted from better execution, good innovation, and strength in the Pringles business. In fact, the Pringles business grew at a double-digit rate. Commercial innovation, strong execution, and promotional programs drove growth, and we expect continued good performance from the brand in 2016. And our focus on high frequency stores continues to drive results. We've seen results in Convenience and Mini Super Stores in Mexico, and in smaller mom and pop stores in Columbia and we've also had success driving sales growth through packaging initiatives designed to drive affordability and accessibility in various areas of the business.

We also had a good year in the Latin American business in 2015, despite challenging conditions driven by slowing economies and weakening currencies. The team has done a great job managing through these situations and we expect continued good performance in 2016.

Let's turn to slide 20 and our Asia Pacific business. Overall, currency neutral comparable sales growth was 3.3% in the fourth quarter, although this does not include the impact of the JVs in China and West Africa. If we include the impact of those businesses, we would have seen double-digit sales growth.

The Asian business posted double-digit currency neutral comparable sales growth in the quarter. We saw double-digit sales growth in Japan driven by the continued growth of the granola category and the impact of new packaging. We also saw double-digit growth in Korea and Southeast Asia.

The Pringles business in Asia Pacific grew volume at a double-digit rate. We saw broad-based sales growth and share gains through the innovation and gains in distribution. And the sub-Saharan African business also posted double digit, currency neutral comparable sales growth. We saw better execution and the benefit from the introduction of new products. And as I mentioned, the JV in West Africa also posted very strong growth.

The environment in Australia remained challenging with category sales continuing to decline. However, the granola and mueslis segments are going well and we have a plan to address the weakness in the overall Australian business in 2016. We're also applying lessons learned from other parts of the business to Australia as we are in Europe.

We were pleased with the performance of the Asia Pacific region last year. For the full year, the region posted mid-single digit currency neutral comparable sales growth, and including the impact of the JVs, we would have achieved even higher growth. The Asian business continues to perform very well and while we expect the environment in Australia to remain challenging, we do expect another good year from this business. We have plans in place and our

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execution remains strong.

Let's turn to Page 21 and the summary. Our results in the fourth quarter were in line with or ahead of our expectations. We saw good performance in net sales, operating profit, EPS and cash flow. We built a strong base and generated momentum in 2015. We told you we needed to improve the performance of the U.S. Cereal business and we have. We saw increased consumption and share gains in the quarter. Special K is performing well and the Kashi Cereal business is responding to the introduction of new products and all of our international businesses posted sales growth in the fourth quarter and we're on track to meet our expectations for 2016. We expect our momentum to continue. We've made changes where we needed to; we've improved our support; we're launching exciting new products; we've improved our foods through renovation, and we're executing well. And we also had significant flexibility in 2016 from Project K and the zero-based budgeting initiative. These two projects will give us an incremental \$200 million of savings in 2016 that we will invest in revenue growth and use to improve margins.

So, as we step back and look at where we are, we built momentum in 2015. We generated significant savings. We launched a new strategy and we have a strong management team. And as we enter 2016, we are absolutely committed to our algorithm to deliver results through sales, operating profit and EPS, and to building long-term earnings visibility.

So, finally, I'd like to thank all of the Kellogg employees around the world. Your efforts are making a huge difference, and none of this would be possible without them.

And now, I'll open up for questions.

Q&A

Operator

Thank you. We will now begin the question-and-answer session. [Operation Instructions] And our first question comes from David Driscoll of Citigroup. Please go ahead.

<Q - David Cristopher Driscoll>: Thank you, and good morning.

<A - John A. Bryant>: Good morning, David.

<Q - David Cristopher Driscoll>: I wanted to ask just two questions. First on Cereal, can you talk about the impact of the U.S. sales force structure and the head count increases and kind of how it's impacted your Cereal operations? And then, specifically, John, I don't think you gave a sales growth. I mean, I think you said it for the Other segments, but what is your sales growth expectations for 2016 U.S. Morning Foods? And completely separately on ZBB, just love to hear a little bit more about your initial learnings on the program and then for you just to kind of talk about the size, this \$100 million and kind of why is that the right number and what are you learning as you're going through the program?

<A - John A. Bryant>: Great. Thanks, David. I'll take the Cereal questions and the sales growth questions. I'll hand ZBB over to Ron. There's no question that the additional investments made in our sales organization as part of our Project K reinvestments absolutely helped the performance of our U.S. Cereal business. In addition, our U.S. Cereal business has been helped by some of the great food improvements we've made, such as Special K Red Berries; some of the outstanding brand building programs we have such as the Raisin Bran program out there. But in-store execution this year has been significantly better than in the past and I think the U.S. sales reps, U.S. sales team have done a tremendous job of improving the in-store execution and driving the performance of that business.

Because of those changes, because of the momentum we're seeing in the U.S. Cereal business, we actually are quite optimistic about 2016. I think if you asked me back on the third quarter conference call, our expectations for U.S. Cereal, we would have defined flat sales in 2016 as success. Given the strength of U.S. Cereal across 2015, we'd actually expect our U.S. Cereal business to grow slightly, a couple of percent in 2016.

The Morning Foods business obviously includes more things than just U.S. Cereal. There's the Pop-Tarts business in there, which is also doing well, and Health & Wellness business. But in aggregate, I'd say that total business we expect

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to be up slightly in 2016.

<A - Ronald L. Dissinger>: So in terms of zero-based budgeting, David, first, we're on track and the project is progressing well, as we had said. Now, remember, we're targeting over \$2 billion worth of discretionary spend in North America for the start of the program, and the areas that we're targeting are in general administrative overhead, distribution costs, brand building and supply chain overhead as well. As we said, we still expect to save \$100 million in 2016, but what I would point out is that's not a ceiling in terms of our savings, okay. This is a multiyear program and we obviously believe that there are more opportunities for savings and then we're implementing a process to make sure that we can sustain those savings. We are reinvesting some of those savings back into our business. For example, we're [ph] refining (36:48) money in brand building. We're taking some opportunity to reinvest back into brand building for revenue growth. And as we've talked all along, we're investing money back into our food as well.

Our international regions are underway. So we have started the work in all of our international regions at this point in time. Kicked off the process, dissecting our spend, identifying the opportunities as well.

Some specific areas or learnings in terms of where we're seeing savings. So we look to cost of goods sold, for example, we've identified opportunities in our transportation and warehousing costs. We've done a deep dive in professional and contracted services and found some money there. And on people-related costs, things like travel, relocation, things of that nature, we've implemented policy changes to impact and benefit our cost structure. As I mentioned, we're finding some money in brand building as well around media, non-working media, as well as TV media. But, again, we're investing some of that back into the business to drive revenue growth. So overall, project is progressing well, remains on track.

<Q - David Cristopher Driscoll>: Thank you.

Operator

And our next question comes from Alexia Howard of Bernstein. Please go ahead.

<Q - Alexia J. Howard>: Good morning, everybody.

<A - John A. Bryant>: Good morning, Alexia.

<Q - Alexia J. Howard>: I guess, the main question that I have is around U.S. Snacks. There wasn't much color on it in the presentation and the operating profits looked to be down pretty sharply. What's going on there? It's been weak for some time. When do you think you're going to get better traction on that side? Thank you, and I'll pass it on in the interest of time.

<A - John A. Bryant>: Thanks, Alexia, and great question. You're right. We've had a disappointing couple of years in U.S. Snacks. We've talked a lot in the context of our Cereal business about Special K. The Special K has also had a fundamental impact to our Snacks business. We've had a headwind from Special K in Snacks over the last couple of years. You've seen that come through in our cracker business with Special K cracker chips. It's come through in our Wholesome Snacks business with Special K Bars. The good news is where we have renovated those foods similar to what we've done in Cereal, we're seeing the business stabilize. And so Special K cracker chips is stabilizing and Special K Chewy Nuts bars actually are doing quite well in the Wholesome Snacks business.

So if you look at that, that headwind is still there to a degree but to a much less degree. And as we go forward, we expect some of the tailwinds in the business to become more evident. So we've had strong growth in Cheez-It over the last several years. We're seeing good growth in Pringles; we're seeing good growth in Rice Krispies Treats and Wholesome Snacks. Our cookie business is stable the last couple of quarters. So we've actually seen better trends within the business.

So as we go forward into 2016, we expect to return this business to top line growth, although modest, and we absolutely expect to return the business to bottom line growth. So we recognize that's been an area of weakness for us. Deanie and the team have taken actions to address it and we feel much better about our 2016 outlook and you're

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actually seeing it in the consumption data even in 2015, and the consumption in the fourth quarter for 2015 was stronger than the prior parts of the year and we're seeing sequential improvement as we go through the year.

<Q - **Alexia J. Howard**>: Great. Thank you very much. And I'll see you next week at CAGNY.

<A - **John A. Bryant**>: Thank you.

Operator

And our next question comes from Jason English of Goldman Sachs. Please go ahead.

<Q - **Jason English**>: Hey. Good morning, folks. Thanks for squeezing me in.

<A - **John A. Bryant**>: Good morning, Jason.

<Q - **Jason English**>: Questions on margins. First, gross margin, I noticed in the Appendix you cited about 130 basis point tailwind from FX. Can you elaborate on the detail of what that is and give us some color in terms of the commodity backdrop that you've seen what inflation was last year, what your expectation is on the forward?

<A - **Ronald L. Dissinger**>: Yeah. So let me just talk a little bit about our cost structure within cost of goods sold for 2016. Overall, we do expect net deflation driving gross margin expansion, and I'm speaking specifically excluding Venezuela. We're seeing a lot of volatility and inflation in Venezuela. So set Venezuela aside. Excluding Venezuela, we expect gross margin expansion. We are seeing raw and packaging material deflation in 2016. We also have our base productivity improvements, Project K, and we've set Project K that \$100 million. About 75% to 80% of that runs through cost of goods sold.

On the zero-based budgeting savings that we quoted, a little less than half of that is coming through cost of goods sold. But remember, Jason, we've said all along that we were going to invest in our food, and we've done that in 2015, and we're doing it in 2016. Renovating our foods, and launching granolas and mueslis based on consumer trends that we're seeing. That investment in food remains at about a 50 basis point headwind in relation to our gross margin performance.

The other thing that we have impacting us in 2016 is some transactional currency exposure. So we had good hedges in 2015, some of those are rolling off and what we're seeing is some headwind, particularly around the Canadian dollar and the peso, but also some of the other international currencies as they've weakened versus the U.S. dollar. Now we're seeing about a 40 basis point headwind in relation to transactional currency exposure. So all up, slight net deflation and some gross margin expansion in 2016.

<Q - **Jason English**>: That's helpful. Great color. One more question on margins, a bit higher order. Just looking at North America overall, you seem to set – I guess, our model goes back to 2003, we can't find a year where margins were this low in North America. I don't know if you go further back in time, kind of how far you have to go to get down to the 15% level?

Looking across the space in food, your margins are going up. You look at your portfolio and you contemplate it and then you look at your margins and there seems to be a mismatch. What are the impediments of you getting back to that near 20% type margin that you had a bit more than a decade ago and what's the glide path forward to try to get there?

<A - **Ronald L. Dissinger**>: Jason, if you go back to our Investor Day and what we shared at the Investor Day, and I believe we even showed a chart at CAGNY, we did say that we had operating margin improvement opportunities in North America where we may expect to grow our sales around low-single digits over the long-term. We said we had 200 basis points to 250 basis points worth of operating margin expansion. And as you look at 2016 and how you'll see that play out for North America, you will see strong operating margin expansion within that business as a result of the zero-based budgeting work that they are doing and also savings from Project K.

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<A - **John A. Bryant**>: Jason, if I could just add to what Ron said, there's absolutely no impediment to us improving our margins. We're absolutely committed to doing that. You'll see that in 2016 and beyond.

<Q - **Jason English**>: Very good. Good luck, guys. Thank you very much.

<A - **John A. Bryant**>: Thank you.

Operator

And our next question comes from Ken Goldman of JPMorgan. Please go ahead.

<Q - **Kenneth B. Goldman**>: Hi. Two questions for me if I can. One just a clarification. The commentary on the pacing of EPS that it would be roughly evenly distributed per quarter. I just want to make sure was that a reference to absolute EPS dollars or to EPS growth year-on-year? I assume the former, just wanted to make sure.

<A - **Ronald L. Dissinger**>: You're absolutely right, Ken. So that's EPS dollars based on the things that I mentioned in terms of currency headwinds and below the line.

<Q - **Kenneth B. Goldman**>: Thanks, Ron. And then, I guess, this question is for anyone who wants to take it, but Nielsen data, they're really showing a very steep decline in private label cereal take away and it's very recent and sudden. Did this correspond with what you're seeing in the market? I appreciate that you and your branded peers are doing better, but that drop off seems kind of unusual and it makes me wonder if it's accurately representing what's truly happening out there.

<A - **John A. Bryant**>: Well, Ken, on private label data, you get the same data that we do. I think private label has been soft in a number of our categories now for a number of years, and I suspect what's happening there is that the U.S. consumer is getting stronger obviously lower petrol prices is putting more cash into people's pockets, et cetera. And at the same time you've got the branded players I think playing a much better game. We're investing back in our food. We've got strong brands. We've got standing in-store execution. All of those elements drive our business and provide a stronger offering. And, so, I think, the trends not just in Cereal, not just in the U.S., but in some of the other markets, but also in some of the other categories in the U.S. We've seen pretty weak private label sales now for a number of years.

<Q - **Kenneth B. Goldman**>: Thank you. See you next week.

<A - **John A. Bryant**>: Thank you.

Operator

And our next question comes from Rob Dickerson of Consumer Edge Research. Please go ahead.

<Q - **Rob Dickerson**>: Thank you very much. Good morning.

<A - **John A. Bryant**>: Good morning.

<Q - **Rob Dickerson**>: I had two questions. One clarification for cash flow and then another sort of broader. The broader question is, I see the improvement that's occurring in U.S. Morning Foods driven by Cereal. It's obviously positive, but it does seem like the one area that does continue to hinder much more accentuated top line growth is your Snack Bars. So I'm wondering, as you think about the Snack Bar category in general and relative to Cereal, what are the main differences you see to actually being able to recapture growth and take share and improve the top line off of somewhat depressed Snack Bar performance relative to what you're doing in Cereal? And the reason why I ask is we've done a lot of work that has shown that there really hasn't been that many new players in Cereal over the past few years, but over the past, let's say, three to five years there's just been a massive influx of brands that might make the category a bit more competitive. Thanks.

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<A - **John A. Bryant**>: Yeah, great question. So within our U.S. Snacks business, we have four large segments or businesses. One of which is Wholesome Snacks. Within that, the key is to have great food that's on trend. Well, we have that. We're growing strongly. So, Rice Krispies Treats is up high single digits in the fourth quarter. Some of our foods though, are not as on-trend as they need to be. We've been renovating some of that food with Special K Chewy Nut Bar. We have worked on Nutri-Grain, [ph] et cetera, so (47:29) new Nutri-Grain bars coming out. So we believe we have strong brands.

So, our Wholesome Snacks piece is more about ensuring all of our foods are on trend. There's work that's been done there. We've done that work; we've seen better results and there's still more to do.

But if you look at that Snacks business in totality, we have other large businesses in there beyond just the Cereal bar side, including crackers, where we have a strongly advantaged footprint, particularly with Cheez-It we're seeing strong growth. We have Pringles, and for Pringles around the world we're seeing double-digit growth in Europe, Latin America, Asia Pacific, and low-single digit growth in North America. We believe we have an opportunity to drive much more growth around Pringles in North America as we go into 2016 and that will help our U.S. Snacks results. We have great areas of strength within cookies as well.

So, if you think about our Snacks business, yes, there's some challenges on Wholesome Snacks. I think the answer to that is renovate, improve the food, continue to have strong brands, continue to execute in store, but it's really a food discussion. I think we're making great progress there. And then we have other sources of growth within that Snacks business. That's why we have confidence we'll get that business back to growth in 2016.

<Q - **Rob Dickerson**>: Okay. Great. And then just a quick clarification on free cash flow. I know your guidance for the year is \$1.1 billion, again, I know in 2015, you called out, you said \$330 million of cash for Project K then that was offset by the supplier financing. When we think about 2016, I'm not sure if you stated it before, but if so, I'm sorry, if you could just remind me what the Project K cash outflow is expected to be net of supplier financing improvements, if there are any?

<A - **Ronald L. Dissinger**>: Sure. So let me give you a little bit of color on how our cash flow kind of holds together and the \$1.1 billion that we guided after capital spending. And first, I think it's important to note that in 2016, we are converting net income to cash flow after capital spending at a rate of 100%. And in 2015, we actually did better than that. So we have a slightly elevated capital spending in 2016. We're in the 4% to 5% range. That includes Pringles growth, some capital behind that growth, and then as well some cash for Project K.

Our cash for Project K is a couple of \$100 million and what we're doing is we're continuing to roll out that supplier financing initiative to offset the cash requirements for Project K. We did just that in 2015 and we were able to offset the cash requirements for Project K based on the improvements we saw in our core working capital. So, we're expecting the same thing in 2016, and that's what's allowing us to convert our net income to cash at 100%.

<Q - **Rob Dickerson**>: Okay. Great. Thanks a lot.

<A - **Ronald L. Dissinger**>: Yep.

Operator

And our next question comes from Bryan Spillane of Bank of America. Please go ahead.

<Q - **Bryan D. Spillane**>: Hey. Good morning, everyone.

<A - **John A. Bryant**>: Good morning, Bryan.

<Q - **Bryan D. Spillane**>: I guess I wanted just a clarification on Venezuela, and thank you for the disclosure you put at the end of the press release because I think it really helps to clarify quite a bit. But I just wanted to make sure, so in the fourth quarter, Venezuela, because of the pricing, contributed about a little over 3.5% to currency neutral sales growth and it contributed about 2.5% to currency neutral operating income growth.

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So as we look at your guidance, and I heard you comment about revenues, you're basically I guess my interpretation of it is, to the extent that it has sort of impact on revenues, you're still looking at you're one to three as if, kind of normal. So if Venezuela contributes significantly more, there could potentially be upside to revenues. Would that same hold true for operating income as well? To the extent that it has the potential to deliver this type of impact on the growth to operating income, would you be looking at operating income the same way in terms of the effect of what a normal growth would be and how Venezuela affects it?

<A - John A. Bryant>: Sure, Bryan. Good question. And let me just kind of run through how Venezuela is impacting things. First, as we said in the prepared remarks, Venezuela was always included in our sales guidance, back in August, as we gave the original guidance. We always expected about a point of contribution from Venezuela to our sales performance. It's hard to predict and it's gotten even harder as inflation increased dramatically in the fourth quarter of 2015. And based on our projections that could continue as we move to 2016 as well and that's why we said we could see sales growth exceed the 1% to 3% range as a result of pricing actions we'll take in Venezuela to offset inflation and make sure that our business stays profitable.

So we said excluding Venezuela, we still expect to be in that 1% to 3% range on sales. And also, on operating profit and earnings per share, excluding Venezuela, we expect to be in the ranges that we communicated. Okay?

<Q - Bryan D. Spillane>: Okay.

<A - John A. Bryant>: Now, remember, we're pricing to offset inflation. So it's possible that could throw off more profit but it remains to be seen. There are margin controls within Venezuela. Some may have the question as well, so why haven't we deconsolidated Venezuela, and let me just put that out there.

In terms of Venezuela, we operate in a preferred industry, food, within the country and most of our inputs are locally sourced. Remember, Generally Accepted Accounting Principles, one of the key criteria for deconsolidating is exchangeability of currency. We've been able to exchange bolivar for U.S. dollar in the fourth quarter of 2015 and also here in January of 2016. We have control over our business. As I said, we're profitable in local currency as well. We re-measured to the SIMADI rate in 2015 so it has become a smaller portion of our business as a result of that. We continue to monitor and manage the business and our team there is doing a superb job at that.

<Q - Bryan D. Spillane>: All right. Thank you. And thanks for the clarity on that. It's really helpful.

<A - John A. Bryant>: Thank you.

Operator

And our next question comes from Kenneth Zaslav of BMO. Please go ahead.

<Q - Vishal Bhailal Patel>: Hi. This is Vishal in for Ken. Just a quick question for me. I wanted to confirm your response to an earlier question, I think you said that the global rollout of ZBB has already started. Is it fair to say that some of that margin improvement may flow through the P&L ahead of the late 2016 schedule that you kind of outlined at your Investor Day? And that's it for me. Thanks.

<A - Ronald L. Dissinger>: So it remains to be seen. Obviously, our teams are progressing that initiative as fast as possible. We haven't provided any outlook in terms of 2016 from the international regions and we'll provide you an update when we have that, but our teams are trying to generate savings as quickly as possible from ZBB.

<A - John A. Bryant>: Just one thing I would add to that, if you think about Project K, that's that is giving us additional savings in 2016, 2017, 2018. We have ZBB for North America in 2016, additional rollout in 2017, international will be partially 2016, 2017, 2018. What we're working on as a company is not just having great earnings visibility into 2016 but into 2017, 2018 and beyond. So we're building a long-term pipeline of productivity programs here to drive that long-term earnings visibility.

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<Q - Vishal Bhailal Patel>: Great. I appreciate it. Thanks.

<A - John A. Bryant>: Thank you.

Operator

And our next question comes from Eric Katzman of Deutsche Bank. Please go ahead.

<Q - Eric R. Katzman>: Hey. Good morning, everybody.

<A - John A. Bryant>: Good morning, Eric.

<Q - Eric R. Katzman>: Maybe this is a better question for CAGNY. But you've got hundreds of millions of ongoing productivity savings. You've identified ZBB, Project K savings on top of that. And I think, John, at the Analyst Day you had said we spend the right amount on advertising today and, if anything, we'll kind of optimize that and make it more efficient so there aren't necessarily incremental dollars going into that. It isn't clear to me why more of the savings aren't assumed to be helping your EBIT growth?

<A - John A. Bryant>: Well, Eric, firstly, I think you're right on brand building, we have industry-leading levels of brand building. Obviously investing in our brands is important, but we have enough fuel in the tank to do what we need to do. So as you look at 2016, we expect our brand building to be largely flat to 2015. So I think we have the money there that we need to have.

Obviously we are, as I told you, back at Day K, we're very focused on improving margins over time and we're very, very focused on getting back on our long-term growth algorithm. Our long-term growth algorithm, our 4% to 6% operating profit bottom line growth is a target, it's not a ceiling, and obviously the company will continue to do what we can do to drive performance over time.

<Q - Eric R. Katzman>: But – so, I guess, borrowing some bonus for Simon or something, you've got savings of – or you've got reinvestment in the quality of the food, right, as a partial offset, but then I think you said ZBB can kind of cover that. Maybe we'll follow up at CAGNY but it seems to me that the number is, especially of advertising is flattish, along with deflation, the numbers don't really add up to what is relatively modest margin expansion.

<A - John A. Bryant>: Well, Eric, I think some of the \$100 million of ZBB savings are within the brand building line, it's likely to get spent back into the brand building line. As you look at 2016, we're obviously continuing to invest back into our food. We're also investing back into the Emerging Markets. So I think you'll start to see the strategy to come through even in the regional results. As you look at 2016, we expect strong profit growth in North America and Europe, but now we're investing back in Asia Pacific and Latin America. So you'll see our investment decisions and where we're driving for margin come through our results as we go through 2016.

<Q - Eric R. Katzman>: Okay. And then last one for Ron just as a follow up to make sure I got it. The \$0.04 of Venezuela hit in the first half of this year, and I think you said \$0.02 to \$0.03 of JV cost, are you excluding that or including those items?

<A - Ronald L. Dissinger>: So the \$0.04 on Venezuela in the front part of the year is part of the \$0.10 of currency that I communicated. So that rolls right through our comparable earnings per share performance. The \$0.02 to \$0.03 is integration costs. And we do typically walk those out of comparable. That's to integrate those businesses.

<Q - Eric R. Katzman>: Got it. Okay. See you next week. Thanks.

<A - Ronald L. Dissinger>: Yep. Thank you. We have time for one more question.

Operator

Yes, sir. And our final question will come from Eric Larson of Buckingham Research. Please go ahead.

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<Q - Eric Larson>: Yeah. Thank you, everybody. Congratulations, team on really getting that sales momentum back on track. It's very encouraging. Ron, I just would like to follow-up. I have two quick questions. I'd just like to follow-up a little bit more on your free cash. Obviously, you've got some new capacity going into Pringles around the globe. Is some of your new growth initiatives – will most of that capital be a 2016 event, or will some of that carry into 2017? I guess, what I'm trying to do is get a feel for what we could see in 2017. And I know it is way too early for any kind of guidance, but I'm looking at the timing of your capital projects.

<A - Ronald L. Dissinger>: Yeah, fair enough and we're not trying to guide on capital spending for 2017 at this point in time. But on Pringles, I'd say we're growing this business very quickly, as John mentioned. We're growing high-single digits overall as a company and double-digits in some of the regions. So we're investing capital in 2016, but we see a glide path for continued growth and likely continued capital investment. Obviously, we're trying to squeeze as much capacity out of the current assets that we have, Eric, but we'll continue to invest behind that business as long as we're seeing strong growth.

<Q - Eric Larson>: Okay. Good. And then a question for either Ron or John but it relates to the first question, I think, that Dave asked in the conference call. And it's a meaningful investment that you made in your direct sales force in the U.S. Cereal business. The question that I have, as you get your Wholesome Snacks business, you get the right food and you invest in your food in that business and get everything lined up. Structurally, will your U.S. sales force, direct sales force, be responsible for the in-store market for your Wholesome Snacks or how is that structured?

<A - John A. Bryant>: That's great question. As we think about our business, we require three things to really drive our business. One is to have great food. Second is strong brands and the third is in-store execution. And you think about that in-store execution, as you say, we're very pleased with the U.S. Cereal business, which is a warehouse sales organization. Our Snacks business is a DSD sales organization. We've made investments back into that organization as well. We're very happy with the power of DSD and the ability to win in-store with that system. I think the opportunity in our Snacks business is making sure the food is absolutely on trend and that's where we're focused and making great progress.

<Q - Eric Larson>: Okay. Thanks, everyone, and congrats again.

<A - John A. Bryant>: Thank you.

John A. Bryant

Okay, everyone. Thanks very much. We'll be around, as usual, for questions, and we look forward to seeing everybody next week. Thanks.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.

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