

Company Name: Kellogg  
Company Ticker: K US  
Date: 2016-05-05  
Event Description: Q1 2016 Earnings Call

Market Cap: 26,512.85  
Current PX: 75.27  
YTD Change(\$): +3.00  
YTD Change(%): +4.151

Bloomberg Estimates - EPS  
Current Quarter: 0.935  
Current Year: 3.708  
Bloomberg Estimates - Sales  
Current Quarter: 3425.571  
Current Year: 13398.368

## Q1 2016 Earnings Call

### Company Participants

- Simon D. Burton, CFA
- John A. Bryant
- Ronald L. Dissinger
- Paul T. Norman

### Other Participants

- David Palmer
- Michael Lavery
- Robert Moskow
- Kenneth B. Goldman
- Alexia Jane Howard
- David Cristopher Driscoll
- Bryan D. Spillane

## MANAGEMENT DISCUSSION SECTION

### Operator

Good morning. Welcome to the Kellogg Company First Quarter 2016 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period. [Operator Instructions] Thank you.

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

### Simon D. Burton, CFA

Thanks, Gary. Good morning and thanks, everyone, for joining us today for a review of our first quarter 2016 results. I'm joined here by John Bryant, Chairman and CEO; Ron Dissinger, Chief Financial Officer; and Paul Norman, President of Kellogg North America.

The press release and slides that support our remarks this morning are posted on our website at [www.kelloggcompany.com](http://www.kelloggcompany.com). As you are 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, May 9. And the call will also be available via webcast, which will be archived for at least 90 days.

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

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## John A. Bryant

Thanks, Simon, and thank you, everyone, for joining us. Before I start, I'd like to announce that Simon will be moving into a new role in the business. I'd like to take this opportunity to thank him for all his contributions over the years in Investor Relations. He's done a tremendous job. To backfill Simon, we've asked John Renwick, who many of you already know, to come back to Investor Relations. John has 16 years of experience with Kellogg, including stints not only in Investor Relations, but also business unit CFO roles in both the U.S. and international regions. And before coming to Kellogg, John was a sell-side analyst covering the packaged food industry. So he brings great experience that will enable us to sustain a strong Investor Relations program. So thank you, Simon. And welcome, John.

Turning to the business, we are pleased to report a good start to the year, with operating profit and earnings exceeding our expectations in the first quarter. Earlier pricing actions in Venezuela certainly gave our results a boost, but, even excluding Venezuela, our profit came in better than anticipated.

Net sales, excluding Venezuela, came in slightly below our expectations, but, even where we came up short, we can point to specific factors that we don't consider to be ongoing. For example, first, in U.S. Snacks, we underwent a major reorganization of our DSD sales force, changing thousands of employees' roles, managers, zones and customers. And this impacted our display activity in Q1 and into Q2, but it was the right thing to do. And when everyone settles into their new roles, we should see improved selling and merchandising effectiveness.

Second, in European Cereal, sales were soft in Q1. We think this is largely the consequence of timing of investment. Our innovation came in midway through the quarter, and we have our big events, such as tie-ins with Euro Soccer and Olympics, coming this summer.

And finally, in businesses like Eggo and MorningStar Farms, we made portfolio changes and product transitions that weighed down short-term results. Those should lead to better performance as the year goes on.

Like I said, these are all factors that should prove to be temporary, and we expect to see gradual improvement as the year progresses.

Q1 featured some very tangible signs of progress and clear evidence of sustainable improvement in results. Our U.S. Cereal business continued to gain share, reflecting the benefits of investing in our food and Kellogg sales reps. Our Big Three U.S. Cracker brands collectively grew sales, consumption and share. We generated growth in our Pringles brand in all four regions, reflecting our expansion of that brand's portfolio and presence around the world.

Our business in Asia grew currency-neutral comparable net sales at a high single-digit rate, reflecting our commitment to emerging markets. And our joint ventures, though not consolidated in our net sales results, also provided excellent emerging markets growth.

Meanwhile, Project K and zero-based budgeting initiatives, in conjunction with our underlying productivity initiatives, delivered strong efficiencies that contributed to a higher operating profit margin, so there's a lot to be encouraged about in Q1.

Let's talk briefly about where this leaves us for the full year. Ron will get into the specifics of our guidance in a moment, but here's how I would summarize our outlook on a currency-neutral comparable basis. Our outlook for operating profit and earnings per share, excluding Venezuela, has not changed. We are on track. Including Venezuela, our outlook actually improves for sales, profit and earnings, owing to an earlier impact from inflationary pricing actions.

We'll see a little more of our net sales growth coming from Venezuela, due to the pricing, and a little less from the rest of the business, which we now believe will finish the year with 0% to 2% net sales growth, excluding Venezuela. But remember, as the short-term factors I mentioned earlier get behind us, we continue to expect to build momentum as we go through the year.

And with that, let me turn it to Ron for more details on the financials.

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## Ronald L. Dissinger

Thanks, John, and good morning. Slide four shows highlights of the financial results for the first quarter. First quarter currency-neutral comparable net sales increased by 6.6%. Like last quarter, these results included the impact of pricing actions in Venezuela. Total currency-neutral comparable net sales, excluding the impact of Venezuela, declined by 1%.

First quarter currency-neutral comparable operating profit increased by 34.9%, also including the impact of Venezuela pricing. Currency-neutral comparable operating profit, excluding the impact of Venezuela, increased nearly 2% and exceeded our expectations.

Reported operating profit for the first quarter was \$438 million, including the impact of mark-to-market accounting, Project K upfront costs and the currency remeasurement to the Venezuelan business. You will see more detail regarding items affecting comparability in the appendices to this presentation.

Comparable earnings were \$0.97 per share in the quarter, which exceeded our expectations due to operating profit performance. This included \$0.36 of currency headwind, \$0.34 of which was due to the mid-2015 currency remeasurement in Venezuela. As a result, currency-neutral comparable earnings were \$1.33 per share, which represented a year-over-year increase of 36% and which was above our original expectations.

It's worth noting that the currency remeasurement to the Venezuelan business occurred at the end of the second quarter 2015. So this large year-on-year impact from currencies will continue through the second quarter of this year.

Now, let's turn to the slide five and the drivers of the first quarter sales. Volume declined slightly in the quarter, including a few factors that are temporary, as John mentioned. These included a sales force transition in U.S. Snacks, trade inventory reductions in markets like Mexico and product calls and transitions in U.S. Frozen Foods. These factors masked good volume growth in our U.S. Specialty Channels, our Asian Cereal business and our International Snacks businesses, led by Pringles.

Price/mix contributed 7.3% to sales growth, largely due to the impact of pricing in Venezuela. Price/mix, excluding the impact of Venezuela, declined slightly by 0.4%, largely a result of the difficult economic environment in Europe. And finally, you can see on the chart that the impact of foreign exchange lowered reported sales growth by almost 12% in the quarter, with 10 points of that impact coming from Venezuela.

Slide six shows the currency-neutral comparable gross profit and gross margin for the quarter. Currency-neutral comparable gross margin increased by 210 basis points in the first quarter, including the impact of significant and earlier pricing actions to cover inflation in our Venezuela business. Excluding the impact of Venezuela, our gross margin decreased by 20 basis points, reflecting the investments we're making in our food and packaging around the world, as well as some headwinds from transactional currencies.

We also experienced the impact of some category and channel mix in the quarter, but we should see this reverse a bit as our sales trends improve in certain categories and markets as the year progresses. We still expect that gross margin, excluding Venezuela, will improve for the full year as we experience positive contributions from Project K, our zero-based budgeting initiative and net deflation in input costs.

Slide seven shows the regional operating profit performance for the first quarter. Currency-neutral comparable operating profit in North America increased by 8%. This was due to gross margin growth and lower SG&A, driven by Project K savings, the zero-based budgeting initiative and lower net input costs. In Europe, first quarter operating profit increased by 1%, building on difficult comparisons last year.

This year's performance was the result of the timing of brand investment to support commercial programs and innovation, which was partially offset by the lower impact of sales. We were also lapping difficult comparisons in Latin America, although operating profit increased by 329%, due to the impact of pricing in Venezuela. Excluding the impact of Venezuela, operating profit decreased by 27%, due to the impact of lower volume driven by trade inventory reductions, as well as inflation we saw in cost of goods sold.

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Asia Pacific's operating profit decreased by 6% in the quarter, and this included increased levels of investment in capabilities to support growth, as well as transactional currency impacts.

It's important to note that our Project K and zero-based budgeting initiatives remain on track. The North America business realized savings from zero-based budgeting in line with our plan. And our international regions are making good progress assessing their spending and developing their goals for late 2016 and beyond.

Slide eight details cash flow for the first quarter. Our first quarter cash flow included the impact of a bond tender offer completed during the quarter. This lowered cash flow by approximately \$145 million, although it's important to note that we get a cash tax benefit in the second quarter, so the net cash impact of the tender will be around \$95 million. Even with the impact of the bond tender, we are still on track to deliver the \$1.1 billion of full year operating cash flow after capital expenditures that we targeted initially.

And finally, our board recently approved a 4% increase in the dividend, which will bring our payout ratio slightly above 50%, and we remain committed to returning cash to our shareowners.

Slide nine shows our low levels of core working capital as a percentage of net sales. And as you can see, we reached 5.6% in the first quarter. This improvement was again driven by the accounts payable initiative that has been benefiting our working capital over the last year. And importantly, we have plans to improve this metric further in the periods to come.

Now, let's turn to slide 10 and our full year earnings per share walk. As you can see, there is no change in our comparable earnings per share, which remains a range of \$3.64 to \$3.71. What has changed is our currency-neutral comparable earnings per share, which increases to \$4.00 to \$4.07 per share, a year-on-year growth rate of 13% to 15%. And this is because of the impact of earlier pricing actions in Venezuela.

In the slide, this is depicted in the walk from currency-neutral to comparable, with Venezuela's currency impact going to \$0.30 per share from a previous estimate of \$0.04 per share. Obviously, Venezuela is a volatile market, so this estimate could change, but, as a reminder, our guidance for comparable earnings per share remains unchanged at \$3.64 to \$3.71.

Pre-tax upfront costs remain consistent with our original guidance of between \$200 million and \$250 million, or approximately \$0.40 to \$0.50 per share, about half of which should be in cost of goods sold. And full year integration costs are still anticipated to be between \$0.02 and \$0.03 per share.

Slide 11 adds net sales and operating profit, showing everything on a currency-neutral comparable basis and giving you a sense of what our outlook looks like with and without Venezuela. On this basis, including Venezuela, our guidance for net sales and operating profit, just like our earnings per share, moves higher. Specifically, currency-neutral comparable operating profit growth goes to 11% to 13% from our previous estimate of 4% to 6%. And currency-neutral comparable net sales growth goes to 4% to 6% from our previous estimate of 1% to 3%.

The makeup of our net sales outlook changes with more growth coming from Venezuela and a little less from the rest of the business. We are toning down our outlook outside Venezuela because of some of the first half factors that we've already mentioned, such as the sales force transition in Snacks, product transitions in Frozen Foods, and market conditions in Europe and Latin America. The good news is that we still expect the business to build momentum throughout the year. But the result of a trimmed down first half sales growth estimate is that we now expect full year comparable sales growth, excluding Venezuela, to be more like 0% to 2% instead of 1% to 3%.

Looking into other assumptions, we continue to expect improved gross margin for the year. We expect that input costs will be net deflationary, and that savings from Project K and zero-based budgeting will contribute to the margin improvement. As was the case previously, our margin guidance excludes the impact of Venezuela, given the inflation-driven pricing increases there and volatility in the market.

Incremental savings from Project K are still expected to be approximately \$100 million for the full year, approximately 75% to 80% of which will come in cost of goods sold. Savings through zero-based budgeting are still expected to be roughly \$100 million, spread between cost of goods sold, brand building and overhead.

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Comparable interest expense should be in a range between \$235 million and \$245 million. Comparable tax rates should be between 27% and 28%. And we still expect to repurchase approximately \$700 million to \$750 million of shares in 2016, so no changes here.

And we continue to expect that full year operating cash flow will be approximately \$1.1 billion. Full year capital spending will be in a range between 4% and 5% of sales, including the investments we're making in Pringles growth and Project K.

And remember, we said on the fourth quarter call, that our comparable earnings per share delivery would be spread relatively evenly across the quarters. This is changing, as we delivered slightly higher earnings per share in the first quarter than we anticipated, and this will likely come out in Q2, partially due to the timing of investments.

And now, I'll turn it over to Paul for more detail regarding the North America operating segments.

## Paul T. Norman

Thank you, Ron. Good morning, everyone. Slide 13 (sic) [12] (18:33) is one I showed you at CAGNY earlier this year. As I mentioned then, our priority in North America is to return the business to profitable growth. And there are three key drivers of this transformation. We will accelerate the momentum behind advantaged brands in Cereal, Snacks and Frozen. We will transform the Veggie business and unlock the full potential of the Kashi Company. And we will expand margins while investing to grow, driven by our Project K and zero-based budgeting initiatives. As you'll hear over the next few minutes, we're making progress in all of these areas. Some may take longer to achieve than others, but we are confident we're on the right and that we'll see continued improvement.

Now, let's start with slide 14 (sic) [13] (19:21) and the U.S. Morning Foods business. Overall, we are pleased with the results in the first quarter, and we remain on track with our plan to return to growth in 2016. Our Core Six cereal brands, in combination, drove another quarter of share growth. Special K, Raisin Bran, Rice Krispies, Frosted Flakes and Mini-Wheats all gained or maintained share in the quarter. And Special K led the way, with good performance resulting from our redesigned messaging, product renovation and innovation. And, as you know, we recently launched new Special K Nourish in the U.S. It's early, but we're encouraged by the initial acceptance.

Our See You at Breakfast promotion in January and the Give a Child a Breakfast promotion in March both performed very well. We did see some volatility in consumption in the cereal category during the quarter and an impact from the timing of Easter at the end of the quarter. But if you look at more recent weeks' data, the category has picked up again and it's clearly better than it has been in recent years.

We have confidence that our business will continue to improve in the coming quarters. Our share performance reflects the actions we took last year, and we've got more activity planned for the remainder of the year. In Q2, this includes two new Raisin Brand granolas and a Pixar's Finding Dory-themed cereal and promotion timed to coincide with the launch of the movie here in June. We also have our Olympic-themed activity coming in Q3 that also coincides with the timing of our big Back to School promotion.

Turning to Pop-Tarts briefly, it's worth mentioning that the business posted a mid-single-digit increase in net sales and share gains in the quarter. As we look forward, we have great new products planned, including Orange Crush and A&W Root Beer flavors. We expect growth to continue for the full year.

In summary, the Morning Foods business has made significant progress and will continue to improve. We've identified the issues that we needed to address. We've taken action, and we've started to see the benefits. The work isn't over, but we're committed to continuing the progress we've made so far over the balance of 2016 and 2017.

Turning to U.S. Snacks and slide 15 (sic) [14] (21:46), our net sales decline in Q1 was a little more than we'd planned, really because of two factors. First, we reorganized our sales force, creating a more clearly-defined roles for the selling, merchandising and support. This is going to drive more effective selling and merchandising, but we did see some disruption in our sales and display activity as we transitioned thousands of employees to new roles, zones and

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customers. This was most visible in Cookies and Crackers and it continued into the month of April, but will be behind us as we get through Q2.

Second, our Wholesome Snacks business continued to decline in Q1. As we've discussed previously, this business remains our biggest challenge in Snacks, and we're still up against lost distribution, particularly from some prior years' innovations that simply haven't stuck. As you know, it's absolutely critical to get the food and the brand positioning right in this category. The good news is that Rice Krispie Treats have been a strong performer and its share was up again in Q1. And that we have several on-trend innovations and renovations launching here in the back half for all of our big Wholesome Snacks brands, such as Special K Protein Trail Mix bars, a new Nutri-Grain Pumpkin Spice variety and a couple of Cocoa Krispie treats, one including M&Ms. These give us reason to believe we can stabilize this business as the year progresses.

Now in the meantime, let's not lose sight of what's working well in Snacks. Our Big Three brands in Crackers, Cheez-It, Town House and Club, together posted good growth in net sales, consumption and share, all led by accelerated base consumption in the quarter. This is where we have invested both in brand building and innovation, and it continues to pay off. We feel very good about our plans for the rest of the year in Crackers, including Cheez-It sandwich crackers and Club Snack Stacks launching mid-year.

We also feel very good about our Pringles business. In Q1, it posted growth in net sales and consumption. In fact, we saw double-digit consumption gains for our [ph] core range, (24:09) aided by efforts to improve assortment on shelf and increased brand building support. We also had double-digit consumption growth in our on-the-go formats business. We have more brand investment and exciting promotional events coming, giving us confidence in an accelerating growth trend for this brand year-to-go.

While Cookies declined in Q1, it was probably the category most affected by our sales force reorganization. It was also held back by an investment plan that doesn't really get going until here in Q2. We are reinvesting in our core foods in the form of renovated products and packaging, new products and seasonal rotations. And importantly, we are returning to advertising behind Keebler after several years off air. So the plans are in place for a better performance ahead.

We've still got work to do on Snacks for sure, but we are starting to see signs of the return to growth we expected this year. Growth will accelerate in Crackers and Pringles, with more brand investment, a focus on assortment and formats and exciting innovation coming here in the back half.

We've got advertising coming on Cookies with the Keebler Elves returning. We'll get past this sales transition in Q2, and we've got much in the way of improved innovation that should start coming in Wholesome Snacks later in the year to turn that business as we go forward.

So now, let's turn to slide 16 (sic) [15] (25:42), and the highlights of the U.S. Specialty segment. Our Specialty Channels business posted good mid-single-digit net sales growth in Q1, with net sales growth in all channels and a balance between price realization and volume growth. Leading the way was double-digit growth in the Convenience channel, which featured strong consumption and share growth in Cereal, Crackers, Rice Krispies Treats, Pop-Tarts, and Salty Snacks.

Foodservice also recorded good sales growth, led by Cereal, Wholesome Snacks, Pop-Tarts, Cookies and Salty Snacks. We also saw distribution gains in Vending in various categories, and we had a strong Girl Scout Cookie season.

Slide 17 (sic) [16] (26:32) shows the North American Other segment, which includes the U.S. Frozen Foods, Kashi and Canadian businesses. Net sales for the segment were down, but we're making good progress in each of the businesses. In Frozen Foods, our Eggo business was down because of last year's SKU rationalization and a shift in the timing of innovation this year to Q2 from Q1. But excluding the cold SKUs, Eggo grew consumption in Q1. Similarly, our MorningStar Farms business felt the impact of resetting the shelf with our new resealable packages. But where we have converted to the new packaging, we are seeing positive results, and this conversion is now largely behind us.

Frozen Foods will see better performance as we get past these colds and resets and as we see the benefits of advertising on Eggo and MorningStar Farms, a promotional tie-in with the movie Finding Dory and some great innovation

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launching right here in the month of May.

Last, our Kashi business posted lower sales year-on-year in Q1. We did see sequential improvement led by Cereal, where we maintained share overall and gained share in the Natural Food channel. In addition to our renovation efforts, we've got great new products rolling out soon, including new Kashi and Bear Naked cereals, new gluten-free crackers, and some great savory granola bars. In addition, we're introducing here in May the plant-based protein powders we showed you at CAGNY a couple of months ago. All of this means that we expect continued improvement as we progress through the year.

And finally, in Canada, we saw good performance by both Cereal and Snacks. Cereal posted gains in net sales consumption and share led by core brands and the continued recovery of Special K, which grew 6% and gained 40 basis points of share.

So let's turn to slide 18 (sic) [17] (28:36) and the summary. Hopefully, you have a sense for the progress we are making on our priorities. We're continuing to gain share in U.S. Cereal and our Core Six brands are performing well. Our core snacking brands, including our Big Three Crackers and Pringles, are gaining momentum. The Frozen Food business is poised to return to growth on the strength of innovation. Kashi performance continues to improve as we get the food right and new products arrive in the market. Significant savings from Project K and ZBB are driving strong gross margin and operating profit growth.

I'm confident we've taken the right actions across the region to invest, drive growth, and increase margins. So finally, I'd like to thank all the members of the North America team for their hard work. We're making great progress together.

Now, I'll turn it back to John.

## John A. Bryant

Thanks, Paul. Now, let's turn to slide 19 (sic) [18] (29:36) and our European business, where sales declined slightly in the quarter. However, we did see some pockets of growth, particularly in the Pringles and Wholesome Snack businesses. The Pringles business in the region posted high single-digit growth in the quarter. This was led by sustained momentum in key markets and expansion of Pringles Tortilla into new markets.

Pringles posted strong share performance in the region, with share gains most pronounced in the UK and Germany. The Wholesome Snacks business also posted high single-digit sales growth, led by continued good performance in the UK, in Russia and in the Mediterranean Middle Eastern region. We've launched some great food and the business has responded.

However, our Cereal sales remain soft, particularly in the UK and France. Much of this is due to the timing of investment. As I mentioned earlier, our innovation launched later in the quarter and we have promotions tied to the Euro Soccer Tournament and the Olympics planned for the summer.

Over the balance of the year, we're investing in our food. Specifically, we have new innovation including Ancient Legends and Special K Nourish, which is similar to the product that recently launched in the U.S. And we will continue to work on the underlying fundamentals, including focusing on increasing our distribution in alternate channels. We also have a plan that has more support in Q2 and the second half than in Q1.

We expect a slight increase in net sales in the coming quarters on sustained growth in Wholesome Snacks and sequential improvement in Cereal, as the brand building investment begins to pick up in support of innovation and the promotions. We also should see continued expansion of our Pringles business.

Slide 20 (sic) [19] (31:23) highlights the performance of our Latin American business in the first quarter. As was the case for much of last year, the impacts of pricing in inflationary Venezuela drove double-digit currency-neutral comparable net sales growth in the period. We continue to manage the Venezuelan business very carefully, navigating local supply and power outages. Despite this, we gained share in Venezuela in the quarter.

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Excluding the Venezuelan business, sales in the region declined by 2% in the quarter, driven by Cereal and softness in two markets. In Mexico, where we compared against strong year-ago growth, we saw a reduction in trade inventories and the timing of promotional investment, and these factors pulled down our net sales. However, our consumption in Mexico increased, and we gained share across our Cereal and Snacks categories, driven by strong innovation and commercial activation.

In the [ph] Mercasol (32:20) region, we felt the impact of economic softness and trade inventory reductions in Brazil, especially where we lapped difficult year-ago comparisons. The good news is that amidst this economic softness, we did increase our share of the Cereal category and Wholesome Snacks category in Brazil. And I'd also like to point out consumption and share gains in Colombia was better than our shipment performance in Latin America. We launched new products late last year and in Q1 of this year, which are contributing to the consumption performance. Specifically, the launch of Special K Protein, which I mentioned last quarter, has gone very well.

Meanwhile, the region's Snacks business continued to perform well, posting mid-single-digit sales growth, with growth and expansion in markets like Mexico and the Andean and [ph] Mercasol (33:11) regions. The Pringles brand grew at a mid-single-digit rate, and we believe that we have considerable upside in this brand.

As we said on the Q4 call, the macroeconomic conditions in the region are challenging, but we've seen some good results in many parts of the region, especially in our in-market performance with the share gains I mentioned. So we remain on plan to improve results, ex-Venezuela, as the year progresses.

Let's look at slide 21 (sic) [20] (33:38) and our Asia Pacific business. Currency-neutral comparable sales growth for the region was approximately 1%, although sales would have increased at a mid-single-digit rate if the impact of the joint ventures in China and Africa were included.

In Asia, our sales increased at a high single-digit rate, with strong growth in Korea, Hong Kong and Taiwan, Southeast Asia and Japan.

We reinvested in the Pringles business and launched new products, both of which helped to drive mid-single-digit sales growth for the brand in the quarter. In Australia, sales declined in Q1, although we saw sequential improvement. And year-to-date through April, we've gained share in the Cereal category. We also have innovation planned for introduction in Australia beginning in the second quarter. This, in combination with new support, should contribute to the improving trend that we've started to see.

In summary, our plans for the overall business are exciting, and we expect improving performance over the remainder of the year. So let's turn to the summary on slide 22 (sic) [21] (34:46). On last quarter's earnings call, I mentioned four reasons to believe that we are building momentum in 2016. First, we are investing in our food and packaging. We saw this in Q1, with cereals like Special K Nourish driving improved performance in the U.S. and Canada. We rolled out GMO-free Kashi products in the U.S. and new resealable packaging in MorningStar Farms. In Europe, we saw good success in new granola and muesli offerings, and we'll see more consumer-driven renovation and innovation as we go through the year.

Second, we are expanding Pringles. This could be seen during Q1 with our growth across every region. This will continue to be an avenue of growth for us in the future.

Third, we are enhancing our sales capabilities. We took action in Q1, as evidenced by our reorganization in U.S. Snacks, the continued progress of additional feet on the street in Morning Foods and expanding our presence in high-frequency stores in Latin America and Asia. Winning where the shopper shops is a key strategic pillar for us and we should see even more benefit from these capability investments as the year progresses.

And finally, increasing our earnings visibility by Project K and ZBB; this helped drive profitability already in Q1. And behind the scenes, these initiatives are creating a cost discipline and spending behavior that can yield more savings and more earnings visibility going forward.

So I'm happy to report that we are on track on all of these. I've also stated that we should see steady improvement in our performance as the year progresses. The plan is designed that way, with bigger reinvestments ahead, savings

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developing as the year progresses and some hurdles coming early in the year and giving way to better performance later. In short, we expect momentum to build through the year.

And now, I'll open it up the questions.

## Q&A

### Operator

We will now begin the question-and-answer session. [Operator Instructions] The first question comes from Dave Palmer with RBC Capital Markets. Please go ahead.

<Q - David Palmer>: Thanks, two questions. Good morning. Paul, could you go into what exactly were those sales structure changes and how do those relate to the investments in feet in the street that Kellogg's has made in recent years? Thanks.

<A - Paul T. Norman>: Okay. So specifically, regarding the changes in Snacks, the change was designed to separate sales and merchandising functions within the sales force to enable better focus and execution between setting up and merchandising. It's as simple as that. It does come on top of previous investments we've made in our DSD, specifically sales force, in terms of technology, which obviously will unlock some of the benefits of the technology as we do this as well.

So it's separate from anything we've done in Morning Foods and feet on the street, but it is a continuation of building more effective and efficient working practices within our DSD sales organization.

<Q - David Palmer>: And do you think that there's just a learning curve that needs to happen for the merchandising to come? Is that what happens?

<A - Paul T. Norman>: Obviously, any disruptive change is disruptive. And so when you touch as many sales people, merchandisers in the context of customers, there is some disruption. So many people find themselves in new roles calling on new stores. And so we anticipated that. We've seen a bit more on the incremental side in terms of display, especially on Cookies and Crackers, but we're largely through that now as we come into the month of May. And so we expect things to pick up from here.

<Q - David Palmer>: And then, just circling back on U.S. Cereal and, for that matter, overall U.S. Packaged Food, even if you exclude Easter noise and look through the latest period year-to-date, it looks like the overall growth rate in the industry is just less than what it was last year. Have you seen any good reasons for this? And do you think you can drive revenue improvement, even with the type of growth that we saw in the first four months or so?

<A - Paul T. Norman>: It's interesting. I meet with a lot of customers. I haven't met a customer yet who doesn't want to engage with big brands to drive growth. So I think our focus across all our categories is very much on building winning plans for our customers. The bigger the idea, the better you execute it, the more impact you'll have in-store. I think specifically to Kellogg, there's a little bit of timing in the Cereal business, where we were very strong last year in March, April because of The Avengers promotion. Our big idea this year is the Finding Dory movie, which launches in June. So there's a little bit of timing in there, but we feel very good about the quality of our plans, our brand communication and our innovation ideas as they come to market here.

<Q - David Palmer>: Great. Thank you very much.

### Operator

The next question comes from Michael Lavery with CLSA. Please go ahead.

<Q - Michael Lavery>: Good morning.

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<A - John A. Bryant>: Morning, Michael.

<Q - Michael Lavery>: I know you talked about the DSD changes and some of the disruptions there. How much of an effect did that have on margins and how much of that is temporary?

<A - John A. Bryant>: In the quarter, in terms of gross margins, or operating margins?

<Q - Michael Lavery>: Yeah, on the operating margin.

<A - Paul T. Norman>: If you've seen the reported data, the Snacks business did pretty well on operating profit through the first quarter, so there's no real near-term impact on margins. There was some sales disruption, as I said, when it comes to our performance on display at the top line. Now, we're hopefully through that and we move forward. We expect this to be a more effective and more efficient way of operating going forward.

<Q - Michael Lavery>: It sounds like some of the transformation you made, it doesn't add any fixed costs or I'm just trying to get a sense of, even with the performance in the quarter, if there's a different trajectory for how that business looks?

<A - Paul T. Norman>: No, there's no cost addition to this at all. In fact, it'll be more efficient and effective going forward.

<Q - Michael Lavery>: Okay, nice. Thanks. And then just one other on Kashi, could you give a little better sense of some of the moving parts there? I know you've still got some innovation and marketing efforts there to turn that business around. What's the latest update in a little bit more detail?

<A - Paul T. Norman>: If you look at the Kashi business over the past 18 months or so now, or at least 15 months, we continue to see sequential improvement in the performance of the business. As you are aware, we put the team back in California just over a year ago. We're seeing especially our Cereal business perform a lot better. Share was flat in the first quarter. We're actually growing the business now in the Natural channel, and the team's been really working hard at building a pipeline of ideas to get back ahead in terms of a food-focused, mission-based operation.

So we have new Kashi and Bear Naked cereals launching here now. We have savory granola bars launching at the end of the second quarter. We have some culturally-inspired crackers that I've spoke about before. We have granola bites coming from Bear Naked at the turn of the quarter as well in the third quarter. And we have a brand new range which is shipping now of Kashi GOLEAN and Kashi branded protein powders to lean into new segments with the brand. Of note, our Bear Naked Granola business is growing at a good mid-single to high single-digit click. So the Granola business in Bear Naked does well.

One more part of the Kashi Company is Stretch Island Fruit Snacks, a very small business we don't talk a lot about, but that's growing at a strong double-digit rate as well. And we've reinvented that food, made it all organic, invested back in the food there as well. So there's been a lot of reinvestment in food to renovate and now a lot of innovation about to come, which gives us the confidence we're going to get this business back to growth over the coming months in 2016 and into 2017.

<Q - Michael Lavery>: Okay. Thank you very much.

## Operator

The next question comes from Rob Moskow with Credit Suisse. Please go ahead.

<Q - Robert Moskow>: Hi. I guess I'll focus my question on European Cereal, because the declines you're experiencing now seem to be on top of declines a year ago and maybe even a year after that. And, John, you've made management changes in Europe. You've tried introducing some innovation along the way. If you had to do like a root cause analysis as to what's happening there, why hasn't it stabilized like the U.S. has? And what should give us confidence that the new innovation you're talking about for second quarter – why is that going to stabilize the business?

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Maybe start there for me.

**<A - John A. Bryant>**: Sure, Rob. I think if you come back and look at the U.S. business over the last couple of years, we said there are two big brands in the U.S. that we needed to fix. One was Special K. One was Kashi. In both cases, where we've put on-trend food in the marketplace, we've seen consumers respond to that very positively. And you've seen those results come through in the U.S. results last year and into this year. Same is true in Canada. And, as I said in the prepared remarks, in Australia, we're also seeing significantly improved results through first quarter on the back of improved food that's more on-trend with what consumers are looking for.

The same will be true in the UK. So we have four large cereal markets, U.S., Canada, Australia and the UK. The UK is the last one for us to turn, but we believe, again, putting the right food in the marketplace for consumers is going to make the difference. The Ancient Legends food that we had at Day at K is more of a granola, great taste, visible nutrition-type food, as is the Special K Nourish food that's being an important part of the Special K turnaround in the U.S. and the Special K Red Berries renovation in the U.S. we'll also have going into the UK market as well. A lot of those food changes, though, got cut into the shelf in the later part of Q1. So we do expect to see the business respond to that.

I don't necessarily expect to see the European Cereal business get back to growth in this year, but, in many respects, that Cereal weakness in Europe is masking some very strong growth in other parts of the European business. So when you have Pringles up high single digits and Wholesome Snacks up high single digits, we clearly have the ability to execute if we have great food in the marketplace. We had great food behind Cereal. I have confidence we'll see our European top line trends improve as we go through this year.

**<Q - Robert Moskow>**: Okay. Can I ask a follow-up on Wholesome Snacks? You talked about some innovation that's coming, but I think you mentioned Cocoa Krispies with M&Ms. Can you give us some examples of some wholesome snacks that are a little more wholesome that are coming in the back half? I think you said Special K Trail Mix. There's a lot of trail mix items out there. Is there anything really innovative coming?

**<A - Paul T. Norman>**: Rob, it's Paul. Obviously, turning around Wholesome, as we said, is going to take a bit of time. And it does mean a focus on food and a focus on core brands. So Rice Krispie Treats is a great brand that plays in a certain segment within Wholesome Snacks and has been doing very well and it's a question of fueling its growth, so those things fit.

When you come across to Nutri-Grain, looking forward on Nutri-Grain, it's really reinvesting in the core soft-baked bars. And we have two initiatives coming: one, a pumpkin spice initiative; another one with chocolate and raspberry, which is very close in to what Nutri-Grain stands for.

Beyond that, as you lean toward the healthier, if you like, perceived elements of wholesome snacks, we've already renovated many of our base Special K bars. And since those renovations there are doing better, we are now bringing protein trail mix bars to Special K.

And then the one or two brands that really I think need to step up and step in here to broaden out our portfolio and our growth are actually coming from Kashi and Bear Naked because they have really been absent over the last two, three years. And therefore, we're renovating our core Kashi granola bars. We're bringing new to the world savory bars on Kashi. We're bringing new granola bites from Bear Naked as we go into the end of the second quarter here. And you'll see more innovation coming on bars from Kashi and Bear Naked in that, what I would call, lifestyle performance area of wholesome snacks. So you have to look at the whole picture to think about how we innovate and renovate across every segment. Again, the turns are not going to come overnight, but we've spent a lot of time with a lot of customers talking about our view for the future, and there's a lot of encouragement coming about how our portfolio can play to win as we look forward.

**<Q - Robert Moskow>**: Okay. Thank you.

**Operator**

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The next question comes from Ken Goldman with JPMorgan. Please go ahead.

**<Q - Kenneth B. Goldman>**: Hi. Thank you for taking the question. You talked about Special K Cereal doing well. At least in the Nielsen numbers, and I know it doesn't tell the whole story, the brand seems to have trailed off a little bit in recent months. And now takeaway is trending somewhat negatively again. I don't know if that's truly reflecting what you're seeing, but if it is, we're also seeing Kashi still doing much better, but still negative year-on-year, too. So I guess the question is what needs to happen in terms of innovation or marketing for these brands to sustainably grow very positive takeaway year-on-year, so that we really don't talk about them as sort of restoration products any more?

**<A - John A. Bryant>**: I'm not sure the data you're looking at, Ken. I mean, Special K was up about 3% and gained 30 basis points of share. The Red Berries initiative, that part of the portfolio was still growing at north of 5%. So the brand is growing. There may be some timing of activity year-on-year where we launch Red Berries so you may be something in the near-in data that might look strange, but the underlying trends, as we see them – and now with Nourish just gearing up, we have some great seasonal items coming in Q3 as well on Special K. We think the brand is back on its stride. I mean, I don't think it's going to be growing double digit year-in, year-out, but it should be a contributor to growth across our core portfolio going forward.

So we feel good that we've got it growing. I mentioned in Canada, where we've done something similar, the Canadian business is ticking up as well. And so when we think Core Six brands and growing across our major customers, K's a huge component part of that. And so we're happy with the progress we've made.

**<A - Paul T. Norman>**: Maybe just to comment at a macro level, I think when the category was soft, and this is true for all of the large markets, it really had to do with some of the adult brands not doing well. And now the adult brands are doing much better, with Kashi coming back, with Special K, even a brand like Raisin Bran doing a lot better. And bringing adults back into the category and driving adult consumption I think is what happened across the 2000. It helped drive the category then, and that's our focus as we drive forward here.

**<Q - Kenneth B. Goldman>**: Okay. Maybe I'll follow up offline about the Special K stuff. But, John, one follow-up from me, you made some comments at the end of your prepared remarks about some ZBB. It sounded to me as though maybe you're sensing some upside, possibly not this year but down the road, to the guidance of \$100 million. Is that the right way to think about it or is it just too early to be confident in the out-year outlook here?

**<A - Ronald L. Dissinger>**: Ken, it's Ron. We're confident in the \$100 million. There is no doubt about that. So we're still on track within North America to deliver against that. As I mentioned on our fourth quarter call, our international regions would start progressing their zero-based budgeting initiatives early in the year. They have done so. They're identifying targets, assessing the discretionary spend across similar categories as to what we did in North America. That is progressing extremely well. We do expect to see a little bit of savings from the international regions in 2016, but most of that will come into 2017. North America, by the way, also in the first quarter, was on plan. We had embedded the zero-based budget savings into their plan, and they were on or slightly above plan, frankly. So we're in good shape on the program.

**<A - Paul T. Norman>**: And just on zero-based budgeting, it both delivers savings but also provides a great tool and mechanism just to challenge historical assumptions and to challenge in maybe some areas where some investment was happening that were not getting the return and move it to areas that we are getting good return. So it's not always just the savings that comes out of it so much as the underlying methodology and driving and pushing on key assumptions.

**<Q - Kenneth B. Goldman>**: Great. Thanks very much.

**<A - Paul T. Norman>**: Thank you.

## Operator

The next question comes from Alexia Howard with Bernstein. Please go ahead.

**<Q - Alexia Jane Howard>**: Good morning, everyone.

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

<Q - **Alexia Jane Howard**>: You mentioned negative category and channel mix just that caused some headwinds to gross margin this quarter. Could you elaborate a little bit on that, as well? And just as a follow-up, the Cereal category seemed to be getting into some more stable position a few months ago. And now, it seems to have slumped back again. How close are you getting to retailers talking about shrinking the size of the category? What are your distribution and shelf space trends at the moment? And what's the outlook there? Thank you.

<A - **Ronald L. Dissinger**>: Well, Alexia, first on the category and channel mix, so across the business, we're seeing a little bit more adverse mix as a result of some of our big developed Cereal markets and the trends in those businesses and, as Paul mentioned, the transition that we're doing in U.S. Snacks, very profitable business for us both from a gross margin standpoint and profitability standpoint. So as they go through that transition, sales were down a little bit more than we had expected. That had an adverse impact on our mix. And as we're growing in some of our emerging markets, we're seeing a little bit adverse impact in mix. But as I said in the prepared remarks, we expect this to improve as we progress through the course of the year and we build momentum on our sales outlook.

<A - **Paul T. Norman**>: Alexia, Paul. On the question about space in-store and retailers, we're not seeing anything at a macro level, but different retailers obviously have different strategies as to how they manage the category. So we have seen in instances, for example, number of sizes reduced in certain retailers, but we've also seen an increase in space for natural and organic, which has benefited, obviously, brands like Kashi for us.

So I think it really is a quest of always looking to maximize assortment. And we spend a lot of our time trying to maximize assortment holding power behind the fastest moving biggest items. So to me, it's very much a question about sales fundamentals and back to this notion of customers want big brands to grow. We need bigger, better ideas to help them grow. And so nothing at a macro level, but every retailer is different in terms of their strategy.

<Q - **Alexia Jane Howard**>: Great. Thank you very much. And, Simon, we'll miss you and looking forward, John, to working with you going forward.

<A - **Simon D. Burton, CFA**>: Thanks, Alexia.

## Operator

The next question comes from David Driscoll with Citi. Please go ahead.

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

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

<Q - **David Cristopher Driscoll**>: Two questions for me, just like little ones and then kind of a bigger one for you, John. Just the little questions are can you give us some sense of the cost savings pacing throughout 2016? And then, on Latin America, I think we begin to lap some of the big currency devaluations in the second half of the year. What kind of growth do you expect in profits after you lap all of that currency issue in LatAm?

<A - **Ronald L. Dissinger**>: Yeah, so, first, in terms of their cost savings that we're seeing, zero-based budgeting and Project K as well, it's spread relatively evenly over the course of the year. So we saw savings within the first quarter and we'll see savings as we progress through the year as well.

In terms of Venezuela, as I mentioned, we did this remeasurement at the middle of 2015. So we'll be past that after the second quarter. We do expect our sales trends to improve. And as those sales trends improve, that will improve our profitability performance. Remember, we've guided 4% to 6% operating profit growth on our ex-Venezuela business. We delivered 2% in the first quarter. So as you'd expect, we'll see more growth going through the balance of the year.

<Q - **David Cristopher Driscoll**>: Okay. And then, John, for – go ahead, John.

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<A - **John A. Bryant**>: Sorry. I was going to turn to your Latin American question there for a second and margins in Latin America. As you look across the company, you can see us investing back in the emerging markets. So Asia Pacific and Latin America, we're not looking for as much, say, margin expansion as we are from North America and Europe. Within Latin America, within 2016, it's fair to say that we're seeing a little bit more economic softness and a little bit more challenges in the southern part of Latin America than what we would've liked to have seen. We do expect to see operating profit growth on a comparable basis ex-Venezuela in the region, but probably more low single digits and sales growth [ph] in the sense of range, (56:47) again, ex-Venezuela just reflecting the difficulty in the marketplace.

<Q - **David Cristopher Driscoll**>: That makes sense. Big picture, John, last night, one of your major competitors reported. They show up with an operating margin at 27%. It was up 700 basis points year-over-year. You guys are running just over 15% on your operating margin. Can you just kind of frame up for us like what's the long-term opportunity at Kellogg? I mean, are we right to think that there really is a substantial operating margin improvements opportunity at Kellogg? And just love to hear your perspective on what's happening in this industry right now.

<A - **John A. Bryant**>: Well, David, as we discussed at Day at K and at CAGNY, we are committed to expanding our operating margins over time. We've set a goal of 17% to 18% operating margin by 2020. Clearly, we look very closely at what other companies are doing, our peer group and our competitors. One of the core values of the Kellogg Company is that we have the humility and hunger to learn. And we will look very closely at what's happening at Kraft Heinz and all the other companies in the industry. And if we see opportunities to improve the economics of our business and to drive shareholder value creation, we'll certainly pursue those.

<Q - **David Cristopher Driscoll**>: Okay. Thank you so much.

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

<A - **Simon D. Burton, CFA**>: Gary, this is Simon. I think we've got time for one last question, please.

## Operator

The final question comes from Bryan Spillane with Bank of America. Please go ahead.

<Q - **Bryan D. Spillane**>: Hey. Good morning, everyone. Actually just one question on phasing, Ron, I think you said earlier that there may be a little bit of giveback in 2Q, on the second quarter. So in terms of, I think when we started the year, we talked about the EPS being pretty much the same each quarter through the year. You over-delivered a little bit in the first quarter and maybe that giveback would be in 2Q. So could you just elaborate a little bit more? Did I hear that correctly? And, if so, is that still we've got some of the sales drag that kind of leaks from 1Q into 2Q? And I don't know if maybe there are some other expenses or other items that would just affect 2Q specifically versus the balance of the year?

<A - **Ronald L. Dissinger**>: No. Bryan, you're thinking about it correctly. When we started the year, on the fourth quarter call, I said expect our comparable earnings per share, and that includes the impact to currency, to be spread relatively evenly across the four quarters of the year. We did deliver a little bit more in the first quarter. And we said that might come out of the second quarter. And some of that is related to the timing of investments and activations that we're doing against our commercial programs and our [ph] innovation (59:26) as we move into the second quarter. So expect the second quarter to be a little bit lower than the average of the four quarters now.

<Q - **Bryan D. Spillane**>: Okay. Thank you.

<A - **Ronald L. Dissinger**>: You're welcome.

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This concludes our question-and-answer session. I would like to turn the conference back over to John Bryant for any closing remarks.

## John A. Bryant

Thank you all for your questions and interest in the Kellogg Company. At this time, I'd like to share with you the news that Ron Dissinger, our Chief Financial Officer for the past seven years, has decided to retire after 30 great years with the company. Ron has been a key member of our leadership team, combining a strong business acumen with a disciplined approach to finance. And I'm sure you all have enjoyed working with Ron as much as I have.

It may not surprise you that Ron will be retiring in a very careful, deliberate way. He will remain the company's CFO through the end of 2016. This will give us proper time to do a thorough search, both internally and externally, for his successor. Ron will also stay on into 2017 to ensure an orderly and effective transition, so we'll have good continuity. Please join me in congratulating Ron on a wonderful career and in thanking him for his outstanding service.

And that wraps up our call. Thank you and have a great day.

## Operator

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

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