Company Name: Kellogg
Company Ticker: K US
Date: 2017-02-21
Event Description: CAGNY Investor Conference

Market Cap: 26,244.14
Current PX: 74.74
YTD Change($): +1.03
YTD Change(%): +1.397

Bloomberg Estimates - EPS
Current Quarter: 1.010
Current Year: 3.949
Bloomberg Estimates - Sales
Current Quarter: 3306.429
Current Year: 12719.941

CAGNY Investor Conference

Company Participants

- Unverified Participant
- John A. Bryant
- Paul T. Norman
- Adrienne Deanie Elsner

MANAGEMENT DISCUSSION SECTION

Unverified Participant

Good afternoon. If everyone could find their seats for our next presentation. Welcome back from lunch. A couple of reminders before we get into the introduction here. There are charging stations in the back of the room for anything you need, a bunch of power strips in the back corners of the room. Please make use of those. Don't run long extension cords, random places. Please use those.

And as you leave the room for the day, I know you're not doing that now, but over the next few presentations and at the end of the night, please be sure to take everything you have with you. This room is used for rehearsals, and your stuff will be all piled up and thrown into a dark closet somewhere if you do leave it here. So, please take your stuff with you when you're done for the night.

Before I go ahead and introduce Chief Executive Officer, John Bryant and his team, I'd like to thank Kellogg's for delighting us all for many, many years with their breakfast, a tradition that they'll renew tomorrow morning. So, please join me in thanking them very much.

It's hard to believe it's been 15 years since John was introduced to us as the energetic, new CFO with a slide for everything, especially the questions you didn't ask but should ask. Since becoming CEO, there's been no let-up at all in the thoughtful, analytical approaches to making Kellogg better, whether it's been transforming volume into value, adding new capabilities in developing markets, or rethinking distribution in existing ones.

Alongside John today is Paul Norman, who marks 30 years at Kellogg this year and serves as President of Kellogg North America; and Deanie Elsner, the President of U.S. Snacks who joined in 2015 after a very successful 20 years in the Kraft system.

Also in attendance for today's presentation are Ron Dissinger, retiring CFO – congratulations, Ron – and Fareed Khan, soon-to-be rising CFO. Welcome to you, Fareed, and a different kind of congratulations, but congratulations nonetheless; and VP of Investor Relations, John Renwick, who is back at CAGNY after a long time after several executive roles within Kellogg.

So with that, John, welcome, thank you, and take it away.

John A. Bryant

Great. Thank you very much. Well, good afternoon. Seems odd to be saying good afternoon in CAGNY being the Kellogg Company, but good afternoon and we have quite a lineup for you this afternoon. I'm going to do a quick introduction. Paul and Deanie are doing most of the presentation, most of the discussion. Please join us tomorrow morning for breakfast. We'll have some of the new products. We'll have our team there. We'll have plenty of the [indiscernible] (02:37) and opportunity for photos. So, please come by and see our new products.

Before I get started, just refer you to our forward-looking statement disclaimer. Any questions, please refer to our SEC filings online. Also, it's my privilege and honor to recognize Ron Dissinger after 30 years with the Kellogg Company, the last several as CFO, for all his tremendous effort and hard work and to welcome Fareed Khan to the company as our new CFO. Fareed and Ron will be here over the next couple of days and I'm having an opportunity to thank them and to say hi to Fareed. And we're very excited to have Fareed onboard in the company.

In terms of the agenda, I'm going to give you an update on our 2020 growth strategy. And we've been making some meaningful progress here. But this isn't always obvious to investors because some of it is outside our reported results. Paul is going to talk about transforming our North American organization prioritizing to win, where basically North America goes, the Kellogg Company goes. It's our biggest region. And then within North America, our biggest business unit globally is U.S. Snacks. And we're transforming our U.S. Snacks business, and Deanie Elsner is here to talk about and obviously our recent announcement around DSD. It's a big reason for us to take you through this today.

On our 2020 growth strategy. Not surprisingly being the Kellogg Company, the first two of our growth strategy is winning breakfast. The second one is global snacking in powerhouse. The third is emerging market footprint and the fourth is win where the shopper shops. Firstly on win in breakfast, about 40%, 41% of our sales today comes from the breakfast occasion. And we're making good progress on this. We have four core cereal businesses that have been somewhat challenged in recent years, and we're seeing good progress in three of these: U.S., Australia, and Canada are all largely stabilized. And we believe we can get them back to growth over time.

UK is a little bit more challenged here recently. Quite frankly, we had Brexit impacting that business as well as increasing higher discount penetration in the UK trade environment putting more pressure on the entire trade in that country. So, more to do in the UK, but as you've seen in the other three core markets, we know the playbook, we know what needs to be done, and we're executing those programs in the UK as well. So, improving performance in that Core 4 cereal business.

When you get outside the Core 4 cereals is clearly a growth business despite demonetization in India or economic issues in Brazil, we are seeing good growth in our cereal business around the world. So we feel very good about cereal as a growth business globally. And if I come back to the Core 4, what gives me confidence in our ability to grow the Core 4 over time is we're seeing consumers eat cereal very differently. Yes, they continue to eat it at the breakfast occasion. But increasingly, they eat it in the evening. They eat it – kids eat it after school, et cetera. So, what a growth potential as you look at how the food is consumed, and Paul will talk more about our specific goals, our plans in the U.S. business.

Now, the company today is 41% in cereal. What I think may surprise you is at 50%, 50% of the company sales is actually in snacks. And Deanie is going to talk about what we are doing to transform our U.S. Snacks business. I'm going to focus here more on what we've been doing to transform our international snacks business. And Pringles really revolutionized our international snacks business, doubled or tripled the size of the business in certain key markets.

If we look at the growth in volume, so I'm going to do most of my slides here in tonnage to take out the impact of foreign exchange. As we look at that increase in tonnage from 2013 to 2016, 2013 is the first full year with Pringles in the base, we've seen about 8% volume CAGR over this period of time, and the biggest driver of this has been Pringles. And as you look at Pringles across the international market, we've done a tremendous job developing it in Europe and it's still very early days in Latin America and Asia Pacific and quite frankly in North America as well.

What has really helped us make a difference in our snacks business across international is our dedicated teams. So in the past, before Pringles, we had one combined business unit trying to do cereal and snacks. Now, we have dedicated teams in Europe, Latin America and Asia Pacific focused on snacking. That also helped us unlock the wholesome snacks opportunity across the international business. So we see very strong growth in the international snacks, and we're going to continue driving this going forward.

The other goal we set in our 2020 growth strategy was to make a step change in our emerging markets. It's a very ambitious goal of doubling the size of the emerging markets platform. And we've made more progress here than most of you realize because a lot of it is not within our reported results.

First, when you go from 2012 to 2016, we had seen about a 4% to 5% annual growth in volume across that time period. Add on to that our joint ventures, particularly in Nigeria. Now Nigeria is not within our reported results, but it adds almost a third more tonnage to our emerging market business. As a reminder, we made the largest investment of any food company in Nigeria, and with this joint venture, we are one of the largest food companies in Nigeria.

And then add to that the acquisition of Parati in Brazil acquisition of Parati in Brazil. Parati triples the size of our Brazilian business and changes the shape of our Latin American business. So after Parati, around 25% of our sales in Latin America comes from snacks, where in the past it was largely a cereal business. Parati adds about another 20% tonnage to our emerging market business.

So when you look at this, we're on track in 2017 to sell 80% more tonnage in the emerging markets than we did in 2012, but some of that's outside our reported results [indiscernible] (08:29) to be delivered from the Parati acquisition. So you see here a pretty dramatic change in the emerging market footprint.

Obviously, this is the – the emerging market is redefining trend in our lifetimes, on our careers in the food industry and it's still very early days in the emergence of the middle classes in these countries. We're excited to be making these investments and we'll continue to do more to expand our emerging market footprint.

The fourth one is win where the shopper shops. As we become more of a snacking company, as we drive more into the emerging markets, we need to be within arm's reach of desire. To do that, we're investing in high frequency stores, whether it be C-stores here in the U.S. or mom-and-pop stores in Mexico and around the world. Obviously, acquisitions like Parati gives us distribution scale in some of these markets, but also having the right portfolio is important. So having Pringles in smaller cans, having individual cereal bars, having small sachets of cereal, all targeting key price points is critical to high frequency stores. And we recognized the retail landscape is going to change dramatically over the next decade.

eCommerce is going to be a major disruptive force in our industry. Today, about 1% or 2% of our sales in the U.S. goes through eCommerce. There are some markets in Europe where as much as 10% of our sales go through eCommerce. And in China, 30% of our sales go through eCommerce. We're going to see eCommerce continuing to grow around the world, and so we're positioning ourselves to take advantage of that by making investments, build internal capabilities to be the partner of choice with our retail partners, to be a thought leader in this area.

We're making good progress against all four growth [ph] pillars (10:10): improving performance in cereal, dramatic growth in snacks particularly internationally. We're seeing good emerging market footprints and investing back to win where the shopper shops.

In addition to all of this, we're on track to hit our 350 basis point margin expansion from 2015 to 2018. You see it coming through in 2016 and our 2017 guidance has this as well. As you think about our margin expansion though, as we think about our company, we are focused on having on-trend food and packaging. Quite frankly, that means we're investing back in our foods which is a headwind against our margin expansion goals. We're absorbing that and still on track for our margin expansion target.

We're also absolutely committed to having strong brands. That means building brands in different ways, and we've seen these sorts of transformational changes before in our industry from print to radio, from radio to TV, from TV to social mobile digital. Today, we're increasing these [indiscernible] (11:05) different channels, driving for improved ROI and driving for impact on our brand building model.

We have on-trend food, strong brands. We can improve our price realization and our revenue growth management program is targeted at achieving exactly that. And then, we have unprecedented productivity programs with Project K, with zero-based budgeting and our normal ongoing productivity programs. So with all of that, we are on track to hit the 350 basis point margin expansion by 2018.

Let me now hand over to Paul Norman to take you through our North America, prioritizing the win strategy. You can see in this strategy we have strong pockets of growth in North America and a real opportunity to get this business back to growth for the long term.

Over to you, Paul.

Paul T. Norman

Thanks, John. Good afternoon, everyone. I am going to talk to you about how we're prioritizing to win in North America with a view to driving long-term sustainable, profitable growth in our North American business, and I'll do this with Deanie as we unpack our portfolio here. For those of you who aren't super up to speed with our portfolio in North America, it's a $9 billion business. You can see the categories we play in. Our brands are iconic and hold leading shares across the majority of the places we play.

Now, let's get into detail about how we're making choices within our portfolio, and I'll show you a fairly familiar matrix in a second, how the money is following those choices in our portfolio, and what capabilities we've been building to ensure that we do drive the best performance when it comes to execution across our company in North America.

We think simply about our portfolio and this wouldn't be different to many others. There are four what I would call buckets, four sides to this. One is the core, and I'll talk through in more detail about the core of our business in a second. We have what we call invest to grow, those brands that are already growing that have potential to accelerate in the future. We have a group of brands in our business, and this is [indiscernible] (13:10) agnostic for this purpose of this conversation, that have significant potential, are on trend but are not performing as they should in today's environment.

And then we have a group of brands that I'll talk to you in more detail. They're really managed for profit. These aren't necessarily brands that are going away. Some of these brands are really important, play important roles from a repertoire point of view in our portfolio.

Now, how do we build this? We spent two years really understanding how the consumer thinks about the brands they buy and the categories we play in and how the shopper shops these categories. We've looked backwards, but importantly we've looked forwards as to where we think demand is going and how we need to position our portfolio to win in the future. And we've also looked in detail of our brands themselves and really interrogated their right to win as we think about how we put resources, focus resources to grow going forward.

We've laid that on top of our economics, our financial model because we know today where we make our money, and the purpose of this is obviously to look forward and understand how we get resources against the highest returning activity, the highest returning brands in our portfolio as we go forward.

So let's go into this in a bit more detail, the core of our portfolio. It's about 40% of what we sell in North America. Examples of the brands in the core as you would expect are big 6 cereal brands: Pop-Tarts, Eggo – Eggo waffles. This portfolio over the past three years has been down just under 1%. These brands are huge in terms of their reach and the numbers of consumers and the breadth of needs they get after. So we have significant scale. They also have high margins. We've seen these brands stabilize over the past two to three years and our aim is to get these brands moving back to growth as we go forward.

If I dip into the Core 6 cereal brands, we've seen these brands perform better in the recent couple of years. Our consumption is getting better and our share performance in the category is improving. The recipe for this will continue to look hard at as we go forward, but investing in our foods, making sure our foods are on trend. This has taken place in the form of investment in renovation. We did Red Berries two years ago. We invested in Raisin Bran Crunch last year. This year, we're placing a big investment back into our core Mini-Wheats food to drive delight of our biggest brands to our largest basic consumers. We also continue to innovate around the edges of our brands where we see incrementality and return on investment. Frosted Flakes Cinnamon is doing extremely well out of the gate and answers the need that our portfolio wasn't answering today in the marketplace.

Craig Bahner talked about brands that matter, firing on all cylinders when it comes to communication and ideas to bring our brands to life in relevant ways with today's consumer and then taking that to the store and bringing to life the center store as I've always said with fun in the box and the impact inside our retail environment. We have a great property, Despicable Me coming in the second quarter this year which we think will be huge across not just cereal but the whole company. So we invest in our foods. We renovate to add value. We unlock opportunities for growth. We invest heavily behind these brands and we bring that fun to store.

Think about Pop-Tarts, a huge brand for us here in North America. In measured data, it's a $700 million brand. It's grown 34 of the last 36 years in the U.S. Last year, it grew again and it grew share. The secret success in the Pop-Tarts brand is constantly being relevant to the team target, whether that's in communication on how we engage that consumer or whether that's in the foods we make so that those foods are hot and trendy at all points in time.

Last year, we launched an A&W root beer flavor and an orange crush flavor. Being from England, I didn't know what either of those were, but they performed extremely well. We're in the market now with Dunkin' Donuts flavors, and we have some great flavors inspired by Jolly Rancher that come in the middle of the year. Keeping our food relevant in this way has kept this brand constantly [ph] only (17:21) up over the last 30-plus years.

One big opportunity, we've started to lean in and we've seen good results in the specialty channels, i.e. convenience, foodservice and vend, and we expect to see more in mainstream retail is putting more Pop-Tarts with more hands and mouths in single serve. It's a massively underexploited opportunity for us given so much of our business today still goes through in-home consumption. We'll go to the Eggo brand, another huge brand, pushing $700 million in sales as well. It's had a bit of a bumpy ride in 15 of the last – 18 months of the last 24 months, partly because of egg inflation.

And as we came through that, we have reinvested in the back half of the year heavily in brand building, behind the brand, and we're seeing consumption and share come back on the business. And we have a huge program this year around innovating against our core. We know Eggo [ph] mums (18:16) and Eggo purchasers would like us to remove the artificials. We've done that in Eggo.

We're also investing in what we call family fun again. This frozen aisle needs the traffic. We need to encourage shoppers down the frozen aisle. So putting in products as you can see here like Despicable Me and the Spiderman-themed Eggo waffles generates excitement and request in the family and drives excitement down the aisle. And then we're increasing brand building this year with a very much focus on taste and versatility, given that this brand has always stood for irresistibility in the way it talks to its consumer. So that's our core.

Let's go to the invest to grow bucket. About 25% of our business growing at a mid-single-digit rate over the last three years. The three biggest brands in here, which make up the large amount of this 25% are Cheez-It, Pringles, and Rice Krispies Treats. As I said, we've seen strong growth and we expect more strong growth, and we're going to invest to drive more growth. These brands have great margins. These brands, if you look at the foods, are highly differentiated and unique in the places they play.

And through the work we've done looking at consumer demand on how shoppers shop, we see enormous potential to expand consumption on these brands. Deanie will go into more detail obviously, as she talks about the transformation of snacks and exiting DSD. One of the reasons to exit DSD is so that we can get more of investment against these big differentiated brands to accelerate their growth across all channels.

If you take Cheez-It to start off, a $1 billion brand, growing for 20 years, grew well again in 2016. Our goal here, invest more in the core, expand channels in occasions and source from adjacencies outside of crackers through innovative foods as well as our base foods.

Pringles has room to grow, similar story. We should need and want to invest more in our core from a brand owning point of view. This brand has potential to expand more across channels and unlock all kinds of new occasions to consume through smaller formats. The smallest format on this page is called a snack stack, you barely see it up there. That format is growing at 25% a year and putting Pringles in more places for more use, more consumption is a big bet for us going forward. So more to come on Pringles.

Deanie will also talk to one of the jewels in her portfolio, which is Rice Krispies Treats, growing at a high-single-digit rate over the past three years. [indiscernible] (20:54) a brand we can do a lot more with. Same reasons, more investment behind the core of this brand, expand it to channels and occasions, and as mom's favorite treat for her children, how do we capitalize on seasonal and licensing opportunities to make this brand grow even faster as we go forward.

Now let's look at the realize potential bucket. Like I said, these brands, in my opinion, should be growing. They're on trend and they should be moving forward. Unfortunately, they've been underperforming in the recent past. I'm talking about brands like Kashi, MorningStar Farms and our wholesome snacks business particularly the Special K component of our wholesome snacks business because Rice Krispies Treats and Nutri-Grain have been doing much better. So, significant potential but underperforming.

We spent the last 18 months investing in our foods and our packaging. We have seen those sales declines. We are seeing them moderate, and we are looking to get back to growth in the future. These brands or this section of our portfolio, the realize potential section of our portfolio, is about 15% of our sales. It actually represents, if you look at our decline in sales over the past three years, 50% of the decline. These brands are pivotal. We get these right, we really can believe in a low-single-digit growth algorithm going forward.

[indiscernible] (22:18) on Kashi. I'm feeling quite happy about where we are on the cereal business right now. The cereal business grew in the natural channel last year for the first time in several years about 7%. We continue to – we've renovated. Now, we're innovating on our portfolio, and we're now back on air with the Kashi brand for the first time in probably three, four years seriously. We are renovating and innovating heavily against wholesome snacks. The trend on wholesome snacks is sadly behind the trend on cereal. I expect cereal to grow this year across Kashi and Bear Naked.

I expect a sequential improvement, if you like, in the decline of our wholesome snacks business, with the turn coming later in the year or into 2018. But our cereal business is healthy. We expect it to grow. And when you think about those Core 6 cereals and you think about a healthy Kashi and Bear Naked cereal business, you have reasons to believe we can get the category back to growth.

Another key component here is obviously Special K. Deanie will talk to Special K in the context of transforming snacks. Where we've renovated food, the brand is doing better, and that transformation continues. We have eight new items hitting stores as we speak under the Protein and the Nourish brand, real food bars and bite formats. And we're back on air – or back talking to consumers on the brand for the first time in a while. That's all happening as we speak here through Q1 into Q2.

So, reinvesting in K. We expect a sharp decline in the rate of decline in Special K this year with a view to getting back to growth as we can put more resources behind the brand in the future, as we get out of DSD.

Now, manage for profit. Probably three things to say about manage for profit. About 20% of our sales. Manage for profit in our world, as we look at our portfolio, is not all about things that are going away. A big portion of manage for profit for us are brands that don't really have the scale to be core, but play really important roles from a repertoire point of view in our portfolio, our businesses like cookies and cereal. Repertoire is really important as we look to satisfy consumer needs. So these brands are stable and play important roles in our portfolio.

A second category would be brands that we do expect to disappear over time. And we're not going to do a lot to keep these brands. And if you think about things like Kashi pizzas or breakfast drinks, these are all exiting our portfolio as we speak.

The third bucket, to be honest with you, maybe brands or portions of our portfolio where they're home maybe better somewhere outside of the Kellogg Company. It's not a big part of our portfolio, but we're constantly looking to rationalize not just SKUs, but our portfolio to make sure that our portfolio is the portfolio we can win [ph] where that's (25:06) best suited to us going forward.

So there's three buckets. By far the biggest bucket is those brands that play a repertoire role that are performing quite stably within our portfolio today. So there you have it. A simple way to look at what we make and where we sell it.

Our core business, low-single-digit growth; invest to grow growing mid-single-digit, we want to keep that going, if not accelerate that. Our realized potential have been down mid-single-digit. We expect and we'll play to get that back into growth and then manage our profits, some limited declines as we exit some parts of that portfolio. But when you put that together, you have an algorithm that can deliver long-term, low-single-digit growth in our portfolio.

Behind this, we're making deliberate choices about where we put our resources as a North American part of the company. And we're shifting our investment to where the full potential is on our brands.

So let's talk about investment just quickly. John talked about the new marketing model a little bit, but what's important as we look at how we manage our portfolio almost in a BU agnostic, business unit agnostic way is that we deploy our human resources, our brand building resources, our capital resources against those brands that have the highest potential and the highest margins as we go forward to grow or to sustain our business.

It's been a big part of the decision to go from a push to a pull model when you see the caliber of some of those snacks brands and the need to invest more to drive more growth from a consumer pull point of view, the big part of our decision to exit DSD.

From a marketing mix point of view, as John talked about how the consumer is thinking differently, the days of marketing mix modeling, placing a bet and then [ph] 15 months (26:55) later, understanding how you've got, what you've got the year before are gone. We're far more into agile return on investment calculations in real time to influence our mix as the consumer who buys our foods, behaves in different ways and we interact in different ways particularly digitally.

And then to close – before I close, there's a new marketing model capability. As I said, Agile ROI and data analytics from our supply chain right from the store back together helping us make better decisions. The demand chain aspect of understanding consumer segmentation and shopper habits applied to our economic model is giving us much more clarity around where we see demand for our products, our brands in the future on what really is incremental and what isn't incremental to our business. Because there's not a lot of growth to be had in many of the categories in which we compete, but you want to go for where the real incremental highest returning opportunities are and avoid those cannibalistic – margin cannibalistic opportunities as you go.

That leads to revenue growth management. [ph] I talked about it (28:04) every retail environment. Having our packaging and our opening price points fit for every retail environment is critical to revenue growth management.

We're 18 months into ZBB where we've chopped and cut all the waste, if you like, out of our portfolio. Every dollar that isn't being invested in something the consumer is willing to pay for or we see a benefit back from the consumer is gone. And now the next phase of the journey, coming to market in different go-to-market models does not optimize how we play as a company to be as effective as we look forward; therefore, a single go-to-market model and opening up a real end-to-end supply chain discussion with our retail partners to create significantly more joint value going forward.

So we are prioritizing to win in our portfolio. The money, the investment is following those priority choices. We're improving our operational excellence. We are seeing progress. Today, we grew gross margin and operating margin in both – in 2016.

We are seeing core brand performances improve and that transformation continues and the next step Deanie will come up and talk to is our exit of DSD, how that transforms our snacks business and from my point of view, how it transforms our North American business as we go to one common platform and can ship everything and anything we make to our retail customers off of one platform. There are significant joint value creation opportunities for us as a company going forward.

So with that, thanks for listening and I'll pass you to Deanie.

Adrienne Deanie Elsner

Good afternoon. I'm going to talk to you a bit about the U.S. Snacks business but first, let me just ground you on the portfolio of the U.S. Snacks business. At $3.2 billion in net sales, it's a big and profitable business. It is the biggest business in North America. Importantly, it's the biggest business in the global Kellogg infrastructure. And so when

John says in order for Kellogg to grow, U.S. Snacks has to grow, that is real.

We have a stable of great brands, Cheez-It, Pringles, Rice Krispies Treats. These are brands that are competitively advantaged and unique in the industry. We compete against five major categories: cookies, crackers, wholesome, salty and fruit snacks.

Our distribution or our route-to-market is split in two different ways. Warehouse represents just shy about 40% of our total business. It ships our Pringles business, as well as the remaining part of our categories to our non-grocery channels.

Our DSD or our direct store delivery business delivers our entire portfolio, ex-Pringles to our grocery channels. A big part of our P&L is invested in our DSD business which is fixed cost and volume dependent.

Two weeks ago, we announced the decision to exit DSD. It sparked quite a bit of debate. Much of it continues on today, I know. I'm not going to get involved in this debate. I'm going to tell you why the Kellogg Company chose to make this move and why we chose to make this move now.

First, if you look at what drives DSD in this channel – our channels, our products are not fragile. Our products have longer shelf lives and although some of our products have very high velocities, none of our products have such high velocities that our retailer warehouse system can't keep up with them seven days a week, sometimes two and three shipments a day to a store.

Second, the consumer is changing. The consumer is shopping across more channels, many of them not serviced by DSD. Although trips ticked up just slightly last year, market baskets per trip are still down. And when you look at the consumers who are coming into the mainstream; the millennials, the multi-cultural consumers, this is even more of a behavior for them. This consumer is going to be with us for the next 30 years, this is the way these consumers will continue to shop.

As our customers react to this landscape change, they're shifting to smaller formats in a lot of urban areas. Those stores are not serviced by our DSD. Actually, when you look at our retailer warehouse delivery system today, many of our retailers have stepped up quite a bit in their sophistication in terms of how they get products to market much more sophisticated than they were 5, 10, 15 years ago.

And finally, when you step back and you really objectively asses how we're doing in our channels where we are playing in DSDs and where we are not playing in DSD, we actually realized that our fill rates and our market share is higher in those channels where we do not have DSD.

So for us, the numbers are clear. The move to exit DSD is now and we shift to what it does for us, which overnight gets us to a more effective and efficient model, lower costs, lower inventories, better fill rates. It enables us to shift our investment out of DSD and importantly gives Kellogg, for the first time in our history, one route to market for our customers across center of the store businesses, cereal, and all the snacks brands.

This simplified route-to-market also has tremendous benefit for our customers, three specifically. As we shift the distribution and the work in-store to our customers, we will pass along to them a margin expansion to take on this work.

Second, our retailers are as concerned about inventory and cost management as we are. The move out of DSD for them means less back of the store inventory, less trucks showing up at their store and importantly, lower [ph] inventorial (34:02) rates in their DCs because now they can count on more frequent loads from the Kellogg Company that are mixed across multiple categories.

Third, our move freeze up a tremendous amount of dollars because we unlock the dollars we have to hide in our DSD infrastructure and shift them to growing our businesses in-store. Our businesses compete in the center of the store representing 75% of our retailers' profitability. This is big news for our retailers and they're excited about this move.

We have a transition plan in place and we have confidence that we can deliver that transition plan, really, based on three key [ph] planks (34:44). First, we have an infrastructure that remains intact, specifically our DSD infrastructure will remain open and fully functioning all the way through our transition. We have incentive plans that we've put into our employee plans. Our employees today are incentivized and engaged.

And importantly, we have a stable manufacturing network. So our network is able to keep up with what we're doing. We also have an established and world-class warehouse system. That means it's a plug-and-play for us. Now, it's not an easy plug-and-play, but we have a world-class system that already serves 75% of the Kellogg portfolio. That's a big deal. We're not creating this. We're moving into a great running system that has IT, order to cash setup, as well as customer service.

Finally, and importantly, we have a seasoned transition team in place. We are managing this like a large scale M&A acquisition within the Kellogg Company. We have a fully resourced cross-functional team, representing almost 300 people within the Kellogg organization and external support.

In addition and importantly, we have retailer support. We have PMOs set up at our key retailers that tie to PMO teams internally so that we are managing through the details of this transition. Now, this is a big transition. There is no playbook for this transition and there's a lot of moving pieces. But I'm confident that we've got the right infrastructure to make this successful.

You have to be wondering about the financials and what this all means to our business. Ultimately, and at the end of the day, this means accelerated net revenue growth for our organization once we get through this transition. We will do that by investing back into our brands, putting feet on the street in our new warehouse delivery system. And in doing so, even with that step-up in spend, we still have an improvement on our overhead model, which enables us as a U.S. snacks organization to achieve our average KNA operating margin as of 2019, with a big step-up being accomplished in 2018.

Back at Day at Kellogg, about 15 months ago, I took you through the road map for the U.S. Snacks business. I said, first and foremost, we have to reset this business. That was our focus in 2016; reset the business and prove that we actually can grow this business again. Next, we have got to transform this business to accelerate where those bets really can be placed. And finally, we'll be in a position to accelerate our business.

I'm happy to say in 2016, reset the business fundamental is exactly what we did. We improved our efficiencies behind the ZBB and Project K which consolidated our network. We've focused our investments against our big brands that actually can grow Cheez-It, Pringles and Rice Krispies Treats. And we established a revenue growth management capability for the first time in our organization. The results of where this all plays out really is the playbook of what happened last year on the Cheez-It business. Cheez-It, a $1 billion business, we put all of that to play into that business.

Through ZBB and Project K and revenue growth management, we've dialed up our investment aggressively on this business increasing our brand going by 30%. We dialed up digital, we activated in social, we improved our ROIs on this business by getting smarter about how we deliver our message to the right consumer.

Through the form, we expanded our formats across occasions by channel, getting the right packs to the right consumer, at the right price point, at the right time and she bought it. And we innovated new platforms on Snack Mix and Sandwich Crackers. The result of this playbook in the year was net sales increase of over 8%, an expansion on our gross margin, an increase in our consumption and an increase in our share.

We moved Rice Krispies Treats and Pringles onto this playbook, mid-Q2, and the results of those three big brands in our portfolio shifting behind that playbook gained traction in our results. Actually, if you look at our first half versus our second half results, we saw almost a 400-basis-point improvement between our first half net revenue sales versus our second half.

Importantly, the percent of our customers driving revenue growing doubled in the second half of last year versus the first half of last year. We can grow this business. The move to a warehouse model is the enabler that lets us still grow this business.

Transforming the portfolio then is about redeploying the spend towards growth, so we can invest in these brands the way we need to be investing in these brands; more food, better formats. It enables us to move from a supply-based distribution model to a demand-based distribution model, putting the consumer at the front of every single thing we do.

Finally, it enables us to invest and optimize across our category of portfolios. That means focusing on our high margin businesses with higher velocities. As we move to the accelerate part of this equation, we will force growth through a pull model by increasing our brand investment not just on any brand but on our high investment brands that are driving great ROIs as they exist today.

Beyond that, we will have the money to invest across the broader portfolio. We'll be operating with a stronger, leaner portfolio on shelf, growing new margin-enhanced items in a higher velocity shelf set. That's a shelf that's going to work harder for our retailers.

Finally, we're going to move towards a total Kellogg's joint business partnership, launching cross-category promotions for the first time in our organization; serviced one route-to-market, and we're going to push harder to become the partner of choice in eCommerce for our key retailers.

I want to show you how this plays out across a number of items in our portfolio. Cheez-It, we've talked about this a couple different times, $1 billion business; last year, grew over 8% in net revenue, 8%. It's an invest to grow business in the North American portfolio. We will dial up even more media behind this business, but importantly, focus that media against a millennial and multi-cultural activation. We'll push that out across digital and social. We'll expand across more occasions with new formats and we'll drive more innovation.

On Pringles; our focus on Pringles will be to dial up our growth. Pringles, in the last four years, has grown on a compounded annual growth rate of 4% a year. Those are good numbers. We wanted to go faster than that. And so, we will invest in growth, dial up very aggressively on the digital aspects of this business, focusing millennials and multi-cultural. Importantly, we will now be able to do joint tent-pole events behind Pringles and Cheez-It across the year. Pringles and Cheez-It together are in size, formidable in the space and will be great partners as we engage in joint merchandising activities.

We will, as Paul mentioned, expand our focus on small can and on-the-go. Why? Because that's the way the consumer is consuming today. These two businesses, small can and snack stacks, growing double digit and we will drive innovation. We've just launched our brand new entry into the Pringles family, Loud, which is old flavor and epic crunch. It is just hit the stores as of January of this year. Early signs are positive. We'll keep an eye on that one.

Rice Krispies Treats, another one of our invest to grow brands. Rice Krispies Treats, over the last four years, has been growing at a compounded annual growth rate of 9%. This is a business that has tremendous [ph] legs (43:43) well beyond the wholesome aisle. However, it's got wholesome credentials. It's a mom's yes food. It's got good nutrition. It's hugely satisfying and it's a sweet treat. There's a lot of different places we'll be activating this in store.

We'll start with investing behind this business for the first time ever with dedicated communications, 100% digitally focused around a campaign that we're just about to launch, so much to love. Again, very focused against millennials and multicultural. We'll expand against formats like on-the-go, grab-and-go pantry packs, as treat sheets as well as seasonal activations and we will drive innovation towards indulgence.

Paul talked about the Special K and the need to realize the potential of that brand, I agree. We now have the money to holistically transform and reset our Special K Bar business and that is what we're doing as we're speaking. It is out in the market as of January.

Our objective here is to drive a complete reassessment of the Special K brand in the bars wholesome section; transform the portfolio, invest back in the food, both in terms of quantity as well as ingredients, and launch a master brand campaign. We'll be renovating the portfolio across the entire wholesome Special K business and innovating first of the world bites in this section for mainstream. Really excited about what we're doing at Special K but not just what we're launching, but where our pipeline is going to be looking back half of this year and into the next two years.

I'd be remiss if I didn't talk about the Elves. We dipped our toes in the water last year as we advertised for the first time in over seven years Ernie and the Keebler Elves. As a matter of fact, during the time we advertised, our base volume growth was two times the cookie based volume growth. We know advertising works. So as we go down this path with incremental investment, we will go to a master brand campaign and bring our cracker brands into the forefront.

There's no reason why those Elves can't be talking about [ph] Club and Town House (46:00). We dabbled in this last year and we got great response. We'll expand across occasions with pantry packs, single serve, as well as big bags targeted at sandwich consumption side of the plate for adults.

Finally, we'll innovate in our cookie aisle with limited edition, freshness packs, snack stacks and new bites coming from the Club business; excited about what's happening on the Elves.

We'd be remiss to sit here and say we're moving out of DSD and not acknowledge that we lose muscle in store doing so. And so we've put together a comprehensive in-store activation plan that actually does enable us to maintain a merchandising presence in store that will happen through established tent-pole events that have been expanded and broadened in terms of our activation. In addition, we're hard at work in building shipper-ready modules and pallets so that as our retailers order our products in to support these events, they don't require a lot of labor to put up this product.

So, in summary, we've made good progress in 2016. We expanded [ph] IR (47:28) margins. We've proved we could grow our priority brands. And our sales in the back half did deliver growth. DSD exit really does unlock the resources necessary for us to accelerate our growth and become the growth BU that both John and Paul required at the Kellogg portfolio. Coming out of this, a stronger Kellogg emerges on the snack front and I look forward to the progress.

Thank you. John will come up and close now.

John A. Bryant

Thank you, Deanie. So I think you can see here we're making great progress against our 2020 growth strategy. We're stabilizing cereal in the core markets. We're growing it around [ph] a little outside (47:59) the core. We are transforming ourselves into a global snacks business, with 50% of our sales now coming from snacks. And we're making major transformational investments in the emerging markets and we'll continue to do that as we build out that footprint.

[ph] With (48:16) the presentation from Paul, we have great sources of growth within our North American business. We have a few businesses that are holding us back, that's masking that growth. We're investing there to fix that. We expect the North American business to return to growth over time. To do that, we're transforming our U.S. business, our U.S. Snacks business. And to be clear, the transformation, the exit of DSD in U.S. Snacks, yes, it increases margins, but we're doing it because it better positions us for long-term growth.

We can take resources that are tied up in a physical distribution system that the consumer can't see and invest it back into things that consumer can see, brand building, food, et cetera. We believe that exiting DSD is a tough decision, has a large organizational impact. It was absolutely the right thing for the Kellogg Company to do.

A couple reasons why; it's worth remembering that we have a world-class warehouse system in the U.S. Today, 40% of our snacks business already goes through that warehouse system. When we go to market through warehouse, we have higher growth, higher share, higher margins.

Today, we already have a very merchandising-intensive category in warehouse: cereal. Cereal [indiscernible] (49:38) a very high merchandising categories. So we already demonstrated this warehouse system can deliver the sort of merchandising that we need in the snacks business.

Remember, as we go into the warehouse system, we'll continue to have Kellogg dedicated beat on the street. This is a warehouse delivery system where we'll continue to have an in-store activation model that's more than just shipping it to a retailer and then it's making the retailer do all the work. So we are well-positioned to do this transition. It will be disruptive. There's no question, the next 12 months is going to be a very volatile period. Some of our competitors would try to take advantage of this shift, but it is absolutely right, long-term decision of the Kellogg Company.

And with that, let me hand – let me turn over to Q&A.

Q&A

<A - John A. Bryant>: [indiscernible] (50:19)

<Q>: Thank you. I guess, Deanie, one of the potential risks with the shift to warehouse that's been raised quite a bit, I think, is there some very high profit SKUs but that might be lower velocity. That maybe the risk is through a warehouse model, maybe they're below the threshold that it really works through a warehouse model. So, I guess how do you guard against the risk of maybe losing distribution or in shelf space for some of those really highly profitable, high contribution margin items that maybe [indiscernible] (50:50) velocity that – with DSD, you could control more directly. Thank you.

<A - Adrienne Deanie Elsner>: [indiscernible] (50:59). Thanks. It's a great question, [ph] Andrew (51:01). Look, as we make the shift, our focus is going to be on our higher margin, higher velocity items, it has to be. We also know that as we make this move not every item in our portfolio is going to succeed in a warehouse model. We've been quite clear what that's going to be and has been prudent about reducing some of those SKUs. However, the high profit SKUs that sit in our portfolio today actually have a very clear position from a demand chain standpoint. There's a consumer need for them.

And so what we'll be able to do now is invest in the resource and make sure the consumer or the retailer understands the consumer segments, the insights and the need for a broader portfolio of options on the shelf. In some ways, DSD has worked against us from the standpoint because DSD really leans into the muscle and store, the high velocity SKUs and kind of ignores some of the lower velocity SKUs. In this world, we'll be able to invest in category management, talk to retailers and build the total category story. And those discussions so far have gone successful with our retailers. So I would contend I'm not as concerned about that.

<A - John A. Bryant>: Yeah. If I can add to that [ph] Andrew (52:13), I think this is an opportunity for us to make the [indiscernible] (52:15) SKUs. Yes, there will be SKU rationalization but that's good because it makes more room on the shelf, the [ph] shelf floor (52:22) harder for the big SKUs, the big brands. We see this as an opportunity also to clean up the portfolio. [ph] Jason (52:29)?

<Q>: Thank you for the question. Another question on DSD for Deanie. I agree that long-term, it seems to make tremendous sense. I think the risk is around the transition phase as you guys have rightly pointed out and in both the expectations we may have and the expectations you may have going through that transition. So that's where my question is what are your expectations? What should we be [ph] incurring to (52:54)?

And specifically, the slide in terms of the multi-year road map, the path to acceleration in 2018 seems optimistic. Given that you come into 2018, you'll still be lapping having the DSD network [ph] either (53:10) the front half and arguably there's going to be a nice pipeline fill in terms of filling the warehouse network, probably in the second quarter that you would have to anniversary as well. So, are you really looking for growth in 2018, or is that sort of throughout 2018, we come in with some sales softness and then the back half is when we get the ramp?

<A - Paul T. Norman>: Let me take the sales guidance on Snacks. To be clear, we don't expect sales growth in the Snacks business in 2018 because we'll have a full year of the price reduction to retailers in there. We'll be lapping the warehouse build, as you said, here in 2017, also be lapping the disruption. So a lot of moving pieces going on there, but we don't have an expectation, mathematically, for growth in 2018 just because of the pricing adjustment, but 2019, we should see growth.

Let me also just say, [indiscernible] (53:55) more broadly, as we go through 2017, we're going to see a significant amount of volatility in our sales forecast. So it's actually a hard year for us to forecast sales because we have these disruptions and this impact in the DSD system; plus, as we said on the last quarterly conference call, we have some challenges as we get through pricing realization in some markets.

So, as we think about our business, we think about how we gave guidance for 2017, we gave guidance of down 3%. We think that's still the right sales guidance and largely because of DSD disruption, but we could be down 3% and still hit the operating profit and EPS guidance. So we have some flexibility in the forecast to achieve that.

<Q>: You've had the growth you pointed out with Pringles and Cheez-It, but the Special K snacks has been offsetting a lot of that. And so you've got the plans you've announced. Can you give a sense of the trajectory for when we could expect to see growth from that and just how you think that would build and what that means for the total snacks portfolio?

<A - Adrienne Deanie Elsner>: [ph] Michael (54:52), I actually remember our conversation back at the Day at Kellogg and your desire for us to get Special K back on track. For Special K, we are launching a transformation of that portfolio that is flowing through as we speak started in January and it is hitting the shelf. So we'll expect, as Paul stated, Special K to exit the year stronger but still down and we'll see the change in the evolution towards growth in 2018.

<Q>: And just one follow-up to that, as far as mix goes, what are the implications there?

<A - Adrienne Deanie Elsner>: In terms of?

<Q>: Does Special K snacks growth help mix? Is that mix accretive in terms of on the margins side?

<A - Adrienne Deanie Elsner>: Special K operates in our wholesome portfolio that is Rice Krispies Treats, Nutri-Grain and Special K Bars. The mix in that total portfolio is accretive to our business and our Nutri-Grain and our Rice Krispies Treats products are both in a growth mode that offsets the Special K. So we should be in a decent mix position.

<Q>: Deanie, a question, I guess if you think about the channels that DSD services today which are mainly food channels and I guess some mass merchandisers and then the universe of channels that DSD doesn't service today, [indiscernible] (56:12) some proportion, like how much business do you – or how much sales do you expect to gain in those channels that you're really underrepresented in today where you'll be able to put more sort of dollars to work into versus what you may lose because you won't have DSD in some of those DSD-intense channel?

<A - Adrienne Deanie Elsner>: Right. Let me see if I can reframe the question. What you're wondering is are we going faster in those non-DSD channels or...

<Q>: How much faster do you think you will grow in those channels to maybe offset what you might lose in some of the more DSD channels?

<A - Adrienne Deanie Elsner>: So important to note that as we look at our DSD business, we are servicing probably about two-thirds through DSD of our grocery stores today. So we're not even servicing directly as many grocery stores [indiscernible] (57:01) in our channel. So as we exit DSD, we actually think there could be upside in terms of an expanded warehouse model through wholesalers. It is true that we will be able to invest back into formats and that's going to be a key driver for us in terms of our current retail footprint, front of store and more immediate consumption activation, but also in terms of format outside of the grocery channels and so I don't think that we're going to be in a position to share exactly how the mix is, but we will see an opportunity to grow in both areas.

<A - John A. Bryant>: The channels that aren't served by DSD are actually growing faster. We have better in-stocks and better shares and what happens when you come out of the brand building that comes back in, everyone gets the benefit of that. This has come back to retail in terms of the mass channels. It comes back to brand everywhere. To your point, in all the formats, we can put in all those channels. So the benefits flow across every retail environment we market in.

<A - Paul T. Norman>: Yes. We think we can grow much faster in those channels over time. If you look at the percentage of sales of our snacks business in single serve versus most snack companies, we dramatically under-represent because we have historically been a big box grocery-focused company. So we think we have an opportunity to drive greater consumption in more channels once we unleash the marketing opportunities of moving the money around.

[ph] Back to you, Andrew (58:26)

<Q>: Thanks. Another question for Deanie. You've talked about the progress you've already made in establishing the RGM capabilities in snacks and there's a huge amount of innovation in the pipeline. So I guess as you go through this transition period over the next few quarters, what kind of constraints does that play from the ability to actually put the price pack, architecture in place, get the innovation on shelf, should we expect to see a lag before all of that begins to impact the business?

<A - Adrienne Deanie Elsner>: It's a great question. A big part of this plan was set up to cede the pipeline in terms of price pack, architecture and our revenue growth management capability as well as to build the pipeline of transformation and it's why the Special K transformation was hard at work last year, so we could put it on shelf this year. And so a lot of the work that we will need for the next year into Q1, Q2 next year has been accomplished and what we'll be focusing on is back half 2018 and into 2019, building out some of those ideas.

In terms of revenue growth management, the way we're approaching it is where's the whitespace in the category, what is the right format to meet the need of that consumer in that space, and then how do we have the discipline to manage the right price so that we're consistently rewarding the consumer for the value she's willing to pay. And so, that's the discipline of revenue growth management for us. It's not an inconsistent driver to this transformation and should be helpful as we go on this pack because it will allow us to get the price pack in different channels.

<Q>: Thank you. So from a resource allocation standpoint, I wanted to ask about your acquisition strategy. You've been doing a lot of tuck-ins and JVs in the emerging markets. You've done very little in the U.S. since the Pringles deal several years ago. Other people are going the other direction. As you think about future acquisitions, are you likely to remain focused on the emerging markets, could you do more domestically and what role could you see yourself play in consolidation of the U.S. food market? Thank you.

<A - John A. Bryant>: We're always looking at acquisitions around the world and we would look at acquisitions in the U.S. Obviously, we want to drive the portfolio to a stronger growth orientation at a time, so we look at more growthy areas such as natural organic foods in the U.S. and we'll continue to do tuck-ins. We'll be more focused on fixing Kashi before we start doing more of that, but that's certainly a [ph] legitimate (01:00:47) area. And then, the intersection of emerging markets and snacks is a very interesting area for us, and you can see us in some of our recent M&A activity in that sort of space.

So more broadly, we're always looking to create shareholder value. We have a strong track record of success with our acquisitions. Keebler, Pringles have all been great acquisitions for us. We want to keep driving that. And the size of the acquisition is not as relevant as the value creation of the acquisition, so to speak, that creates a lot of value, even more exciting.

Unverified Participant

I think that's all the time we have, John. I want to take this opportunity to once again thank Kellogg. Thanks for the breakfast tomorrow and great presentation. Thanks again, guys.