Company Name: Kellogg
Company Ticker: K US
Date: 2018-05-03
Event Description: Q1 2018 Earnings Call

Market Cap: 20,102.26
Current PX: 58.00
YTD Change($): -9.98
YTD Change(%): -14.681

Bloomberg Estimates - EPS
Current Quarter: 1.095
Current Year: 4.442
Bloomberg Estimates - Sales
Current Quarter: 3221.267
Current Year: 13073.842

Q1 2018 Earnings Call

Company Participants

- John Renwick, CFA
- Steven A. Cahillane
- Fareed A. Khan
- Amit Banati

Other Participants

- David Cristopher Driscoll
- Rob Dickerson
- David Palmer
- Timothy S. Ramey
- Christopher R. Growe
- John Joseph Baumgartner
- Alexia Jane Howard
- Robert Moskow
- Kenneth B. Goldman

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company First Quarter 2018 Earnings 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] Please note this event is being recorded. Thank you.

At this time, I will turn the call over to John Renwick, Vice President of Investor Relations and Corporate Planning for Kellogg Company. Mr. Renwick, you may begin your conference call.

John Renwick, CFA

Thanks, Gary. Good morning and thank you for joining us today for a review of our first quarter 2018 results. I'm joined this morning by: Steve Cahillane, our Chairman and CEO; Fareed Khan, our Chief Financial Officer; and Amit Banati, our President of Asia Pacific, who's calling in from Singapore to update you not only on our strong performance and outlook in that region, but also on some exciting news we have in West Africa.

Slide number 2 shows our unusual forward-looking statements disclaimer. As you are aware, certain statements made today, such as projections for Kellogg Company's future performance, including earnings per share, net sales, profit margins, 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.

A replay of today's conference call will be available by phone through Thursday, May 10. The call will also be available via webcast, which will be archived for at least 90 days.

Before we start, please recall that all year-on-year variances discussed today, both for results and outlook, are calculated off a 2017 base that has been recast for Accounting Standards Updates. For your benefit, we issued an 8-K filing on [ph] April 19 for 2018,(2:05) that provides all of the recast line items.

And now, I'll turn it over to Steve and slide number 3.

Steven A. Cahillane

Thanks, John, and good morning, everyone. We're obviously pleased to report such a strong start to 2018, with growth in net sales, operating profit, earnings per share and cash flow.

There are three elements I'd like to emphasize. First, returning to top line growth is a priority for us, and it's gratifying to see so much of our portfolio showing improvement. Our on-trend Frozen Foods business has accelerated its strong growth. In U.S. Snacks, behind the noise of DSD exit impacts, our core brands are gaining share again. And our overall business is increasing its velocities on shelf. And Pringles is growing strongly worldwide. We stabilized our core international developed cereal markets and even showed some improvement. And we've built scale in snacking presence in emerging markets and it's paying off [ph] with (2:59) accelerated growth in those markets.

Second, we're on track to achieve our full-year guidance. We got off to a strong start in every metric. Our net sales grew ahead of our expected full-year pace. We also improved our operating profit margin. Our productivity initiatives are allowing us both to cover increased cost pressures and deliver on our promise to reinvest behind our brands. Brand building was increased at a strong double-digit rate in Q1 and will be again in Q2, and it's investment behind better consumer ideas. We're truly Deploying for Growth.

And third, we continue to make exciting progress on reshaping our portfolio. Parati, the company we acquired in Brazil at the end of 2016, sustained its strong growth in Q1, and it's enabling us to pursue additional revenue and cost synergies in Brazil and South America. RXBAR, acquired in late 2017, also sustained its exceptional growth in Q1, expanding its distribution and now expanding its product line as well.

And in West Africa, we are announcing today increased investments that allow us to further capitalize on an enormous growth opportunity and even enable these operations' rapid growth to flow through our financial statements. This will give you better visibility on our expansion in this key emerging market. In fact, it will bring our annual sales in emerging markets from being less than 15% of our company's sales to something closer to 20%. This is yet another example of us Deploying for Growth.

We know we still have work to do. For instance, in U.S. Morning Foods and in Kashi snacks, we're busy getting back to basics and investing in what we know can grow. These softer businesses were already incorporated into our guidance, and we have plans to stabilize them as the year progresses. As we go through our results today and our outlook, I hope you'll see why we are so confident that we are on the right track as a company.

So let me now turn it over to Fareed, who will walk you through our financials.

Fareed A. Khan

Thanks, Steve. Good morning, everyone. Slide 4 summarizes our results for the first quarter. It was a good quarter, demonstrating improved financial performance on all metrics. Net sales grew year-on-year, including on an organic basis. And this continues an improving quarterly trend, and we saw improved performance across most of our portfolio. This certainly gives us increased confidence in the full year.

Operating profit grew year-on-year as well, and this great growth came in spite of substantial, planned double-digit increases in brand building. We could afford to do this, of course, because of Project K savings, including our eliminated DSD overhead and because of our top-line growth. And finally, EPS in Q1 increased at a double-digit rate. Specifically, this was $1.23 per share on an adjusted basis, and $1.19 on a currency-neutral adjusted basis.

In addition to the growth in operating profit, this EPS growth was aided by U.S. tax reform as well as a separate discrete tax benefit this quarter. But EPS was up solidly, even without that. So a very good start to the year, and let's examine the results in a little bit more detail.

Slide 5 walks you through the components of our net sales growth in Q1. Excluding currency, which was a strong positive in the quarter, our net sales grew more than 2% year-on-year. RX, which was acquired in October of last year, contributed 1.6 points of this growth. And this includes not only the sales that we acquired, but also the strong year-on-year growth that this business continued to generate. Steve will talk about that more in a moment.

On an organic basis, our sales were up nearly 1% year-on-year, our first organic growth in a few quarters and yet another sign that we are making progress. Keep in mind that this organic growth comes in spite of the impact of last year's DSD exit, specifically SKU rationalization and the elimination of the price premium we used to charge for DSD services.

In the quarter, this somewhat mechanical impact was around negative 1.5%, suggesting a third consecutive quarter of sequential improvement in net sales growth, excluding the DSD impact. Even if you account for year-ago comparisons for the smaller year-on-year DSD impact, there's no question that our Q1 sales performance shows that our stepped-up brand building investment is starting to gain traction towards a return to top-line growth.

We also continued to improve our operating profit margin, as shown on slide 6. While our gross margin was down year-on-year, this was completely related to the DSD exit. Remember, with the exit from DSD, there are two factors that effectively reset our gross margins in U.S. Snacks. First, there's the downward adjustment to our selling price to reflect no longer charging for DSD services. And second, in a warehouse distribution model, logistics costs reside in COGS, whereas in a DSD model, they were in SG&A.

Excluding this dual impact from DSD, we held our gross margin year-on-year. This is a good performance, considering that we're experiencing the sharp rise in freight costs and other pressures that are being felt by many other companies. It reflects our ongoing productivity efforts, our savings for Project K and Zero-Based Budgeting and operating leverage for better top-line performance.

Operating profit margin increased by about 40 basis points year-on-year and this includes a substantial double-digit increase in brand building. This ramp up in brand building will continue in Q2 and even a bit into Q3. In fact, we made the decision recently to add some incremental brand building investment over the next couple of quarters, a testament to the quality of the commercial ideas being proposed and the positive impact it's already having on our top-line performance.

Rounding out the P&L, our interest expense increased because of debt related to acquiring RX, as well as a shift towards fixed rate debt. Other income declined as we lowered the expected return on assets assumptions for our pension plans, and our effective tax rate benefit from tax reform and a discrete benefit that only affects Q1. And finally, while Q1 is always the slowest quarter of the year for cash flow, it did increase year-on-year in Q1, even excluding the 2017 reclass for accounting changes, so good all around performance from a financial perspective.

Slide 7 shows that we are affirming our full year 2018 guidance for our base business; that is, before the consolidation of our West Africa joint venture. We still expect net sales to be roughly flat on a currency-neutral basis. And there are no changes to the components of this outlook. RXBAR is still expected to contribute about 1 to 1.5 points of sales growth this year. On an organic basis, sales should be down about 1% to 2%, but within this outlook, remember that the DSD impact is still tracking to about down 1% for the full year.

Our forecast for adjusted operating profit remains plus 4% to 6% on a currency-neutral basis, even after adding incremental Brand Building investment to what was already a strong year-on-year increase. Adjusted gross margin comes down because of the DSD-related resets in U.S. Snacks, as we've discussed, but excluding this impact, we still believe our productivity and cost savings can offset cost inflation, including increased freight costs. And, of course, our overhead comes down significantly due to the DSD exit, other Project K savings and Zero-Based Budgeting.

We continue to project 9% to 11% growth in currency-neutral adjusted EPS, and this is off a recast 2017 base of $4 per share. Recall that this growth is driven by operating profit and by tax reform, net of a couple of negative items: higher interest expense year-on-year, because of debt related to the RX acquisition; and higher interest rates; and the negative impact on other income from a lowered return on asset assumptions on pension.

From a phasing standpoint, we expect Q2's operating profit, excluding the West Africa consolidation, to be flat to down year-on-year, owing to some possible sales timing from Q1 and an accelerated increase in Brand Building. This leaves our total first half at modest operating profit growth before it picks up in Q3 and Q4. Meanwhile, we make no change to our full year tax rate, so the remaining quarters' tax rates [ph] float up (11:33) after Q1's discrete tax benefit.

Cash flow is still expected to be roughly $1.2 billion to $1.3 billion for our underlying business. I do want to point out that we are still contemplating a one-time $200 million to $300 million pre-tax contribution into our pension plans. This would bring down cash flow net of any related tax benefit, but it could also improve earnings. You will recall from our last quarter's earnings call that this is one of the options we were considering for deploying the tax reform cash benefits. And doing it this year means we could still deduct at the pre-reform tax rate, so it makes good financial sense. And we'll let you know when and if we take this opportunity.

Now, let's take a look at the financial implications of our increased investments in West Africa, as shown on slide 8. You'll recall that in late 2015, we entered into a relationship with Tolaram in Nigeria. As part of that initial investment, we acquired a 50% stake in Multipro, a major food distributor, and the call option to acquire an indirect stake in Dufil, a major food manufacturer.

We also set up a joint venture to manufacture and market cereal and snacks in West Africa and Kellogg noodles in the rest of Africa. The investment we're announcing today is simply a logical progression in this relationship. Specifically, we are investing about $420 million to exercise the call option for the stake in TAF, and to increase our stake in Multipro. These incremental investments had always been contemplated. And it was important, though, that we first learn the business and the market and develop our relationships with our partner, Tolaram. Obviously, we are very pleased with both. And Amit will take you through these businesses in more detail in a moment.

The transaction closed on May 2, and we will now consolidate the financials of Multipro, the distributor, into Kellogg's financials going forward. Among other things, this means that we'll see a lift to this year's net sales and operating profit. At current exchange rates, the total 2017 net sales of Multipro were equivalent to approximately $650 million, and its operating profit equated to over $35 million. This adds roughly 3 to 4 points to our currency-neutral net sales growth this year and more than a percentage point to our currency-neutral adjusted operating profit growth.

Moving down the P&L, interest expense will go up modestly higher due to funding the investment. Below the tax line, our earnings from unconsolidated entities will no longer include Multipro's earnings, but it will benefit from our new stake in TAF, which includes earnings from the very profitable manufacturing company, Dufil. And on the separate line for income attributable to noncontrolling interest, we'll now be deducting the minority interest of Multipro.

Net of all of this, we'll see a very slight accretion to adjusted EPS this year. Over time, these investments will contribute to meaningful sales and earnings growth.

Obviously, being a distributor business, Multipro carries lower margins, particularly as we remain in an invest and expand role, but the growth is exceptional. And with net sales up more than 20% in Q1, as none of this is cannibalistic to the rest of our business, we see continued potential. And, more importantly, this gives us an incredible route-to-market that helps us expand our brands across this region. Clearly, this raises the growth of our company.

So putting it all together, we get to our updated guidance, as shown on slide 9. Currency-neutral net sales growth gets a lift of 3% to 4% for Multipro, bringing our Kellogg Company guidance to plus 3% to 4% growth overall. Multipro adds another 1 to 2 points of adjusted operating profit growth, getting us to a 5% to 7% overall on a currency-neutral basis.

Together, the accretion of this investment and consolidation is relatively immaterial to adjusted EPS this year, as I mentioned. So our EPS guidance remains at positive 9% to 11% on a currency-neutral basis, off the recast 2017 adjusted EPS base of $4 per share. Multipro will have an immaterial impact on our cash flow this year, so there's no change to that guidance.

With that, let me turn it over to Amit, who will give you an update on the performance and outlook of our Asia Pacific region overall and walk you through the strategic merits of this West Africa investment.

Amit Banati

Thank you, Fareed, and good morning, everyone. Before I discuss our West Africa investment, let me first review the results and outlook for our Asia Pacific region, shown on slide 10. We had a very good quarter. At 6%, our quarter one currency-neutral net sales growth continued a general acceleration that we have seen over the past year, as shown on the chart.

Driving this acceleration are three principal factors. The first is growth in emerging markets cereal and, more recently, wholesome snacks across Asia and Africa. We are seeing double-digit growth in markets like India, Southeast Asia, Korea and South Africa.

The second factor is our continued expansion of Pringles. In quarter one, we grew Pringles at a double-digit rate, led by growth in emerging markets. And this represented an acceleration from the mid-single-digit growth that the brand has been achieving consistently over the past two years.

The final factor is a stabilization of the region's core developed market, Australia. By focusing on the playbook we know wins in cereal, relevant food news combined with effective brand building and excellent in-store execution, we returned to share growth in 2017, and we continued to gain share in quarter one of 2018.

The combination of operating leverage from this strong top-line growth with productivity savings from Project K and Zero-Based Budgeting, enabled us to increase brand building investment at a double-digit rate in the quarter and still deliver 17% operating profit growth as well as strong operating margin expansion.

And remember, these sales and profit results don't yet include any of our joint ventures. In quarter one, our joint venture in China delivered another quarter of double-digit growth, led once again by e-commerce, which is where we generate almost half of our cereal sales in that market. And in our JVs in West Africa, our quarter one growth was also double-digit once again, which is why we are so excited about our increased investment in these West Africa joint ventures.

A couple of years ago, we chose the joint venture structure because it was prudent from a capital at risk standpoint as we moved into a new market with a new partner. But as we got to know our partner, Tolaram, as we gained understanding of the business, and as we saw the great success of our combined business, it became very obvious that this is a long-term relationship worth investing in.

Before we get into the strategic merits of these investments, let me clarify the various entities, because I want to convey to you just how strong these assets and operations are. These are shown on slide 11. In each of these, our partner is Tolaram, which has over four decades of experience operating in Nigeria and West Africa.

Let's start with Multipro. We've owned a 50% stake in Multipro for the last couple of years, with Tolaram being the other key owner. Multipro is one of the largest distributors in Nigeria and Ghana, with about $650 million in annual sales at current exchange rates. It distributes Dufil's products as well as other brands.

What makes Multipro special is that it has an unrivalled distribution and logistics system in Nigeria, which enables availability of products across the country. It also has a powerful consumer activation capability, which has been a critical and proven enabler of building brands in this market. Particularly in emerging markets, there is nothing more important than your go-to-market, and Multipro is the best in that market.

By acquiring one-half of its holding company, Tolaram Africa Foods, we now have a stake in Dufil. This is a leading manufacturer and marketer of packaged foods in Nigeria and Ghana, including the number one brand of noodles. Dufil is a well-run company with excellent growth prospects and very strong profitability.

Finally, KT (sic) [KTNL] (20:34) is a separate joint venture that we have with Tolaram. It is focused on the manufacture and marketing of our cereal and snacks brands in West Africa, which it distributes through Multipro, as well as the manufacture and marketing of Kellogg's branded noodles in the rest of Africa.

In just two years, we have seen rapid expansion in this venture. More recently, we constructed a cereal plant in Nigeria for local production. And in quarter one, we successfully launched Kellogg's cereals, which are off to a very strong start. We also launched Kellogg's noodles into South Africa and Egypt. This venture is showing exciting prospects for growth.

As I said, we believe Tolaram is an excellent partner and that these are very high-quality assets. The combination of these entities provides us access to best-in-class distribution, brand building, supply chain and commercial execution capabilities. These are the right companies to build on, giving us a strong foothold in Nigeria, a market of 200 million consumers and the opportunity to expand into surrounding markets in West Africa and, ultimately, across Africa overall.

So let's see how these ventures fit into our broader Africa strategy, depicted on slide 12. This incremental investment is yet another leg in what is a pan-Africa strategy for the Kellogg Company, pursuing growth in a promising emerging market, one with high population growth, a youthful population and a growing middle class. And we're expanding across this continent from very advantaged positions.

We've already discussed West Africa and how we are building on the tremendous strength of Multipro and Dufil, but we are also expanding in the south and the north. We have had a solid long-standing presence in South Africa in cereal. In recent years, we added Pringles, which has been growing at a double-digit rate, so this is a good business with growth opportunity. And now, through our JV with Tolaram, we have launched breakfast noodles in South Africa under the Kellogg's brand, which is off to a strong start. So we're expanding in South Africa with a broader portfolio of affordable breakfast and snacks offerings.

In North Africa, we're not only expanding cereal and biscuits from our acquired operations in Egypt, but, through our Tolaram partnership, we're also launching breakfast noodles there and across other North Africa markets. So there is plenty of room for expansion in North Africa as well.

In short, we have added a partner and capability that enables us to expand the reach and awareness of the Kellogg brand throughout an emerging market region with excellent long-term growth prospects. Africa has become a tangible contributor to our emerging markets growth. And now, thanks to our most recent investment, you will be able to see this growth in our P&L.

So, in summary, Kellogg Asia Pacific continues to perform well, growing organically and delivering improved profitability. Today's increased investment in West Africa continues to fill in a broader Africa strategy that has us rapidly expanding noodles, cereals and Pringles across a promising emerging markets landscape, and doing it with the right partner. This raises our growth profile.

And with that, I'll now turn it back over to Steve.

Steven A. Cahillane

Thanks, Amit, very exciting times in your region. Let's move now to North America, where our largest business unit, U.S. Snacks, is shown on slide number 13. Now two and a half quarters into its post-DSD life, U.S. Snacks continues to show good progress. From a P&L perspective, the savings from eliminating DSD overhead are significantly exceeding the profit impacts of double-digit increases in brand building and the sales impact of SKU rationalization, and eliminating the price premium we once charged for providing DSD services. Simply put, we are realizing the financial benefits of this transition from DSD.

We're also making progress on the top line. If we strip out the mechanical net sales impact of the DSD exit, the SKU rationalization and the list price adjustments, U.S. Snacks' underlying net sales were up year-on-year, and this is the third consecutive quarter of growth, excluding the DSD exit impact.

We also like what we're seeing in the market. As we've stated previously, consumption and share declines were expected during the first year out of DSD, due to our significant reduction in SKUs and the reality of giving up secondary and tertiary displays, once we no longer have as frequent presence in stores by salespeople. But in Q1, our big three crackers brands collectively returned to consumption and share growth and Rice Krispies actually accelerated its growth.

Importantly, all of our major categories experienced year-on-year gains in velocity in Q1. Improving velocity is so elemental to what we're trying to do in our transition from DSD that we're updating this graph for you. Look at the tremendous improvement we are making here now that we have a stronger set of SKUs on the shelf, and that we are supporting these SKUs and brands with sufficient brand building.

I should also mention Pringles, which was never in DSD to begin with, but is benefiting from the investment dollars and management focus freed up by the DSD exit, not to mention the capability to now run cross-category promotions with former DSD brands. In Q1, Pringles boosted its consumption and share via our successful Flavor Stacking campaign, involving both media and in-store activation and via big promotional events with Cheez-It. So we're off to a good start in U.S. Snacks. We continue to expect improving in-market performance supported by strong increases in brand building investment.

Now, let's turn to U.S. Morning Foods in slide number 14. Morning Foods posted a sales decline that represented improvement from recent quarters, cutting in half our decline from 2017, and it was actually a little ahead of our expectations. Aggressive competitor promotion in the kid-oriented segment held back some of our brands in that segment, but we did make progress on what we had prioritized, food news and brand communication on the adult-oriented health and wellness segment.

As a result, Special K returned to consumption and share growth, owing to communication around its new inner strength positioning. Similarly, Mini-Wheats, Raisin Bran and Rice Krispies all started to improve their trends in the quarter, as we renewed communication about their key wellness attributes. These efforts will pick up in Q2 when we increase investment behind this communication and tie it to food news.

We recognize that we have more work to do. In addition to the communication in food news and health and wellness, we are responding to competitor activity in the kid-oriented segment with innovation, including support for our new Chocolate Frosted Flakes, a recent launch that has been well received and a new product launch for Froot Loops.

Additionally, we are launching bagged formats for certain brands in this segment, seeking to widen our consumer base. Pop-Tarts, too, will benefit from innovation and brand support as we head into the second half.

For Morning Foods this year, it's all about getting back to basics. Under new management for this unit, we've been reassessing our shopper segmentation, our brand promise and our investment levels across the portfolio. We've been honing our execution and working on building an innovation pipeline that is exciting and differentiated. We still expect to see profit pressured by increased investment this year, but with a continued moderation in sales declines as we work towards stabilizing this business. We've got a lot of work to do, but we're making progress.

Turning to slide number 15, U.S. Specialty Channels continued to post net sales growth despite not one, but two years of difficult comps on its way to its 11th straight quarter of top-line growth. We recorded strong growth in most of our channels. Vending was up strongly. Convenience posted good growth. And Girl Scouts had another good season. Foodservice posted a modest decline, albeit against a good year earlier growth.

As we had signaled on our last quarterly earnings call, Specialty Channels operating profit in 2018 is forecast to be uncharacteristically down year-on-year, due to changes we made this year in the allocation of costs from other U.S. segments. This is not related to any change in the underlying business, which remains solid. We think Specialty Channels is on track to deliver another year of steady top-line growth.

Let's turn to slide number 16, our North America Other segment, which turned in exceptional net sales and operating profit growth. The acquisition of RX drove a lot of this net sales growth. In its first full quarter since being added to our portfolio last October, RX is tracking to its aggressive 2018 plan. In Q1, net sales were up significantly. Consumption grew significantly and share was up significantly. The brand continued to expand distribution within existing channels and into new ones. We're already realizing the benefits of not only treating RX as a stand-alone growth platform, but also allowing it to tap into Kellogg resources, particularly R&D and supply chain. Needless to say, we're very pleased with its performance so far and we have exciting plans for this growth platform.

Even excluding RX, the North America Other segment still grew net sales organically at a high single-digit rate. This was due to outstanding momentum in our frozen foods brands. On trend with consumers, frozen foods categories are outpacing grocery overall, especially with millennials, who consider frozen closest to fresh and who prize its convenience and value.

And we play in two very promising areas. As shown on the chart, both Eggo and MorningStar Farms sustained double-digit consumption growth in Q1. Both brands have benefited from renovated food and packaging, new innovations and commercial focus on core offerings. We expect Frozen Foods to continue to grow, even as it begins to lap its year-ago acceleration, in coming quarters.

Rounding out the segment, Kashi Company continued to drive strong consumption growth and share gains for Bear Naked Granola while working to stabilize Kashi brands cereal and snacks outside the natural channel.

In Canada, the cereal category softened in the quarter, but we continued to gain share, led by health and wellness-oriented brands like Special K and Mini-Wheats. We also grew consumption in wholesome snacks, Pringles and frozen waffles. Overall, we expect continued growth for North America Other, led by RX's continued expansion and Frozen Foods' growth.

Europe is on slide number 17 and it, too, had a good quarter. Growth was again led by Pringles, which continued to rebound from last year's disruption of normal promotions in some markets. It turned in double-digit growth here in Q1, and it continued to grow across the region, well beyond those markets that had experienced last year's disruption. This brand is in good shape and we have even stronger commercial plans ahead, including a very big soccer tie-in. Our cereal trends continue to improve. This has been led by the stabilization of our UK cereal business, which in Q1 delivered year-on-year increases in consumption, share and net sales.

In the UK, Special K turned in its second consecutive quarter of year-on-year consumption and share growth, accelerating from last quarter. And this key brand also turned positive in markets like Spain and Italy, demonstrating that its new positioning and reinvestment are starting to take hold.

We should mention that emerging markets were a driver of the Europe region's growth for both cereal and snacks. This was led by both Egypt and Russia, so Europe is back to growth this year. Markets remain challenging, particularly in Continental Europe, but we've gotten off to a good start and we have good plans in place for the rest of the year.

Let's finish with Latin America on slide number 18. Operating profit was pulled down, as expected, by the negative impact of forex rates on cost of goods sold. This reflected prior hedges rolling off and the business is on track for operating profit growth for the full year. Importantly, Latin America resumed top-line growth in Q1 after a 2017 held down by the Caribbean/Central America markets. Recall that in those markets, we experienced, first, a trade inventory overhang, and then, devastating hurricanes. The good news is that declines in these markets continued to moderate in, Q1 even as stores in Puerto Rico struggle to reopen.

But it was Mexico and Mercosur that drove Latin America's growth in the quarter. Mexico posted its eighth straight quarter of organic net sales growth. Our snack sales growth in this key market continues to be led by Pringles, and we grew Cereal, too, in net sales, consumption and share.

In the Mercosur markets, we posted double-digit net sales growth, driven by cereal, Pringles and Parati. Parati is clearly a boost for our business in Brazil, where we are leveraging its presence and expertise in high-frequency stores, while sustaining its growth in biscuits. So Latin America is another area in which we are seeing progress.

So to summarize on slide number 19, we are Deploying for Growth, and you can see signs of progress. You can see progress in our strong start to the year. Not only did we grow, but we saw improving top-line and in-market performance in key areas of our portfolio. And not only did we expand our operating profit margin, we did it in the face of cost headwinds and a very strong increase in brand building. It's so critical to get off to a good start because it creates flexibility and confidence for the rest of the year.

We're making progress on the quality and quantity of consumer-oriented ideas surfacing throughout the organization. With much of the heavy lifting behind us on our cost structure reduction efforts of recent years, we're getting more commercially creative, and we're putting more money behind it. Brand building was up substantially year-on-year in Q4 of 2017. It was up substantially in Q1 of 2018, and it will be again through at least Q2 of this year.

We are on track to deliver our full year guidance, and that's even with us leaning into incremental reinvestment. And we've taken further steps forward in our commitment to shape our portfolio toward growth. RX is expanding and giving us a new growth platform. Parati has tripled the size of our business in Brazil and is giving us new opportunities for revenue and cost synergies. And today's announcement of an increased investment in our West Africa partnerships shouldn't be taken lightly. Africa is a big, promising growth opportunity, and we are making an investment that will lift our growth rates for a long time.

Finally, as shown on our Deploy for Growth graphic, our people are our competitive advantage. So we'd like to thank our employees for their dedication and hard work.

And with that, we'd be happy to take any questions you might have.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] The first question comes from David Driscoll with Citi Research. Please go ahead.

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

<A - Steven A. Cahillane>: Morning, David.

<A - Fareed A. Khan>: Morning.

<Q - David Cristopher Driscoll>: Wanted to ask you about your top line. So sales outperformed our expectations in the quarter. You said the brand building is working. Why not upside to the revenue forecast this year? And then a follow-up, if I may.

<A - Steven A. Cahillane>: Yeah, thanks for the question, David. I think we're pleased, obviously, very pleased with the top-line start to the year in Q1, but we're taking a prudent view because it is just one quarter behind us. I'm seven months into the role right now, so we think it's just smart to be prudent, but having said that, we are pleased.

We're seeing good growth, as I mentioned, in Pringles, in Eggo, in MorningStar Farms, in RX, in Bear Naked. Those are all in North America, which in the past has been a bit challenging. Then we've got the emerging markets, Asia really firing on all cylinders, Mexico, Brazil and now West Africa. So making very good progress across our top line, which gives us very good confidence that we'll deliver the year, but we just think, at this stage, it's smart to be prudent. And we will reinvest. We will lean in where we see opportunities. We've given ourselves some flexibility to do that.

<Q - David Cristopher Driscoll>: And then, my follow-up is just related to volume, up a strong 3% in the quarter. This historically has had a nice positive effect on margins because of the leverage that you get through your manufacturing facilities. Can you talk about the effect in the quarter? And secondly, do you think that you'll have volume leverage through the facilities for the full year?

<A - Steven A. Cahillane>: Yeah, I'll start and then let Fareed build on it, but we're pleased with our margins, so if you take out the DSD impact, margins are flat to down ever-so-slightly in the quarter, and that's with increased brand building which I mentioned. And it's also covering significant freight costs, which we're able to cover thanks to the outstanding work that was done in our supply chain. I really tip my hat to our supply chain colleagues. Factories are running very efficiently, very effectively. They're looking at productivity in every corner to overcome some of the headwinds that we've had in order to give the margin performance that we've given. Fareed, you want to...?

<A - Fareed A. Khan>: Yeah, the only thing I'd add is that on the cost pressures, where we're seeing it most acutely is on freight, like many other companies, and a combination of specific productivity initiatives that we have in place, as part of Project K, as part of our ongoing productivity efforts, that's offsetting it. And the volume flowing through our plants really does create some leverage as well, so you put all that together, that generated flat gross profit in Q1. And we expect that type of performance to continue for the full year because we do have visibility on those initiatives.

<Q - David Cristopher Driscoll>: Great. Thanks a lot. I'll pass it along.

Operator

The next question is from Rob Dickerson with Deutsche Bank. Please go ahead.

<Q - Rob Dickerson>: Thank you very much. So just a question on the double-digit brand building investment, can you just kind of break out where you think how that was deployed across snacks, cereal, U.S., emerging markets in Q1? And then, just kind of expectations for the rest of the year as you look at the business and the growth opportunity and you lean in a little incrementally, where do you see most of the investment going or is it just essentially broadly based? Thanks.

<A - Steven A. Cahillane>: Yeah, thanks, David, for the question. I'll start again and Fareed can add, as he sees fit. First, I guess from a very top-line perspective, we're not going to give any great detail about where we're deploying our investments, for competitive reasons. We always had plans, which we articulated, to put more brand building against snacks in the U.S., post-DSD as we move from a push environment to a pull environment. So you see quite a lot of the investment going there. We had a fantastic first quarter promotion in Pringles and Cheez-It leveraged around the Super Bowl, which saw very good momentum.

In emerging markets, we see good opportunities to continue to invest as we think forward-looking, but it's fairly broad-based with the biggest chunk, I would say, coming in U.S. Snacks as we continue to successfully transition out of a DSD environment into a pull environment.

<A - Fareed A. Khan>: And what I'd add is just a reminder, last year, as we were going through the DSD transition, we pulled back a little bit around the first half as we went through the DSD transition, just to basically keep the outlook fairly stable on the businesses. So there's going to be year-on-year acceleration that's pretty significant in the first half. The full year will be up.

And the only thing other I'll add is we continue to make great progress on looking [ph] at our lies (41:10) on our brand building investments. And so, these are pretty precise bets around very specific brands and channels and media, and we're seeing good response. And we'll continue to take a targeted approach. But so far, we like what we see and we can make those kind of investments and watch the returns, very short cycle times.

<Q - Rob Dickerson>: Super. Thank you.

Operator

The next question comes from David Palmer with RBC Capital Markets. Please go ahead.

<Q - David Palmer>: Thanks. Good morning. Just one question on sort of the relative growth that you're seeing in the portfolio, it's interesting how in these categories in snacks and cereals, we're seeing the sweet or fun flavor-type brands doing among the best and seemingly, they're more receptive to innovation and promotion. And you're doing nice job with Rice Krispies and Pop-Tarts, to perhaps feeding into this, offsetting some declines in your wellness bar brands. But on the cereal side, you seem to be still dug in around the wellness news.

And I know you're making some adjustments. You mentioned Chocolate Frosted Flakes and something with Froot Loops, but are you seeing the results from pushing on wellness within cereal or is your best hand perhaps pivoting and going more the fun route within that category? Thanks.

<A - Steven A. Cahillane>: Yeah, thanks for the question, David. A couple things, first, in terms of health and wellness, we are seeing actually good progress against Special K. And that's in all the markets including United States, so we don't think that that's an inappropriate area for us to focus in. Having said that, we've got a wide portfolio with lots of choice, including kind of kid-oriented brands that you mentioned, as well as health and wellness brands, and we see opportunities across the breadth of our portfolio. And clearly, we've got strong brands in all those categories.

In the kid categories, obviously, Frosted Flakes and Froot Loops play very well. We think there are opportunities for new innovations and new ideas there. We've got Chocolate Frosted Flakes, which is doing very well in the market. We've got a new Froot Loops innovation coming. So I would posit that it's well balanced across our portfolio, because the investments we've made to turn Special K have been pleasing to us.

And in terms of wellness overall, and you mentioned bars, RXBAR plays in this space and is really growing at a torrid pace. They're doing such a great job at RX, and we're incredibly proud of the work that they're doing. It's really focused. It's very innovative. It's very brand-centric. It really targets the consumer in a meaningful way and is showing great growth for us.

So, we've got a broad portfolio across health and wellness and snacking and kids. And we invest where we see the best returns, where we see the best potential. So it's not just in one particular area. And I hope that's helpful.

<Q - David Palmer>: That is. Thank you.

Operator

The next question comes from Tim Ramey with Pivotal Research Group. Please go ahead.

<Q - Timothy S. Ramey>: Thanks so much. I just wanted to drill down on a couple of the products. First, your mention of bagged cereals, would you be characterizing or thinking about that in terms of kind of brand investment or is that sort of more kind of capitulation to market trends?

<A - Steven A. Cahillane>: Yeah, thanks for the question, Tim. Capitulation is not a word we like to use around here. Having said that...

<Q - Timothy S. Ramey>: [ph] Copy that. Sorry. Yeah. (44:50)

<A - Steven A. Cahillane>: I'm just kidding. In terms of bagged cereal, it really broadens our consumer base, right? So, we go to where the consumer is. We try and get there in front of the consumer sometimes, but when the consumer goes somewhere, we tend to want to really give the consumer what they're looking for. And there is an element of the consumer that is looking for bagged cereal. We're not the first there, but we've seen – actually, the research that we've done, it tends to be highly incremental. And so, we are going to go into bagged cereal.

Having said that, you asked about investment. We don't necessarily invest behind a packaging format. We invest behind our brands and then offer different packaging formats, different solutions to our customers across a broad array of channels and packages. And so, it's just one of the innovations that we're coming out with when the new product launches that we're coming out with this year.

<Q - Timothy S. Ramey>: Yes. And then just on Pringles. I mean, I think it's fair to say that even excluding the discontinuities last year, the brand is probably doing better, maybe better than you expected, and it's doing quite well. What would you attribute that to? Is that some of the media around the Super Bowl? Is there anything you can really point to or – leaving aside the comp issues, that we're all familiar with.

<A - Steven A. Cahillane>: I think it starts with a good idea, and they had a good idea around Flavor Stacking, which drove multiple purchases because the whole idea is you stack different Pringles flavors on top of each other to create different food type occasions. And it had good communication in the marketplace. The highest profile was the Super Bowl commercial, but it was a full 360-degree digital social approach to it and really drove good consumption, good share, good velocity.

And so, we know if you have a good brand and then you have a good commercial idea and you follow that with excellent execution in the marketplace, which the team did – they drove significant improvement in not only the number of displays on the floor, but the size and the location of those displays. And so, it was all of those things. And it's much like all of our portfolio in the branded business, when you have good innovation, good ideas, strong commercial execution, really focused on the consumer and the customer to give the customer excellent customer service and execute at retail, good things tend to happen. And Pringles was a good example of the team executing well.

<Q - Timothy S. Ramey>: Terrific. Thanks for your help.

Operator

The next question comes from Chris Growe with Stifel. Please go ahead.

<Q - Christopher R. Growe>: Hi. Good morning. I just had a...

<A - Steven A. Cahillane>: Morning, Chris

<Q - Christopher R. Growe>: Hi. I just had a question for you. In relation to – when you're talking about brand building, I'm just curious to what degree that includes promotional spending. And just trying to understand, I realize what's going on in the DSD system, but we saw it up in Europe, for example. Is that an element of your incremental spending in the quarter? And I guess it sounds like you're seeing some pretty good results, certainly on the volume side, so I'm curious about that as well.

<A - Steven A. Cahillane>: No. When we talk brand building, we're not talking about trade. So we're talking about bottom line brand building, period.

<Q - Christopher R. Growe>: Okay. So trade spending was up as well, even beyond what happened in DSD. Was that planned? Is that expected to continue through the year? I'm just curious about that level of spending.

<A - Fareed A. Khan>: Yeah, so it's Fareed. That spend is very much brand-specific. I would say if you ex the DSD, there's really no material increase. So the main change was DSD for trade.

<Q - Christopher R. Growe>: Okay. And just a quick question, the profit margin in U.S. Snacks was well above our estimate. Is there a shift in expenses there helping that? And is there anything to the level of spending in the quarter that may have caused that margin to be higher? I'm just trying to get a sense of how that phases through the year.

<A - Steven A. Cahillane>: I'm sorry. Can you reask that? I didn't really catch your question.

<Q - Christopher R. Growe>: The profit margin on U.S. Snacks, it looks like it was quite strong. Is there a shift in expenses that helped that? I'm just trying to get a sense of how that phases through the year, based on your investments behind that business as well, and there's a lot going on with the DSD system there.

<A - Steven A. Cahillane>: Yeah, it – Fareed, go ahead.

<A - Fareed A. Khan>: There is a lot going on. The most significant impact is going to be the whole shift out of the DSD system which flowed through overhead, and some of that gets offset by increase in COGS as it goes through the network. But net-net, significant savings dropped to the bottom line, and that's even with the increased investments in brand building.

And we talked about the Snacks operating profit going up to the average of our North America business, which is a pretty significant lift, and we are right on track to accomplish that. So the DSD savings are flowing through as we had expected, and you'll see that business continue to perform very strongly on operating profit this year.

<Q - Christopher R. Growe>: Okay. Thank you.

Operator

The next question comes from John Baumgartner with Wells Fargo. Please go ahead.

<Q - John Joseph Baumgartner>: Thanks for the question. Good morning. Steve, I'm curious as to the strategy behind MorningStar. That's a brand that really has dominant share and some good name recognition, but it also seems like Kelloggs never really put a full-fledged effort behind it. I mean, there's been talk about RXBAR being a platform for you, but how do you think about MorningStar being a platform and your ability to stretch that into plant-based more broadly?

<A - Steven A. Cahillane>: Yeah, John. Thanks for the question. I'll tell you, MorningStar Farms is a star in our portfolio. We believe that. It's up double-digit in consumption in the first quarter and is really gaining momentum. And the momentum really started last summer, when the team really started to focus on the core attributes of the brand and did some excellent execution around commercial ideas. So we believe actually there's great potential in MorningStar Farms.

As I mentioned in the prepared remarks, the millennial generation really thinks about frozen differently than other generations. It's kind of the new fresh and the new convenient. You couple that then with the whole veggie approach to this, and it's right on-trend. So we believe in the brand. We believe it has great potential. There's innovations that you'll see coming from the MorningStar Farms team. And so we agree with you. We think it's right on-trend, a very good brand. It's being executed well, and it's got a lot of future potential.

<Q - John Joseph Baumgartner>: Do you see an opportunity to move it more broadly into Europe or the UK?

<A - Steven A. Cahillane>: Potentially.

<Q - John Joseph Baumgartner>: Great. Thanks for your time.

Operator

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

<Q - Alexia Jane Howard>: Good morning, everyone. So on the leverage side, you're obviously injecting a decent chunk of change into the new West African expansion, and I think you've alluded to additional contributions the pensions as well. What do you expect the leverage to go to, I guess, as of now and if you were to do the pension thing as well?

<A - Fareed A. Khan>: So our goal is to remain strongly investment grade, and so that's sort of a foundational element of our strategy. We will flex up for attractive acquisitions. I would say everything we're doing has been thought through and planned in Nigeria. Investments were very much a natural extension, and then with the option window coming into sight, we were really planning for that. So, yes, our leverage will go up a little bit, but we'll continue to focus on bringing that down, finding the right balance between dividend, debt reduction, and return of capital in various forms.

<Q - Alexia Jane Howard>: Okay. And as a quick follow-up, on the other income line, I'm assuming that about $25 million of that $70 million is the mark-to-market pension-related line that gets excluded from adjusted earnings. Is the remaining $45 million mostly the expected return on pension assets that is included in the adjusted numbers? And just philosophically, why would that be included in the adjusted numbers, because it's non-cash and really just not part of the ongoing operations? Thank you and I'll pass it on.

<A - Fareed A. Khan>: Alexia, I'm not sure I'm completely following that. So mark-to-market is not in our adjusted numbers. So maybe we could follow-up and just so I can understand the question a little bit better as a follow-up.

<Q - Alexia Jane Howard>: It was really the other part, not the $25 million, but the remaining other income, is that mostly expected returns on pension?

<A - Steven A. Cahillane>: Yes.

<A - Fareed A. Khan>: Yes, it would be, right. And so, as part of our thinking around pension, we are contemplating a de-risk of the pension plan to shifting our asset mix a little bit and, therefore, bringing down our assumptions about the return on assets just to be more prudent. And so coupled with the contribution to the pension, which, again, that's deductible at the pre tax reform rate, so it's a nice soft of financial outcome.

So we end up with a contribution that's accelerated to our pension plans. It puts the funding status in a very nice spot. And recall, that the largest portions of our plans are already frozen, and then sort of shifting the portfolio allocation to de-risk that a little bit as well. We've had nice returns on that portfolio with our current allocation, but as we look at the market, this feels like the prudent thing to do. So hopefully that gets at the question.

<Q - Alexia Jane Howard>: Yeah, I guess the only follow-up is why would you include that in the adjusted numbers, the expected return? I think most companies don't do that.

<A - Fareed A. Khan>: It's always been there. It's been very consistent and it's always been in the numbers.

<Q - Alexia Jane Howard>: Thank you very much. I'll pass it on.

Operator

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

<Q - Robert Moskow>: Hi. Thank you. I have two questions. One is I was just trying to do a little bit of math on the contribution of the Africa business. Based on the sales contribution and operating profit, I got a mid-single-digit operating profit margin for that business. Can you tell me if I'm off on that? But if that is the margin, what can you do to help those businesses improve their margin structure?

And secondly, on the second half of the year, I think you have some tougher comparisons to inventory loading on the Snacks business during the DSD transition. Can you give us a sense of what kind of headwind that poses to sales? Thanks.

<A - Steven A. Cahillane>: Robert, thanks for the question. I'll make one comment and turn it over to Fareed. And the only comment I'd make is as you think about West Africa, what we really have here, what we're really investing in, is a total business system, right? The Multipro investment, which is maybe a 5%, 6% to 7% margin, is a capability that is outstanding and is a route-to-market that is best-in-class in West Africa, which allows our branded businesses and the JVs that manufacture our branded businesses, get to market in a way that is truly advantaged. So it's a total system that we have here, not just the one investment in Multipro.

<A - Fareed A. Khan>: Yeah, and what I'd add is it's a distribution business but they bring a tremendous amount of value-added services as well, so don't just think a logistics company. It's a really unique asset in that market. And so there's a lot of promotion and trial. They bring a lot of services because the retail environment is extraordinarily fragmented and local. So you have Multipro that brings a lot of services and so their operating profit margins look a lot more attractive than you might consider, say, a developed market distribution business. And I think that's sort of mid to low singles. And that's including the investments that they're making as they grow the business.

The other joint ventures that we have, whether it's cereal or with Dufil, those tend to have very attractive margins and they look very similar to what you might see in a development market from an OP delivery standpoint. And again, this is a bet on Africa and the growth that's there. Going with distribution first really allows you to time the subsequent investments in a much more precise way and a risk-adjusted way. And again, we're looking at the businesses sort of together and the big opportunity here is to tap the market potential.

You'd also mentioned, just on the second part of the question, about the balance of the year and how we sort of compared it to priors. What I'll say is that in Q2 of last year in the Snacks business as part of the DSD transition, that was the quarter where we began to see the pipeline fill. So recall, that we had two distribution businesses, one that we were operating to serve customers and the other one that we were putting inventory in to be ready for the transition.

So in Q2, we actually had pipeline fill. We also had the beginnings of the SKU rationalizations and the risk price adjustments but if you put that all together, the Q2 DSD headwind, if you will, on sales was not as significant as in the latter quarter. So that makes Q2 a tougher comp for our Snacks business, and that sort of factors into some of the guidance that we gave you, where we don't see Q2 top-line growth as strongly because of that prior-year impact. And in terms of [ph] delev (58:28) basically, most of the dust has settled on the DSD transition, and I think for the Snacks business, we're in pretty good shape going forward.

<A - John Renwick, CFA>: Operator, we only have time for one quick last question.

Operator

And that question comes from Ken Goldman with JPMorgan. Please go ahead.

<Q - Kenneth B. Goldman>: Hi. I'll be quick. Steve, you have talked in the past at CAGNY about your admiration for the frozen category. You're talking about it again today. One question I would have – and I think John Baumgartner sort of asked a little bit about this earlier, but are you under scale in frozen? And the reason I'm asking is so many other companies out there talk about the need for scale in this category, just given the high fixed costs. You guys have one major brand, one more minor one in terms of size. If it's such a great category, do you need to or is there an optionality there where you could potentially buy your way into a little more scale, which you could then leverage for some synergies there? I'm just trying to think about your strategy along those lines.

<A - Steven A. Cahillane>: Yeah, thanks for the question, Ken. I am bullish on our Frozen business, proud of what the team has done there, and I don't think we're disadvantaged in scale in any way because both brands are growing at double digits. So we like the scale. It's not to say that we wouldn't think about opportunities to scale up, but right now, we've got plans in place to really grow these businesses in meaningful ways that contribute to the top line and bottom line of the company. So we're proud of what the team's done and think it's in very good shape right now.

<Q - Kenneth B. Goldman>: But wait. And that's fair, but it's less about the top line growth than it is about the cost line, right? The scale question is talking about fixed cost leverage across more revenues. That's more what I was asking about.

<A - Steven A. Cahillane>: Yeah, right now, we've got good leverage with our businesses growing double digits. Our factory's pretty full. The question of scale oftentimes is what type of capacity utilization you have in your various plants. And right now, this business is operating pretty well.

<Q - Kenneth B. Goldman>: Okay. Thank you.

[indiscernible] (60:36)

Operator

Go ahead, sir.

John Renwick, CFA

I'm afraid we're out of time, but if anyone has any follow-up questions, please don't hesitate to call.

Operator

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