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Q3 2015 Earnings Call

Company Participants

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

Other Participants

- David S. Palmer
- Robert Moskow
- Eric R. Katzman
- Andrew Lazar
- Jonathan P. Feeney
- Alexia J. Howard
- Kenneth Bryan Zaslow
- Bryan D. Spillane
- Matthew C. Grainger
- Jason M. English
- Eric Larson

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to the Kellogg Company Third Quarter 2015 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Simon Burton of Investor Relations. Please go ahead.

Simon D. Burton

Thanks, Gary, and good morning, everyone. Thank you for joining us today for a review of our third quarter 2015 results. I'm joined here by John Bryant, Chairman and CEO; and Ron Dissinger, Chief Financial Officer.

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

For further information concerning factors that could cause these results to differ, please refer to the second slide of this presentation as well as to our public SEC filings. As a reminder, a replay of today's conference call will be available by phone through Friday, November 6, and the call will also be available via webcast, which will be archived for at least 90 days.

I'll now turn it over to John.

John A. Bryant

Thanks, Simon, and thank you, everyone, for joining us. We are pleased that the momentum we've seen so far this year has continued to build through the third quarter. Total currency-neutral comparable revenue growth of 1% was above our top-line guidance for the full year and it builds on the flat growth we posted in the first half of the year. We saw sales respond to the investment we've made, continued stabilization in many of our businesses in the quarter and growth in the U.S. Specialty channels, Canadian, Latin American and Asia Pacific businesses. In addition, we continue to make great progress with our productivity initiatives.

Overall currency-neutral comparable operating profit was in line with our expectations and included a significant impact from this year's rebasing of incentive compensation. Ron will discuss this in more detail, but, excluding this impact, currency-neutral comparable operating profit growth would've been approximately 6% in the quarter.

We are raising our guidance for cash flow to $1.1 billion in 2015. We're on track to meet our guidance for currency-neutral comparable sales, operating profit and earnings per share in 2015. And we will achieve these results while setting up an even better year in 2016.

The momentum we're building and our aggressive productivity programs give us confidence that we will meet our long-term targets for currency-neutral comparable net sales and operating profit growth in 2016 and beyond. We'll give you more color regarding our overall business at our Investor Day in a few weeks, but we are excited about the plans we have for each of our businesses and the performance we expect as a result.

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

Ronald L. Dissinger

Thanks, John, and good morning. Slide 4 shows the financial results for the third quarter. Currency-neutral comparable net sales increased by 1%, greater than our full-year guidance for growth. We saw strong growth across many of our emerging and developing markets in Latin America, Asia Pacific and Europe. We are pleased with the performance of our U.S. Cereal business. U.S. Snacks improved sequentially. And we grew in the U.S. Specialty channel and Canadian businesses. And Pringles posted increased sales growth in each of our regions. Reported net sales declined by 8.5% due to foreign currency translation.

Comparable operating profit declined by 2.3%; however, as John mentioned, that decline includes a headwind from the rebasing of incentive compensation this year. Without this impact, comparable operating profit would've been eight points higher and would have shown growth of approximately 6%. This reinforces our previous comments on the operating leverage in our business. Reported operating profit was $334 million in the third quarter, including items affecting comparability, as detailed in the appendices to our presentation.

Comparable earnings per share were $0.85 in the quarter. And these results include $0.11 of currency headwind. So currency-neutral comparable earnings per share were $0.96, an increase of 2.1% from the third quarter of last year.

Slide 5 shows the components of the quarter's sales growth. We had good price/mix realization despite some adverse country mix in Europe and Asia Pacific. Overall, volume declined by 1.6%. And while volume declined in our U.S. Cereal and Snacks businesses, we continue to see signs of stabilization. The Asia Pacific region posted good volume growth, as did Mexico, the Mediterranean and Middle East regions and Specialty channels in the U.S. And we continue to see strong volume performance from Pringles across the globe.

The impact of foreign exchange lowered reported net sales by almost 10%, driven by a wide basket of currencies. And note that our devaluation of the Venezuelan bolivar at mid-year represents almost half of the 10 point impact to sales.

Slide 6 shows details regarding our third quarter currency-neutral comparable gross profit and gross margin. Gross margin in the third quarter improved by 20 basis points. Year-to-date gross margin remained unchanged from last year. Overall, commodity and packaging costs are deflationary and our strong productivity initiatives, combined with Project K savings, are benefiting our supply chain costs. However, we are seeing continued higher transportation costs. In addition, we are investing more money in our foods. Examples include our launch of granolas and mueslis across the globe and renovation of existing foods, such as Special K. The combination of these factors has resulted in relatively flat gross margins year-to-date.

Slide 7 shows the third quarter operating profit performance for each of the regions. North America's currency-neutral comparable operating profit decreased by 3%. This was due to the slight decline in sales and a significant impact of rebasing incentive compensation. The rebasing reduced operating profit by eight points in the quarter. We expect further improvement in North America's currency-neutral comparable operating profit growth in the fourth quarter.

Europe's operating profit increased by 3% in the third quarter. This growth was a result of deflation in commodities and strong productivity in cost of goods sold. And it also included an increase in brand building in the quarter.

Operating profit in Latin America increased by 15%, as a result of strong sales growth in the region, including the impact from Venezuela. While we did see some adverse shift in the timing of sales in certain part of the region impacting our third quarter, we are growing volume and sales year-to-date.

Operating profit decreased by 20% in the Asia Pacific region. We are investing some Project K savings in this region to drive growth, so the result includes investment in our brands and capabilities.

Slide 8 shows our year-to-date cash flow. Year-to-date operating cash flow after capital expenditure was $580 million. This result includes year-to-date investment in Project K of approximately $260 million. And, as I mentioned last quarter, cash costs for Project K in 2015 will be approximately $350 million, the most in any year of the project.

As you can see on the chart, we now expect full-year cash flow of approximately $1.1 billion, an increase of $100 million from our original estimate. This increase is due to accelerated performance of our supplier-financing initiative in the fourth quarter. In fact, we expect that this initiative will offset the approximately $350 million in full-year cash costs for Project K.

Slide 9 shows our core working capital as a percentage of net sales. In the past, we have discussed our focus on working capital improvements and our supplier-financing initiative, in particular. Over the first nine months of this year, we have reduced our core working capital as a percentage of sales by more than one point. And, as I said, we expect accelerated progress on supplier-financing in the fourth quarter, and we are also evaluating new initiatives to unlock even more cash from our working capital.

Slide 10 shows our guidance for 2015. We continue to expect that net sales will be approximately flat for the year. We now expect gross margin for the year to be relatively flat also.

We continue to expect that operating profit will decline by between 2% and 4%, and we also still expect that currency-neutral comparable earnings per share will be in a range between flat to down 2%. And results for both currency-neutral comparable operating profit and earnings per share still include a negative impact of three to four points from the resetting of incentive compensation.

The expectations for sales, operating profit and earnings per share do exclude the impact of items affecting comparability. Our expectation for the impact of foreign exchange translation is now approximately $0.31 a share, an increase from the $0.29 per share we expected last quarter. This change is due to the Canadian dollar, the pound sterling and the Australian dollar.

Our expectations for net interest expense have increased to between $225 million and $230 million, driven by slightly higher levels of debt associated with our acquisitions in Nigeria and Egypt. We now expect that the full-year tax rate will be between 26% and 27%, which will cover the impact of higher interest cost and other below-the-line items.

Guidance for total capital spending remains in a range between 4% and 5% of sales, including approximately one point [ph] to (11:33) sales for incremental capital to execute Project K, and we still expect share repurchases of approximately $700 million to $750 million for this year.

Slide 11 shows our full year earnings per share walk. Costs for the integration of acquisitions are still expected to be between $0.04 and $0.06 per share, although they could be to the high end of that range, given the recent acquisitions in Egypt and Nigeria. And we now anticipate that Project K's pre-tax profit and loss statement costs will be between $350 million and $400 million, or approximately $0.70 to $0.80 per share for the year. We expect that two-thirds of these costs will be in cost of goods sold. The change in the expected cost is simply due to the timing of projects between years. Project K remains on track. And our estimate for savings in 2015 and 2016 has not changed.

Slide 12 shows our guidance for 2016. As we communicated on our Q2 call, we expect our currency-neutral comparable sales to be in our long-term guidance range for low single digit growth. We also expect 4% to 6% growth in currency-neutral comparable operating profit. As we mentioned last quarter, if current sales growth trends continue, it could put us at the lower end of our long-term sales targets, but, even if this happens, we will still meet our goals for operating profit growth, due to the significant productivity programs we have underway.

We expect currency-neutral comparable earnings per share growth of between 6% and 8%. Our outlook assumes a [audio gap] (13:30) similar amount of share repurchases to the $700 million to $750 million we expect in 2015.

And with that, I'll turn it back over to John for a discussion of operating performance by segment.

John A. Bryant

Thanks, Ron. Now let's turn to Slide 13 and the U.S. Morning Foods business. Results for the third quarter came in as we expected. The Kellogg brand gained share in the quarter and saw continued sequential improvement in consumption. In fact, our total consumption was essentially flat and we gained share. Importantly, category base sales were up in the quarter and we outpaced the category.

Our six core cereals grew in combination and gained share. Raisin Bran posted double-digit growth, due to great advertising and the popular cranberry innovation. Overall, Mini-Wheats did well, as core Bite Size posted growth in both base and incremental sales and our second half innovation did well, including Pumpkin Spice Mini-Wheats, which were a big hit.

As you can see on the chart, Special K continued to benefit from activity that began in the second quarter. The brand posted increased sales and share gains again, just as it did last quarter. And our adult cereals in total, which have been an area of softness, returned to growth.

And finally for Morning Foods, we've had a great reception for the innovation we have planned for the first quarter. For example, we're launching Special K Nourish, which is a cereal with positive nutrition and ingredients the consumer can see in the food. There are two SKUs in the U.S., Cranberry Coconut Almond and Apple Raspberry Almond. And both are made with a multi-grain quinoa flake. So the food includes fruits, nuts and on-trends grains like quinoa.

You'll remember that this ready-to-eat cereal has been very popular in other parts of the world, and retail acceptance in the U.S. has been encouraging. We've got a lot of activity planned for the launch, and we're excited about the potential.

Let's turn to Slide 14 in our U.S. Snacks business. Overall, we saw sequential improvement in the Cracker, Cookie, Wholesome Snack, and Pringles businesses in the third quarter. In all channels, overall consumption of our crackers was essentially flat in the quarter, and our big three brands posted low single digit consumption growth in measured channels.

The Cheez-It brand posted consumption growth of 3%, driven by increased display and the success of two new products, Cheez-It Grooves and Extra Toasty. In addition, Cheez-It also grew base sales at a mid-single digit rate, much faster than the category average.

The Club brand also posted increased consumption and share gains as the core business performed well, and the new Town House and Kashi also gained share and now holds 0.6% share of the overall category.

Our Special K Cracker and Popcorn Chips, which have been an adverse headwind, continue to impact results. And while we're continuing to be impacted by past losses in distribution, the products we restaged earlier this year posted slight consumption growth in the quarter.

In the Cookie category, the Fudge Shoppe, Chips Deluxe, Famous Amos, Fudge Stripes and Mother's brands all posted consumption growth in the quarter. We have some strong brands which respond well to activity, and we're encouraged by recent performance. We're pleased that we're seeing sequential improvement in the business, although we have been impacted by a decline in 100 calorie packs this year, as we've discussed before.

The Wholesome Snack business posted a low single digit decline in consumption in measured channels, plus the Club channel. And the Special K brand posted an increase in consumption of almost 3% across the same channels, driven by new Special K Chewy Nut Bars.

The Pringles business posted low single digit sales growth, building on high single digit growth last year. Across all channels, including Club and Convenience combined, Pringles posted mid-single digit growth in the quarter.

So the team has been doing a lot of work in each of the categories, and we're seeing sequential improvement as a result. There's a lot more to come as well. And we'll hear more about some of those plans at the Investor Day scheduled for later in the month.

Slide 15 shows highlights regarding the U.S. Specialty segment. Comparable net sales in the Specialty channels increased by 6% in the quarter, with Foodservice, Convenience, and Vending channels all posted growth. The Foodservice performance was driven by the growth of whole grain offerings in the K through 12 school business.

The Convenience business had an easier comp last year, due to a customer lowering their inventory. In addition, we also saw excellent broad-based growth across the categories in the Convenience channel. And year-to-date, we've grown share in the Cereal, Cracker, Wholesome Snack and Cookie categories.

Finally for Specialty, the Pringles business also continues to do well. As you can see on the slide, our new [ph] Zip Dips product, Pringles and dip together, (18:36) won the Retailer Choice Award for best new product in the Convenience channel and helped the overall Pringles business post double digit growth and gain share in Q3. The team continues to expect a strong fourth quarter for both sales and operating profit and are excited about our prospects for 2016.

Slide 16 highlights performance of the North America Other segment, including the U.S. Frozen Foods, Kashi and Canadian businesses. In the Frozen Foods business, our Eggo hand-held sandwiches continued to perform well in the quarter. As you've seen in public data, consumption increased at a strong double digit rate, and we gained share. Elsewhere in the business, a number of items affected performance, including egg prices, network improvements, the timing of activity, and the drawing-down of inventories in anticipation of an exciting change to packaging. We ended the third quarter with low levels of retail inventory. And we expect a continued impact in the fourth quarter, with improvement in 2016.

The Kashi business is seeing stabilized distribution and sequential improvement in cereal consumption and share performance, although sales still declined. In Cereal, our Sweet Potato Sunshine and sprouted grain cereals are doing well. In fact, overall consumption trends improved significantly as the year has progressed. In the latest data, year-to-date cereal consumption was down 13%, 12 week consumption was down 7% and four week consumption was down only 3%. So the team has done a great job and we're on track to return the business to growth in 2016. And we're increasingly confident about next year. We're focused on progressive nutrition and have some great introductions planned. In fact, our total weight of innovation in 2016 is twice what it has been in 2015.

And finally, net sales for the Canadian business increased in the quarter, due to growth in Wholesome Snacks, Pringles and Frozen Foods and we grew share in the Cereal category. Unfortunately, the combination of the performance of the Frozen Food and Kashi businesses led to a quarterly sales decline in the segment.

Let's turn to Slide 17 and our European business. The Pringles business in Europe posted strong double digit net sales growth in the quarter. The base business posted growth in the launch of Pringles Tortilla (sic) [Tortillas] (21:00) in the UK. and Germany also contributed to the overall performance. In addition, we had strong commercial initiatives across the region. And we expect continued good performance in the fourth quarter, traditionally the quarter of the year with the highest level of sales.

We have exciting plans for the region's Wholesome Snack business in the fourth quarter and into 2016. As in many parts of the world, we are making significant investment in our food in Europe. This includes the relaunch of Special K Bars, an extensive innovation that will include completely new foods with fruits, nuts and seeds.

The Cereal business declined in the quarter, as a result of continued difficult environment in the UK and parts of the continent. The focus for the team is to strengthen the overall plan and improve performance. With this in mind, we have included additional activity in the UK focused on Crunchy Nut, Krave, our porridge products, a tie-in with of Star Wars and increased levels of holiday promotions.

In addition, there's exciting activity coming in the first quarter. We're taking lessons learned from the U.S. and applying them in the region. We're adding more red berries to Special K. And we're launching new products including cereals, mueslis and granolas and also launching Special K Nourish cereal.

Slide 18 shows highlights for our Latin American business. Total currency-neutral comparable net sales increased at a double digit rate. Cereal sales in the region increased significantly. And we've seen good volume growth and have held or increased year-to-date share in strategic businesses like Mexico, Colombia and Brazil. These share gains have been driven by children's and family brands and the introduction of Kellogg's branded granolas and mueslis.

Sales in the Snack business also increased in the quarter, driven by innovation and go-to-market activity. And we've gained year-to-date share in the Wholesome Snack businesses in Brazil and Colombia.

The Pringles business continued to perform well and we've launched Pringles Tortilla (sic) [Tortillas] (23:00) in the region. And our initiative to drive sales in high-frequency stores continues to go well. We've gained year-to-date share in this channel in Mexico, Colombia and Brazil and have increased the number of stores we're reaching at a double digit rate. There's a lot of opportunity in these channels in both the Latin American and Asian regions and that will continue to be a focus for us next year.

The team in Latin America is expecting strong fourth quarter results, due to the high-frequency store program, the continued impact of granolas and mueslis, new bars launching in Brazil, new Special K Protein in Mexico and some significant brand-building events across the region. Plans for 2016 include more great innovation and brand-building events. However, as you know, a number of countries are facing a slowdown in their economies. And while we have plans to deal with this and the impact of transactional foreign exchange, it will remain a headwind in 2016.

Let's turn to Slide 19 and our Asia Pacific business. We saw strong double digit growth in the Asian business in the third quarter. The Indian business posted double digit growth, driven by single-serve packs and strong results from the core brands. The Japanese business grew at a double digit rate, as the result of continued popularity of granola and packaging innovation. And the Korean business also grew at a double digit rate.

The business in Sub-Saharan Africa and the Pringles business both posted high single digit sales growth. On Pringles specifically, we continued to see great results in the region and our activity and investment have gained traction. In addition, our new Pringles plant in Malaysia is performing well.

The overall Asia Pacific segment posted currency-neutral comparable sales growth of 2% in the quarter. The Australian business continues to be difficult. And we also faced the impact of differences in the year-on-year timing of promotions in the quarter. We expect declines in Australia to moderate in the fourth quarter. And we have plans for further improvement in 2016.

Let's turn to Slide 20 and comments on our JV's in Asia. Although they're not reported in Asia Pacific's results, both the Chinese and Nigerian businesses posted very strong growth in the quarter. In China, both Cereal and Snacks grew at a double digit rate and we gained share in the Cereal category.

As you know, we announced in September our investment in West Africa. Specifically, we announced the acquisition of a 50% stake in Multipro, a premier sales and distribution company in Nigeria and Ghana. And we announced the creation of a snacks and breakfast joint venture across West Africa with Tolaram Africa, one of the largest food companies in the region. We are very excited about the investment that this region is experiencing explosive growth with a growing middle class.

Nigeria alone has the largest population and economy in all of Africa. At the time of the transaction, we announced that the total company sales from Multipro were expected to be approximately $750 million in 2015. Just to put that into perspective, our Asia Pacific business posted total sales of slightly less than $1 billion last year, so you can see the transformational impact this acquisition has on the region and why we're so excited about the potential.

Amit Banati, our head of Asia Pacific, will discuss both partnerships in more detail at the Investor Day, but I will say that we're very pleased to have these great relationships in place. And we're confident that they will be significant contributors to total corporate results in the years to come.

Let's turn to the summary on page 21. Results for net sales growth and operating profit were in line with our expectations and we continue to build momentum. Currency-neutral comparable net sales increased by 1%. And currency-neutral comparable operating profit, excluding the impact of resetting incentive compensation, increased by approximately 6% and we also increased guidance for full-year cash flow.

In the quarter, we saw improving trends in our U.S. Cereal business. We saw sequential improvement in our U.S. Snacks business. The Kashi brand continued to improve as we expected. Our International business continued to perform well. And importantly, our productivity programs continue to generate significant savings. And we're on track with both Project K and our zero-based budgeting initiatives. These two cost savings programs, in conjunction with our underlying productivity programs, give us a significant amount of visibility into future results.

So, as I said, we are building momentum. With good performance in the third quarter and our visibility into increased efficiency, give us confidence that we'll meet our targets for 2015, 2016 and beyond. We recognize that we have a lot to do, but we have a plan. We know we can achieve our targets. Our employees around the world are doing great work. And, as always, I'd like to end by thanking them all.

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

Q&A

Operator

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

<Q - David S. Palmer>: Thanks. A question about the promotional activity; it seems that, as measured by Nielsen, the in-store promotional activity has been declining in Cereal, as it has been for many categories. Why do you think that is? And do you see promotion spending continuing to come out of the category? And is there perhaps a shift away from traditional in-store promotions towards other stuff, like consumer marketing and digital? Thanks.

<A - John A. Bryant>: We continue to see good merchandising performance behind our categories in-store. We have categories that do respond to that sort of merchandising activity. I think you have seen on an aggregate basis, some merchandising reduction. That actually is more tailored to what a small number of customers are doing in the area of specific clean store policies. In fact, we're lapping one of those larger customers, lapping that initiative sort of the middle of this year. So that should have less of an impact as we go forward. We are ultimately, though, focused on winning with the consumer through brand-building, through innovation, through engaging the consumer directly, but we feel good about our in-store merchandising performance.

<Q - David S. Palmer>: And then just a follow-up on your innovation comments, you said that you'll have double the innovation or have double the innovation activity heading into 2016 than you had in 2015. In food, we're never really sure if more means better when it comes to innovation. Are there reasons why you feel like your innovation will be more incremental or the way you're changing your innovation process to make it more incremental? Thanks.

<A - John A. Bryant>: Great question, David. Let me just clarify that double the weight of innovation is actually a comment only for Kashi in 2016 here in the U.S. And we're doing a lot to invest back into our innovation process as a company to improve the performance of our innovation. We established our global category teams, so we'd have a longer-term innovation platform coming out of those global category teams.

In the case of Kashi specifically, pulling the team back in La Jolla, back in California, and allowing them to focus on the longer-term innovation to move at a faster pace, as is required in that particular segment of the market, is showing dividends. I think you've seen that in the Kashi business performance improving and also in that greater innovation coming through next year.

And also, as you think about innovation, I think you can see more from us in the area of packaging as we try to hit the right package price product offering by channel, by market. So I think as you look at our innovation pipeline going forward, it's both a stronger pipeline in terms of we have a longer-term pipeline with our global category teams; and it's a more diverse pipeline, in that it's not just more food. It's food. It's packaging. It's in the core parts of the business as well as in the leading segments of the business as well.

<Q - David S. Palmer>: Thank you.

Operator

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

<Q - Robert Moskow>: Hi. Thank you. I guess my question is if maybe can give us a little more color on how you're progressing on zero-based budgeting, you mentioned that you have better visibility into next year. And I would imagine that the ZBB efforts are starting to gain some momentum. Can you give us some updates on what areas of your cost structure you're focusing it on and where you expect to see the biggest benefits?

<A - Ronald L. Dissinger>: Sure, Rob. So our initiative is progressing well in North America. And, as we said earlier, we would be rolling that out across the globe as well. We have not started that work yet, but that should be beginning in 2016. We continue to have very good visibility to the $100 million of savings that we've communicated on zero-based budgeting, and that's specifically in North America.

And you may recall, we said we're interrogating around $2 billion worth of discretionary spend. Now, that is just $2 billion within North America. So far, we've identified a number of things. We're looking across supply chain costs, supply chain overhead, distribution costs, and SG&A as well. We've noted a number of areas around our policies and practices, based on benchmarks that we have from this process. An example is travel and people-related costs. We found that we're investing or spending more money in some of those areas and there's a great opportunity to pull back. We've interrogated professional services as well. And we're looking into brand-building as well and dissecting our brand-building investment, both from a working perspective and a non-working perspective.

One other thing that I do want to point out as well, as we get into 2016 and we provide more information on our guidance, we are unlikely to provide guidance around our gross margin percent and our brand-building percent to sales as well. Now, let me assure you, both of these are absolutely critical to our business. And we remain focused on investing behind our brands and building our brands and maintaining a strong gross margin. But the advent of zero-based budgeting and how that may change the complexion of our profit and loss statement as well as the changing landscape, how you build brands, the shift of TV media to digital media as well and the investments we're putting back in our food, make it difficult for us to provide specifics on those items.

<Q - Robert Moskow>: I'm sorry, Ron. You said that it's going to be more difficult to provide gross margin guidance going forward?

<A - Ronald L. Dissinger>: What I'm saying is we won't be providing those details going forward. Obviously, we have a plan and understand where our gross margin and our brand-building are going forward, but we won't be providing those details because of the shifting landscape as a result of our zero-based budgeting initiative.

<Q - Robert Moskow>: All right. I'll get back in the queue.

Operator

The next question comes from Eric Katzman with Deutsche Bank. Please go ahead.

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

<A - Ronald L. Dissinger>: Morning, Eric.

<Q - Eric R. Katzman>: I guess a couple of questions, with the understanding you're going to have the Analyst Day shortly, I guess, first, I guess this is kind of after the quarter closed, but one of your competitors had a pretty big recall with their biggest brand. And I'm wondering if you're seeing a benefit to that or has the category overall been hurt by that? Maybe you could just go a little bit into that. And I have some follow-ups.

<A - John A. Bryant>: Well, Eric, I think we're seeing a very strong performance from the U.S. Cereal category. It's improved significantly over the last couple of years. Total consumption is relatively flat. And within our business, we're seeing a significant improvement within our core brands, also in the two brands that we've struggled with over the last few years, Special K and Kashi. You're seeing significantly better performance from those brands as we go forward.

So I don't think that particular event that you're pointing to has had a meaningful impact on the category or our business. I think it's good for us all to get past those sorts of events. And I think you're seeing a better longer-term build in the performance of the category over time.

<Q - Eric R. Katzman>: Okay. Thank you. And then, I guess, Ron, in answer to Rob's question, maybe can you quantify, at least this year, how much more you're spending in terms of the quality food initiative, like the higher cost ingredients? Like how much is that, let's say, limiting your gross margins?

<A - Ronald L. Dissinger>: So we haven't quantified that specifically, Eric, but it's probably 20 or 30 basis points of impact that we're seeing within our business, dependent upon which quarter you're looking at, based on the roll-out of granolas and mueslis across the globe, the renovation we're doing around Special K and some of our other foods as well.

<Q - Eric R. Katzman>: Okay. And then last thing, I know this is small, but I noticed in the release that you restated $3 million of sales due to restructuring and other items. Why would sales be restated as a function of a restructuring?

<A - Ronald L. Dissinger>: In some cases, Eric, we are having to change our foods. It's requiring us to pull, turn product from shelf and re-slot new product in its place. So these are listing fees, in some cases, associated with them.

<Q - Eric R. Katzman>: So you felt that was part of a, like a restructuring?

<A - Ronald L. Dissinger>: It is specifically related to the Project K network initiatives that we're conducting.

<Q - Eric R. Katzman>: Okay. All right, I'll pass it on. Thanks.

Operator

The next question comes from Andrew Lazar with Barclays. Please go ahead.

<**Q - Andrew Lazar**>: Morning, everybody.

<**A - John A. Bryant**>: Morning, Andrew.

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

<**Q - Andrew Lazar**>: I know that you've talked about continuing to expect your sales and EBIT growth in line with your long-term algorithm in 2016. And I guess for the first time, you provided the EPS part of that for next year, which, I guess, at 6% to 8%, is maybe slightly below what the long-term algorithm has been. And maybe it's just splitting hairs and conservatism or just maybe it's a higher tax rate, but trying to get a sense of why you wouldn't be getting maybe the typical below-the-line benefit that you'd expect. And if you can provide some perspective on that, that would be helpful.

<**A - Ronald L. Dissinger**>: Absolutely, Andrew. So we do have an expectation for slightly higher interest costs, with the potential for rates moving higher into next year. In addition, we're seeing lower than normal tax rate this year, as a result of tax planning initiatives that we've undertaken. We communicated a 26% to 27% rate for 2015. So we do expect that rate to tick up slightly. And then offsetting that are the normal share repurchases that we'll conduct over the course of the year.

<**Q - Andrew Lazar**>: Okay, thanks for that. And then, yeah, thanks for the clarity on the impact to gross margin of food quality and such. I guess I'm trying to get a sense, and I don't think, I guess, you'll be giving guidance on this per se next year, but I guess directionally from a gross margin standpoint with the favorability around some commodity movements of late, all of the ongoing productivity you have, the Project K, the ZBB impact, which ramps up dramatically next year, shift to digital and such, I guess I'm trying get a sense, I would think gross margin directionally would accelerate quite a bit year-over-year versus the flat result that we're likely to see this year. Is there anything that I'm missing in how I'm thinking about that?

<**A - Ronald L. Dissinger**>: In terms of our gross margin performance for next year, obviously, we haven't quantified it yet. And you're right. We are seeing some deflation in some of the exchange-traded commodities. Now obviously, that's just the commodity aspect of that item. We are seeing inflation, though, in other commodity elements. For example, [ph] foods, nuts, (39:31) cocoa, rice are escalating. And we're seeing higher distribution costs and slightly higher factory costs, but we're being able to offset that with our strong productivity initiatives and Project K savings as well. So overall, at this point in time, we're expecting our input costs to be relatively neutral, offset by our productivity.

<**Q - Andrew Lazar**>: Okay. Thank you.

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

Operator

The next question comes from Jonathan Feeney with Athlos Research. Please go ahead.

<**Q - Jonathan P. Feeney**>: Good morning, guys. Thanks very much. I wanted to ask about the Cereal category. John, you mentioned, you'd seen some improved trends there. And it's a simple question, but it touches on a lot of things. What's allowing for improved trends in both the category and for yourself? Is it a change in the number of occasions, like you're losing fewer occasions? Or is it a change – and I'm talking about the category level here – in share, meaning like are more people eating breakfast or maybe less worse change in fewer people eating breakfast? Or is it that Greek yogurt or other breakfast options kind of or maybe Foodservice kind of reached a high watermark and it's ceasing to eat into Cereal's lordly share advantage in the breakfast occasion? Thanks very much.

<**A - John A. Bryant**>: Thanks, Jonathan, yeah, we've seen on breakfast, we've actually seen consumption of breakfast at home growing, so it's not the issue around QSRs, et cetera. It's been more how we compete at that breakfast occasion at home.

If you go back to the 2000s, obviously, our business in the category grew quite strongly. And what was growing our business at that time were the adult cereals. If you look at what's happened here more recently, those adult cereals, particularly Special K and Kashi, went quite soft. By the end of the third quarter, we actually saw our adult cereals return back to growth. You're seeing Special K return to growth behind movement and positioning. It got caught in a little bit more of a diet positioning towards a wellness positioning now, with new foods coming out that support that. Kashi, between the team in California ramping up the innovations, staying on trend with foods that are evolving and emerging in the marketplace, and you're seeing how the innovation is starting to drive that business back to a better place.

And then even a business like Raisin Bran, where we have a cranberry innovation, some great advertising that's on-trend and we're seeing double digit growth in that brand. So I think a lot of this has to do with what we are doing to drive our business. And, quite frankly, the category performance is a combination of what manufacturers do, rather than a determinate of how all manufacturers do it, so if all the manufacturers do better, the category does better.

<Q - Jonathan P. Feeney>: Sure, just a follow up on your answer there, John, you said the adult cereals came back. I don't know how you slice and dice what's an adult cereal for a competitor, but do you get the sense that's true for your competitors as well, that it's that adult segment that's come back or is it just better execution, do you think, at Special K?

<A - John A. Bryant>: I guess I'm more focused specifically on our business. I'd say our business is doing better and that's what's driving certainly our section of the adult segment. And to your point, it is difficult on some of those brands to define what's an adult brand, what's a kid brand, since roughly half the consumption in the kid brands are actually adult consumption, but when we have adult-targeted brands like this, like Raisin Bran and Special K, we've seen those businesses come back.

<Q - Jonathan P. Feeney>: Great. Thanks very much

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

Operator

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

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

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

<Q - Alexia J. Howard>: So, a couple of quick questions, U.S. Snacks, we obviously read in the press that you might've been interested in a Snacks acquisition recently. That doesn't seem to be going to you at this point. How are you thinking about maybe building out your U.S. Snacks business to get more out of your DSD system in the U.S.? And then I have a follow-up.

<A - John A. Bryant>: Well, let me step back a bit and just provide some thoughts on M&A in general, since you had that entry point into the Snacks question. On M&A, we are obviously looking at a number of opportunities around the world. You've seen the company execute three transactions in just the last several months: two acquisitions in Egypt, the largest cookie, cracker company there and the largest cereal business there; and then our West Africa and Nigeria investment. And all three of those are great investments, combination of Snacks, emerging markets, et cetera, and so as you think about our M&A strategy, obviously, the intersection of Snacks and emerging markets is a very interesting place for us to play.

We also would look at M&A in a market like North America in natural and other areas that would be good bolt-ons to our business. On Snacks itself, we have an outstanding DSD platform. It's a company-owned DSD platform. It's an advantaged platform compared to a lot of other DSD platforms out there. And we believe we have an opportunity to keep driving that platform over time. And we're focused on improving the hit rate of innovation in this business. We're seeing good growth in Crackers behind Cheez-Its. We have opportunities in Cookies. We've got some work to do in

Wholesome Snacks. So we had some good progress there on the DSD business.

<**Q - Alexia J. Howard**>: And then as a follow up, can I just calibrate my expectations from what success in U.S. Cereals looks like in 2016? I know you were feeling pressure earlier in the year to really get the U.S. Cereal business back on track by the end of the year. It seems as though you're talking in a very positive way about it. You've got a lot of innovation coming down the pipe, but the U.S. Morning Foods organic sales are still down 2.6%. So is it enough just to be gaining share in a category that's down or what's the color? What's the description of what good looks like for next year?

<**A - John A. Bryant**>: I would say, Alexia, in a market like the U.S., given the performance of the category in recent years, if we could stabilize the U.S. Cereal business in a stable category, I'd define that as success. So in the context of the Kellogg Company portfolio and hitting our low single digit sales growth target next year, we don't need to see growth from the U.S. Cereal business.

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

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

Operator

The next question comes from Kenneth Zaslow with BMO Capital Markets. Please go ahead.

<**Q - Kenneth Bryan Zaslow**>: Hey, good morning, everyone.

<**A - John A. Bryant**>: Morning, Ken.

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

<**Q - Kenneth Bryan Zaslow**>: Just two follow ups to questions, one is you did say that the environment is deflationary. How do you think that's going to play out in the promotional environment and which categories are most insulated and which ones are most affected by it? And my next point, I just want to make sure I got it right, is you pointed out that sales may be at the lower end of next year's guidance. Can you talk about why you're already there before the year starts?

<**A - John A. Bryant**>: Thanks, Ken, great questions. So on the potential deflationary impact on cost of goods and how could that play out in the marketplace, if you look across our categories, our categories are very rational. They compete more on the quality of brands, on the quality of innovation, on ideas, on in-store execution. They are intensely competitive categories, but they're ones that tend to be fairly stable in pricing over time. So I feel good about the dynamic there and don't see that necessarily being disrupted.

On the question of sales guidance, I think there's maybe some confusion there. If you look at the company, we are building momentum. Last year, our internal sales were down around 2%. This year, we're around flat. And next year, we're giving guidance of 1% to 3%. So if you drew a straight line through that trend line, you get down 2%, flat, say, up 2%. The point we tried to make on our guidance for next year is we don't need to deliver 2%, 3% sales growth in order to deliver the 4% to 6% operating profit growth. Our comment there was about the strength and visibility we have into our productivity programs.

And so we believe that if we hit even the low-end of our sales guidance, or even if we were flat on our sales performance next year, we still have the visibility in those productivity programs to hit the 4% to 6% operating profit range. If I add to that, if I'm thinking about our guidance for next year and you asked me the question where is the risk within that guidance, I think the risk is more on the sales guidance than in the operating profit guidance, is another way of getting at what we're trying to say.

<**Q - Kenneth Bryan Zaslow**>: Great. I appreciate the clarity.

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

Operator

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

<Q - Bryan D. Spillane>: Hi. Good morning.

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

<Q - Bryan D. Spillane>: I've just two questions; just the first one is on the FX in Latin America. And I guess in this quarter, Venezuela had a pretty meaningful impact. I think it was like a 61% adjustment to sales and 71% adjustment to operating income. Is that like a catch-up one-time thing or will we have a few quarters of like meaningful negative effect from FX?

<A - Ronald L. Dissinger>: Yeah, good question, Bryan. Thanks for allowing me to clarify. That will impact us as we go through the back half of this year. So this is the translational impact associated with remeasuring Venezuela from the 6.3 bolivar to the U.S. dollar to effectively 200 bolivar to the U.S. dollar. So you'll see an impact for that translational change through the back half of 2015 and into the first half of 2016 as well.

<Q - Bryan D. Spillane>: And roughly same order of magnitude; is that right?

<A - Ronald L. Dissinger>: Will depend on the size of the business, but, yes, a little bit lower as we move into the front half of next year.

<Q - Bryan D. Spillane>: Okay. And then, John, the second question is just around Special K. And I don't know how easy this is to answer, but as the starting point in terms of rebuilding the brand, one of the things was to go after the positioning and kind of positioning away from a weight loss brand to being more of a just more generally healthy brand. How much of the sort of the improvement in Special K has been that that positioning is actually occurring, so consumers are reacting to sort of a different positioning away from weight loss? And if you could also, within that, just talk about how the core Special K business has done, ex-the new products?

<A - John A. Bryant>: Great question. I think we are seeing the brand make that transition to more of a wellness brand, weight wellness brand then a diet brand. The turnaround in Special K, of course, is not just that positioning in isolation. It's also changing the food, in some cases, to be consistent with that positioning. I think where we've made changes to our food, we've seen even more progress than where we have some legacy foods in place. A lot of the food changes, though, are not just new foods in terms of innovation. They're renovating the current foods. And so when you ask the question, well, how much of that is new versus the base? Take Special K Red Berries. Adding more red berries to Special K and reinforcing the berries in there really has had a very positive impact on the Special K business in the U.S.

And so it's hard for me to tease apart what is food and what is non-food-related. But the good news is we're definitely seeing people respond to that program, not just here in the U.S. but also in Canada, and we're seeing the brand do better.

<Q - Bryan D. Spillane>: All right. Thank you. Look forward to seeing you in a couple weeks.

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

Operator

The next question comes from Matthew Grainger with Matthew Stanley. Please go ahead.

<Q - Matthew C. Grainger>: Hi. Good morning. Thanks for the questions.

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

<A - Ronald L. Dissinger>: Good morning.

<Q - Matthew C. Grainger>: Thanks. Just two questions, first on brand-building, I know you called out Europe specifically as seeing increased spending during the quarter, but can you just update us for Q3 and maybe year-to-date, how brand-building overall is trending constant currency or as a percent of sales and how you see this sort of trending into 2016 as Project K savings build, how dependent that may be on how sequential sales trends evolve from here?

<A - John A. Bryant>: It's a great question. It's probably worth spending a little bit of time talking about brand-building. Obviously, brand-building is critical to the long-term performance of the Kellogg Company. And the strength of our brands is something that we're absolutely focused on. And you can see that in that we have industry-leading levels of brand-building and we're committed to those brands. At the same time, we are seeing a transformational change in how you build brands. Think about the transformational changes we've seen in the past from print to radio to TV and now to social, mobile, digital, et cetera.

As you go through each of these transformational changes, the amount and how you spend brand building fundamentally changes. And so as we see people skipping more ads on TV, as we see people, particularly millennials, using their mobile devices, social media, et cetera, having a larger impact, we have to change our brand-building model. And as we do this, we have to both identify what's not working as well as it has in the past and where should we invest more money. Now, we're seeing very good ROI's on digital-type spend, so we're seeing more of our money migrate in that direction.

But because of this sea change, it's very hard for us to say where are our brand-building is going in the future. I certainly feel like we spend enough money on brand-building. And so as we look, say, into 2016, we will have zero-based budgeting savings in brand-building. Some or all of that will get reinvested back into brand-building, but I don't think we need to continue to increase our brand-building as such. And so our brand-building as a percentage of sales may be flat, may even decline slightly, but don't take that as a lack of commitment to brand-building. Take that as a recognition that how you build brands, how you engage with consumers as they engage with media differently, is changing at such a pace here that we have to reevaluate our entire model and continue to push the edge on how much we need to spend to build these great brands.

<Q - Matthew C. Grainger>: Thanks, John. That's helpful. And then secondly, I just wanted to come back to the comparability issues you've been facing in the Cracker category, specifically on the cracker chips, because it feels like we've been talking about it for a few quarters. We probably should now be starting to approach the point where we could start lapping some of those distribution losses. How are you thinking about the ability of that dynamic to be a tailwind next year or should we simply be looking for the headwind to moderate or normalize?

<A - John A. Bryant>: So we have renovated our Special K Cracker Chip business. And that has resulted in velocity stabilizing, so now we're just lapping lost distribution. There may be parts of that business that also get eliminated over time. We come back to a stronger core number of SKUs. So it's certainly becoming less of a headwind. It's been a pretty major headwind across this year. So it'll probably be there, but to a lesser degree in 2016.

<Q - Matthew C. Grainger>: Okay. Thanks.

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

Operator

The next question comes from Jason English with Goldman Sachs. Please go ahead.

<Q - Jason M. English>: Hey, good morning, folks. Thank you for the question.

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

<Q - Jason M. English>: I wanted to come back to the question on Venezuela. Can you give us, first, can you quantify? I'm not sure how Spillane got his math on this one. I probably just haven't read in the detail he has on this one, but what the bottom-line hit was on Venezuela translation this quarter? And also, how much the pricing in Venezuela contributed to organic sales growth or said differently, what would LatAm organic sales look like if Venezuela was not in the base?

<A - Ronald L. Dissinger>: Yeah, so first of all, in Venezuela, let me remind you of how that remeasurement has impacted our results. And then, as well, there's a translational impact. So in the second quarter, we took a significant charge as a result of our revaluing our balance sheet. We took a small charge as well in the third quarter of about $0.41 of earnings per share impact. It's more the transactional impact of remeasuring that business. Also in the third quarter, we would've taken the translational impact of remeasuring that business to the 200 bolivar to the U.S. dollar. And that's roughly around $0.04 or so of earnings per share impact. And, as I said, in terms of a sales impact, it was a little less than half of that 10 point impact to sales.

<A - John A. Bryant>: As you think about what's happening in Latin America generally, there's no question that Venezuela drove the sales growth you saw in the third quarter. On a year-to-date basis, local currency growth ex-Venezuela would be up low single digits. But it's worth remembering within that, that our Pringles business is a U.S. dollar-denominated business. And so what you're seeing there is actually U.S. dollar growth in Pringles, as opposed to true local currency growth. Local currency Pringles was up strong double digits, but that obviously translates to very low U.S. dollar performance, given where the exchange rates have moved.

So it's actually kind of hard within our results to get back to a pure local currency ex-Venezuela for Latin America. What I would say in Latin America is we are seeing a slowdown in economies in Latin America in general, and in our business as well. We are gaining share in key businesses, such as Brazil, Mexico, Colombia. As we go into 2016, we expect this business to continue to be challenged a little bit with the macroeconomic headwinds of the exchange rate movements and how that's impacting consumer demand in the region.

<A - Simon D. Burton>: Gary, we have time for one more question, please.

Operator

The next question comes from Eric Larson with Buckingham Research. Please go ahead.

<Q - Eric Larson>: Thanks for sneaking me in, guys. I appreciate it. Just a follow-up on the headwinds that you're facing kind of in the U.S. business, one is Kashi, which you're starting to transform and renovate. And the other, obviously, is in the cracker chips side, where you're up against some difficult comps, which was a previous question just recently. If you exclude the negative impact of Kashi on U.S. Morning Foods and the Cracker Chip business in your U.S. Snack business, what would your organic sales growth rates have been?

<A - John A. Bryant>: Eric, I don't have that math to hand. But I think it is fair to say that we have some headwinds this year that, in some respects, masks our underlying performance [ph] and as we go into 2016 with those headwinds. (58:57) And I think that's another reason why we have confidence that we are building momentum and will be a better position as we go into 2016.

<Q - Eric Larson>: Okay. Maybe we'll drill down that further in your Analyst Day. And then, the next question is probably for Ron. Ron, obviously, you're generating more free cash this year. I know that this year is your peak cash spending for Project K. You've got some more, I think, in 2016 and 2017. But $350 million of cash costs this year, and maybe you gave this number. I don't have it. What are your cash costs expected for Project K next year? What would be additive to cash next year from just lower cash costs for Project K 2016?

<A - Ronald L. Dissinger>: Sure. So first, Project K, after-tax cash for the entire four-year project is about $1 billion. That includes capital spending and the other elements of cash to execute the program. More than half of that will have occurred through 2015 business. So we were well over $200 million last year, approximately $350 million this year. So our cash requirements are a bit less as we move into 2016 and 2017 and then closing up in 2018. Just a thing and I think it's important to note in both 2014 and 2015, we focused on our working capital improvements and essentially we have been able to offset that impact of the increased cash for Project K through working capital improvements and specifically the supplier-financing initiative.

<Q - Eric Larson>: Okay. Thank you.

Operator

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

Simon D. Burton

Okay, everyone. Thanks very much for joining us. We'll be around for the next few days to answer any questions. And anybody who still wants to register for the Analyst Day in two and a half or so weeks, please get a hold of IR. We'll take care of getting you signed up. Thanks.

Operator

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