Company Name: Kellogg
Company Ticker: K US
Date: 2018-02-08
Event Description: Q4 2017 Earnings Call

Market Cap: 23,181.21
Current PX: 67.10
YTD Change($): -.88
YTD Change(%): -1.295

Bloomberg Estimates - EPS
Current Quarter: 1.103
Current Year: 4.398
Bloomberg Estimates - Sales
Current Quarter: 3266.917
Current Year: 12812.850

Q4 2017 Earnings Call

Company Participants

- John Renwick
- Steven A. Cahillane
- Fareed A. Khan

Other Participants

- Alexia Jane Howard
- Bryan Spillane
- Robert Moskow
- Kenneth B. Goldman
- Timothy S. Ramey
- David Cristopher Driscoll
- Matthew C. Grainger
- Michael S. Lavery
- Pablo Zuanic

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Fourth Quarter 2017 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] Thank you. Please note this event is being recorded.

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

John Renwick

Thank you, Gary. Good morning and thank you for joining us today for a review of our fourth quarter 2017 results. I am joined this morning by: Steve Cahillane, our CEO, who will provide an overview of the quarter and the year in context of our strategy and then will back and review our key businesses; and Fareed Khan, Chief Financial Officer, who will walk you through our 2017 financial results and our 2018 financial outlook.

Slide number 2 shows our usual 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, February 15. The call will also be available via webcast, which will be archived for at least 90 days.

Briefly, I want to be sure that you are all aware of some changes to our statement of results and guidance. Specifically, there are two accounting standards changes that we have been discussing in our previous filings and that finally go into effect into Q1 2018. There's also a relatively small transfer of products between two segments within Kellogg North America. Our press release includes explanations of these changes and preliminary figures to help you recast 2017. Our 2018 guidance will be off this recast 2017 base.

Separately, we will be modifying our presentation of non-GAAP measurements to better align with how we assess our business internally. In effect, we're changing the term currency-neutral comparable to the more commonly used organic. And we will no longer strip out completed acquisitions or divestitures from our sales and profit guidance, but we will provide color on them.

Today, for consistency reasons, we'll continue to discuss results for Q4 and full-year 2017 on the previous currency-neutral comparable basis and before any of these accounting-related restatements to 2017. However, we will talk about 2018 guidance on the new basis.

And now, I'll turn it over to Steve and slide number 4.

Steven A. Cahillane

Thanks, John. Good morning, everyone. I'd like to start off by saying that after four months into the job, my confidence in this company and my excitement to be here have only increased. In fact, having been around the world discussing our strategy and plans, I'm even more convinced that we will return to solid sustainable growth. The brands are strong. The foods are unique. The culture is special. What we have to do is prioritize, invest where the growth is and improve our execution, but our Q4 performance gives a very good indication of exactly what I'm talking about.

We finished the year on sound financial footing. Not only did we deliver on our guidance for all key financial metrics, but our second half net sales performance was vastly improved from the first half. Pringles got back on track globally. Our Frozen Foods brands in the U.S. accelerated their growth. U.S. Specialty Channels sustained its growth. Our emerging markets business improved their growth, and we stabilized our core developed international cereal markets. We also delivered strong profit margin expansion, indicating a reduction of cost structure that keeps us on track for our targeted margin expansion from 2015 to 2018.

We reduced core working capital as a percent of sales, improving our cash conversion and increasing our cash flow. And we continue to return substantial cash to shareowners through a strong dividend and sustained share buybacks.

But more importantly, we made big strategic moves in 2017 that will help us in 2018 and beyond. Our transition out of DSD was well-executed and sets us up to invest more behind our brands in order to get back to growth in that business.

We continue to expand Pringles across the globe via market expansion, new flavors and new pack formats. We worked on brand positioning, media campaigns and new foods to help stabilize what has been our principal source of sales decline, Special K, as well as our overall cereal business in core developed international markets. Both showed strong signs of stabilizing in the second half.

We know emerging markets are a huge opportunity. And in 2017, we integrated and sustained growth in Parati, which tripled our scale in Brazil and provides further growth and cost synergies for us going forward. Through our joint ventures, we are rapidly expanding in West Africa and China, where we are building distribution and brand awareness in big emerging markets.

And around the world, we have reinvested resources in e-commerce. And it paid off with exceptional growth. And we acquired RXBAR, giving us a whole new growth platform. So 2017 was an important year for us, as we were able to deliver dependable results while making progress on key strategic initiatives, many of which were quite challenging.

Now, let's turn our attention to 2018 and slide number 5. We would characterize 2018 as a transition year and here's why. We are completing the actions behind our ambitious Project K restructuring program while beginning plans on our next productivity opportunities.

We strive for balance between profitability, investment and growth. And this restructuring gives us the fuel. In U.S. Snacks, we're transitioning to life after DSD. This includes a little more than two quarters worth of impact from the adjusted list price and SKU rationalization, but it also entails operating differently. And it concludes a ramp-up in investment behind our brands.

We will be increasing brand-building investment in other business units as well. This varies by brand, of course. And for some, it is the quality of ideas that we are improving rather than simply investing more dollars. But this reinvestment is important for building momentum as the year progresses.

We will be integrating and growing our latest acquisition, RXBAR. There is so much we can do with this new growth platform. Meanwhile, we will be building on our other relatively recent acquisition, Parati in Brazil, completing the integration and accelerating planned revenue and cost synergies.

And our joint ventures in West Africa and China, we'll continue to invest behind rapid expansion. Despite being a transition year, we have a plan, reflected in our guidance, that delivers continued gradual improvement in net sales performance, strong reinvestment in our brands and continued growth in operating profit.

From a margin perspective, we will achieve the equivalent of our 18% operating profit margin target, excluding the pending accounting changes. We will continue to grow our earnings per share and cash flow with an additional boost from U.S. tax reform, even after using some of this benefit to de-risk our balance sheet and pension liability. I think we have a balanced plan for 2018. And I believe our Q4 and 2017 actions and results offer confidence that we can achieve this.

So before I get into the fundamentals of each of our businesses, let me turn it over to Fareed, who will walk you through the financials in more detail.

Fareed A. Khan

Thanks, Steve, and good morning. Slide 6 shows a summary of our financial results for the quarter and the full year. Net sales in the quarter continued to improve from the first half, even with the full impact of planned DSD-related list price adjustments and SKU rationalizations in our U.S. Snacks business. We continue to make progress towards returning to growth.

Operating profit showed another quarter of solid growth, and operating profit margin continued to expand. In Q4, we achieved this, even with a double-digit year-on-year increase in brand-building investment. Earnings per share grew in Q4 as well, as the operating profit growth more than offset the impact of a higher tax rate and an increase in interest expense related to our RXBAR acquisition.

Excluded from comparable EPS, of course, are items like upfront costs, which came in inline with our guidance. You may also be wondering about U.S. tax reform. The net impact to 2017 was small, as the one-time reduction in deferred tax liabilities was more than offset by the one-time charge for repatriation of foreign earnings and other eliminated deductions. This resulted in less than a $0.01 per share negative impact in Q4. We'll speak more about the ongoing tax reform benefit in a moment.

We're pleased with our Q4 and full-year 2017 results. Our top-line did improvement in the second half, as we indicated it would. Our productivity initiatives delivered on their savings, helping us to boost margins and deliver solid profit and earnings growth. And we delivered on our guidance for each of the key P&L metrics, are shown on this slide, as well as for cash flow.

So let's get into a little bit more detail. Slide 7 shows the sequential improvement in currency-neutral comparable net sales performance that we generated in the second half. Driving the second half improvement were several factors. First, Pringles returned to growth in Europe after an unusual decline in the first half. Second, our U. S. Frozen brands, Eggo and Morningstar Farms, picked up momentum that started back in Q2. Third, we stabilized key international developed cereal markets, even growing sales in Q4 in Canada, Australia and the UK. Fourth, we slowed the declines in Special K globally, even gaining share in the U. S. and UK cereal markets in Q4. And we improved our growth in emerging markets, led by second half accelerations in Asia and the Middle East.

Remember, our net sales in both Q3 and Q4 had to absorb a planned negative 2% headwind resulting from the DSD exit in U.S. Snacks. This came in the form of SKU rationalization and list price adjustments. There was negligible impact in the first half, so the entire headwind was effectively in the second half. This was in line with our expectations for Q4, as it had been in the prior quarter.

When you exclude the mechanical negative impact of the DSD transition, our sales were up year-on-year in Q3 and up a little bit more in Q4. So clearly, we're starting to see underlying improvement in our top line. That said, we're not content with the sales decline, by any means, and returning to growth is a top priority for us.

Let's turn to profitability on slide 8, where we show the latest savings figures for Project K and Zero-Based Budgeting. As a status update, the bulk of the investments and actions for Project K are largely behind us, even if the savings run through 2019. And the same goes for ZBB, which is now a discipline incorporated into our daily operations. There's no question that we reduced the cost structure of our business with these actions. So we have good visibility into our cost structure going into the next couple of years as we continue to execute against these initiatives.

Slide 9 shows that these productivity efforts again paid off in the form of higher operating profit margins in Q4 and the full year. In fact, we finished the year with an operating profit margin of 16.9%, which is 250 basis points higher than the level we recorded in 2015, putting us well in the way towards the 2015 to 2018 target we set a few years ago.

On operating profit margin, we posted another quarter of strong expansion, led by efficiencies and savings initiatives in SG&A, most significantly from the elimination of DSD-related overhead. In fact, this overhead reduction was large enough to more than offset a substantial increase in brand-building across the company in Q4, both in U.S. Snacks and elsewhere. And it almost immediately brought U.S. Snacks towards the Kellogg North American operating profit margin average in Q4, even with the sizable reinvestments I mentioned.

Gross profit margin in the quarter was again reduced, but was effectively a reset of U.S. Snacks gross margin as it shifts out of DSD and into warehouse. As discussed previously, this involves a list price adjustment for the cost to serve of services we'll no longer be providing to the retailer, along with some logistics costs that now be captured in cost of goods sold as it resets the division's gross margin to a new lower level.

However, excluding this DSD-related reset in U.S. Snacks, the company's gross margin was up year-on-year, both in Q4 and the full year. Savings from Project K supply chain restructuring and Zero-Based Budgeting continue to more than offset the costs of investing in our food and packaging and the operating leverage impact of lower volume.

Our cash flow performance is shown on slide 10. In 2017, our cash flow was on our guidance and ahead of last year. It says something about the durability of our cash flow that through all the changes we are making, all the investments and restructurings that we are executing, we can still deliver strong and consistent cash flow.

Strong working capital improvement has funded nearly $1 billion of restructuring-related outlays over the past few years, not to mention elevated capital for expenditures for Pringles and other growth and efficiency investments. This durable cash flow gives us good financial flexibility, and we expect to increase cash flow again in 2018, so solid financial performance in 2017.

And with that, let's turn our sites into 2018, starting with our outlook for the top line. On slide 11, you'll see our outlook for net sales broken into key elements. First, the DSD transition, because the list price adjustment and SKU rationalizations really didn't go into full effect until mid-Q3 of 2017, we'll have about two quarters of negative 2% impact to total company net sales, just as we saw in Q3 and Q4 of 2017. This translates into about 1% negative impact for the full year. Excluding this DSD impact, our underlying business should continue to show improvement. We saw this in the second half of 2017 and this should continue into 2018.

Pringles Europe is back in growth. U.S. Frozen is back in growth. Specialty Channels continues to grow, and we are stabilizing our core developed international cereal markets.

In addition, we boosted brand-building investment in Q4. And this increased investment will continue into 2018, supporting key brands and with promising growth opportunities.

Consumption trends don't improve immediately, of course, but they should improve as the year progresses. That's why we think our underlying business can move towards flat sales in 2018.

Additionally, we've got RXBAR adding to our reported net sales growth. Between the acquired sales and the sustained growth momentum we see in the business, this could add another 1 to 2 percentage points of growth for us in 2018.

With that, let's turn to slide 12 and how we are looking at operating profit for 2018. Our productivity initiatives give us good visibility into cost savings. We expect to realize more than half of the remaining Project K savings in 2018, as well as all of the remaining Zero-Based Budgeting savings. Some of this will be used to cover modest cost inflation, led by a rise in transportation costs, and a good portion of this will be reinvested into our brands.

As you know, the reinvestment into demand-pull brand-building was a key element of our transition out of DSD. And so you can expect double-digit increases in brand-building in our U.S. Snacks business as well as smaller increases to our other businesses. Newly-acquired RXBAR contributes about 1 to 2 percentage points to our expected operating profit growth, reflecting not only the acquired profit but also its expected year-over-year growth.

From a margin standpoint, remember that gross margin will face the headwind of the DSD-related reset I mentioned earlier, but behind that should be continued productivity-led improvement and modest price realization. And at the operating margin level, we'll see strong expansion, as overhead savings related primarily to the DSD exit more than offset the reinvestments in brand-building. In fact, on the old GAAP basis, currency-neutral comparable and before the pension accounting changes, we would hit the 18% operating margin target that we established for 2018.

From a quarterly phasing perspective, keep in mind that our step-up in brand-building began in late Q3 of 2017 and will continue through the first half of 2018, holding our operating profit to relatively modest growth during Q1 and Q2 before accelerating in the second half.

So now, let's turn to slide 13 and our guidance for EPS. Before U.S. tax reform was passed, there was little difference between the operating profit growth and EPS growth because of offsetting items like higher interest expense related to the debt incurred to acquire RXBAR last October, and increased other income reflecting a higher pension asset base following last year's strong financial markets performance.

But this below-the-line leverage changes meaningfully with the recently-enacted U.S. tax reform. Through a lower corporate tax rate, partially offset by reduced or eliminated deductions, this reform will bring our overall corporate effective tax rate to something closer to 20% to 21% or about 5 to 6 points lower than our 2017 rate.

For now, we view this benefit as an opportunity to improve our financial flexibility. For example, we can use the tax reform's cash flow benefit to deleverage our capital structure. On the heels of our acquisition of RXBAR in December, the timing is right to pay down some debt and keep our powder dry for future opportunities. This means less of a year-on-year increase in interest expense.

Additionally, we can take a more conservative approach to our pension funds by making a cash contribution and/or shifting to a less aggressive investment mix, which would be accompanied by a reduction in our expect return on assets assumptions. This pulls down other income year-over-year.

Our EPS would have grown anyway this year, but this tax reform gives it an added boost. The result is an adjusted EPS growth of 9% to 11% year-on-year, another year of strong earnings growth. This, of course, is a currency-neutral outlook. Currencies are always volatile. And you've seen some swings in the past couple of months. Our best estimate right now is for currency translation to be modestly positive in 2018.

Slide 14 puts it all together: flat currency-neutral net sales, showing sequential improvement in underlying brands; strong currency-neutral adjusted operating profit growth, even with the increased brand-building investment; and strong currency-neutral adjusted EPS growth, helped additionally by tax reform. It also includes cash flow. We expect cash flow of roughly $1.2 billion to $1.3 billion, another year-on-year increase, aided by benefits from U.S. tax reform.

Overall, we think our 2018 outlook offers a good balance between savings and reinvestment, between top-line improvement and sustained operating profit growth. And we think it leaves us with greater financial flexibility for the future. So I agree with Steve. We are entering 2018 on sound financial footing, and we have the plans that will strengthen even further across the year.

And with that, let me turn it back over to Steve for a review of our businesses.

Steven A. Cahillane

Thanks, Fareed. Let's start with our largest business unit, U.S. Snacks, and slide number 15. In Q4, this business unit posted another quarter of strong operating profit growth, owing to the reduction of DSD overhead and partially offset by a planned substantial increase in brand-building, which should help build momentum heading into 2018. You can see the strong net impact on Snacks' operating profit margin.

In Q4, the impact of our DSD transition, namely our price adjustment and our SKU rationalization, came in as expected, roughly 8 percentage points of negative impact to U.S. Snacks' sales or about 2% negative impact to the overall company. This implies underlying growth for this business unit, just as we saw in Q3. This might have been aided by higher trade inventories, as retailers are still finding their optimal level for this new set of products in their warehouse, but this performance certainly indicates that we are on the right track.

Following our pullback in merchandising in late Q2 and early Q3 related to the DSD transition, we started to get back into normal promotional activity in Q4, and we supported key brands with increased advertising. This started with crackers, as the holiday season is an important one for this category. And we saw almost immediate resumption in consumption growth from our two biggest cracker brands, Cheez-It and Club.

We also improved consumption on key supported brands in our other categories, Keebler Fudge Shoppe and Famous Amos in cookies and Rice Krispies Treats in wholesome snacks. As I mentioned previously, we're please so far with the execution of an initiative that was enormously complex and risky. We completed the exit on time and on budget, and we received favorable feedback across our customer base.

Now, we are working through operating and competing in this new way of going to market in the supermarket channel. There will be some noise, at least through the first half of 2018. We've already discussed the noise in the P&L with the gross margin reset and big overhead savings offsetting increased brand-building, but there's also noise in the scanner data. Through the first half of 2018, we know we'll see lower ACV owing to our SKU rationalization. And we fully expect a decline in secondary and tertiary displays. All of this was planned.

We're pleased with our shelf assortment. And we believe that the added brand-building investment will continue to drive gradual improvement in our consumption and share performance. If you're looking for a lead indicator, it is velocity. A shelf strengthened by rationalizing tail SKUs and brands supported with more brand-building point to gradually improving velocities.

And as you can see on the chart, this improvement in velocity is already starting to take shape. So the message is we're on track. We've got a couple more quarters of year-on-year noise, but we feel good about where we're headed. The result should be gradually improving sales with another year of strong operating profit growth.

Now, let's turn to slide number 16 and U.S. Morning Foods. The quarter's operating profit decline was exaggerated by being up against an outsized 29% gain in the year-ago quarter. But what was the disappointing was that the cereal category did not improve on its year-to-date decline rate in Q4. As we've stated previously, we know what it takes to grow this category. It takes exciting food news centered around health benefits and taste and combined with effective brand-building and in-store execution. And we, and others, simply didn't bring enough of that to the category last year. So that's where our focus is. And Special K in Q4 can give you a glimpse of how we're getting back to this playbook.

In the second half, we properly married up food news with an effective media campaign and in-store activation, and we saw good results. The brand stabilized in its consumption and returned to share growth.

Similarly, we realized improved performance in Q4 for Pop-Tarts, a brand that had an uncharacteristic decline in the first half. Driving this improvement were commercial plans with strong in-store display activation.

Morning Foods enters 2018 with a stronger commercial plan, both in terms of bigger on-trend ideas and in terms of higher brand-building investment. In late December, we launched a truly unique cereal offering, Special K with Probiotics, leaning into a budding and justified consumer interest in digestive health.

We recently launched Chocolate Frosted Flakes, already the number one innovation at many retailers, and we've gotten off to a good start to the year. We know we can stabilize this business. We did it in 2016. And we did it this year in our other core developed cereal markets. We expect to see Morning Foods' operating profit [ph] way (25:06) down by increased commercial investment in 2018, but with gradually improving sales performance.

Let's now turn to Specialty Channels, shown on slide number 17. This business unit posted its 10th straight quarter of sales and profit growth in Q4, and this was in spite of the toughest comparisons of the year on both metrics. So this business unit has put together a really impressive track record.

Sales growth in the quarter was delivered by each of our three core channels, foodservice, convenience stores and vending. Foodservice was aided by additional FEMA orders in the aftermath of hurricanes in the Southeastern United States, and all three channels benefited from innovation and distribution gains.

Margin expansion also continued in the quarter on the strength of ZBB and RGM efforts. These are important and growing channels for us. And our sustained momentum reflects our continued focus on winning wherever the shopper shops.

In 2018, we expect to see continued growth in sales and share. We'll have to lap some unusual benefits, such as hurricane-related shipments in Q3 and Q4 of 2017, but we will continue to grow this business. Profit may be down, but that's only because of some reallocation of manufacturing and warehousing costs from other North America business units.

Now, let's talk about our North America Other segment, shown on slide number 18. This segment posted another quarter of sales and profit growth in Q4, closing out the year with an impressive second half.

U.S. Frozen Foods sustained its momentum with both Eggo and Morningstar Farms posting strong growth in consumption and share. Eggo continues to benefit from a reformulation to remove artificial flavors and colors as well as the continued success of Disney-shaped waffles.

Morningstar Farms is being driven by effective brand-building and in-store support, emphasizing our core on-trend, delicious grilling items. Canada also posted another quarter of sales growth, with growth across our portfolio.

Most impressive has been the return to share gains this year in cereal, where brands across our portfolio are responding to innovation and commercial programs. At Kashi Company, while we continue to work to stabilize the Kashi brand outside the natural channel, its fourth quarter was highlighted by the continued momentum of our Bear Naked brand, which has become the number one granola brand in the U.S. behind on-trend innovation and expanded distribution. North America Other carries momentum into 2018, led by Frozen. We'll also build on the incredible growth of newly-acquired RXBAR.

Turning to Europe and slide number 19, this region had its best quarter of the year in Q4 from a top line perspective. Not only did we get back to growth, we did it across our portfolio.

Pringles continues its return to growth following our interrupted promotional activity in the first half. This brand is back on track in developed markets and continuing its expansion in emerging markets like Russia, Central Eastern Europe and Turkey.

Cereal sales grew in the quarter. We grew in the UK, where we have successfully stabilized share with increased advertising behind core brands. Not only did Crunchy Nut, Corn Flakes and Krave gain share on improved velocities, but so did Special K.

We also improved our performance across Continental Europe, in particular France and Italy. Wholesome snacks also posted increased net sales in Q4, with notable contribution from expansion in the Middle East.

Europe was one of the businesses where we elected to add some incremental brand-building investment in Q4. This pulled down operating profit in the quarter, but bodes well for sustaining our improved sales and consumption performance.

Europe's fourth quarter performance gives us confidence as we head into 2018. Pringles is back in growth, with more expansion to come. Our emerging markets businesses, especially markets like Egypt and Russia, will continue to grow. And while the developed UK and Continental Europe markets remain difficult, we're confident we can maintain their stabilization via improved commercial plans, such as health and wellness-oriented innovations. And on the operating profit line, we should continue to benefit from productivity initiatives.

Slide number 20 discusses Latin America. All year, our soft top-line and bottom-line performance in this region was attributable to one particular sub-region, Caribbean/ Central America.

Just as we were getting out from under an overhang of trade inventory in the first half, business got substantially interrupted by Hurricanes Maria and Irma in Puerto Rico in late Q3. Business remained challenging through Q4, though we started to see signs of stabilization. Outside of Caribbean/Central America, we again posted growth. In Mexico, our biggest business in Latin America, our consumption and sales were up in both cereals and snacks, finishing a good year. In the more economically-challenged Andean and Mercosur sub-regions, our cereal sales were down, but this was offset by strong expansion in snacks.

And not fully in these currency-neutral comparable results was Parati. Acquired in December 2016, this business tripled our scale in Brazil. And despite very challenging economic conditions, the business posted double-digit growth in both the fourth quarter and full-year 2017. It's now largely integrated and is showing in-market momentum and it has great plans for expansion.

In 2018, we should see stabilization in Caribbean/Central America, steady growth in Mexico and momentum in Parati. The result should be improved performance for Latin America, both on the top line and the bottom line.

We'll finish up with Asia Pacific on slide number 21 Asia Pacific had another strong quarter, with solid top-line and bottom-line growth. We grew in both cereal and snacks. Cereal growth was led by rapid growth in India and Korea, and we also posted another quarter of growth in our very developed Australia cereal business.

As we've discussed previously, we have stabilized this business, growing consumption and share through food news and media behind our health and wellness brands as well as innovation and brand-building behind our taste-oriented brands.

Snacks growth was driven by both Pringles and wholesome snacks. Pringles' continued growth was broad-based across the region, driven by emerging markets as well as Australia and Korea.

Wholesome snacks, still a relatively small business for us in this region, posted especially strong growth in Korea. And we're in the early phases of launching these products elsewhere in Asia and Africa.

It's important to remember that these results do not include our joint ventures in West Africa and China. Once again, these operations posted strong double-digit net sales growth year-on-year, continuing to build scale and brand awareness for us in these emerging markets. If these JVs were consolidated, we'd be reporting a significantly larger growth rate in Asia Pacific and, in fact, one of the fastest growth rates in our peer group in that region.

So Asia Pacific finished strongly in what was a very good year in 2017. We expect Asia Pacific to continue to be a growth driver for us in 2018, led by cereal and Pringles expansion in Asia. Though not in our consolidated results, we'll also continue to expand our joint ventures.

So allow me to summarize with slide number 22. First, I am so excited to be here at this company, at this time. We have special brands, special foods, special people and a special culture. These are key ingredients, and we have an organization that is hungry to win again. We're coming off a year in which we gained traction in several businesses, reduced our cost structure, improved our working capital and delivered strong profit and earnings growth that was in line with our guidance.

We're on sound financial footing going into the new year. We've made big important strategic moves. The transition out of DSD was central to accelerating growth and margin expansion. We boosted our emerging market scale by growing organically, while integrating Parati in Brazil and rapidly expanding our joint ventures reach and product line in Africa and China. We acquired RXBAR, filling in a white space for us and offering us a new growth platform. And we boosted our resources and sales in the rapidly-growing e-commerce channel. We are on our way back towards top-line growth.

Net sales guidance for 2018 reflects roughly two quarters of negative DSD transition impacts and the prudent assumption that it will take some time for our investments to take hold. Our commercial ideas are stronger, and we are putting increased investment where the growth is. We have strong cost savings that enable us to boost investment in growth, while still delivering on margin expansion and solid profit and earnings growth.

We'll go into more detail at CAGNY in a couple of weeks, when we'll discuss where I see the most promising growth potential and how our growth trajectory might look over the next few years. I also look forward to meeting many of you while there. I'd like to finish by thanking our employees for their incredible dedication and hard work.

And with that, let's open it up for questions.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Alexia Howard with Bernstein. Please go ahead.

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

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

<A - Fareed A. Khan>: Morning.

<Q - Alexia Jane Howard>: Hi, there. I guess, I'd like to focus on the Morning Foods segment because the sales trends have been particularly challenged in there, even against a negative comp from a year ago. Could you talk a little bit about the competitive dynamics in there? It looks as though your key competitor has taken pricing down. And also maybe trends on distribution in the U.S. cereals category for you as well, when do you expect that to actually bounce back into positive sales growth? Thank you and I'll pass it on.

<A - Steven A. Cahillane>: Thank you, Alexia, appreciate the question. First, I'd start off by saying as regards to our Morning Foods business, it's an important business for us and one that we believe can return to growth. And we've demonstrated that by growing three of the four core cereal markets around the world. We stabilized the business in Canada, in UK, and Australia around a playbook that focuses on nutrition, on brand-building and in-store execution.

These are the things that I've learned in my four months are key drivers to the category. They stabilized the business in those three markets, and they can do the same thing in the North American market as well.

Having said all that, I'd also remind you, though, that Morning Foods is not going to be the growth driver for us in the Kellogg Company. We know we can stabilize it. We aim to stabilize it, but we look across the world and we see our emerging markets growing the way that they are, Asia Pacific doing incredibly well, the growth of Parati in Brazil and Mexico back to growth, the UK and Europe stabilizing and growing in the second half and the incredible growth driver that is Pringles around the world.

It sets us up for really solid growth. But Morning Foods is a business that we know we can stabilize once again, focusing on nutrition, brand-building, in-store execution and the right level of investment. And you'll see that coming out of Q4, where we put additional investment behind all of the businesses I just spoke about and that'll continue into the first half of 2018, where we aim to slowly stabilize the business of Morning Foods.

<Q - Alexia Jane Howard>: Great. Thank you very much. I'll stick to my one question and pass it on.

<A - Steven A. Cahillane>: Thanks, Alexia.

Operator

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

<Q - Bryan Spillane>: Good morning.

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

<Q - Bryan Spillane>: Hey. I guess a question around the Snacks business and investment in 2018. Steve, can you talk a little bit about how much of the investment is going behind I guess, increasing like marketing or pull investments? And how much of it in 2018 will go towards beginning to expand the Snacks footprint into other channels, given that it had such a focus on large-format foods? So really trying to understand how much of that investment is brand pull or marketing pull and how much might be beginning to inch out distribution into channels where it was under-represented.

<A - Steven A. Cahillane>: Yeah. Thanks, Bryan. First, I know you're aware of the whole reason that we pulled out of DSD. It was not a good return on investment and I give great credit to the team that pulled this off, because it was incredibly complex and it was brave and it was done with great execution. And it's allowed us to put that money back into brand-building. Significant pressure against the brands started last year and will continue into this year, with the whole model now being a pull model versus a DSD push model focused on the consumer, focused on brand-building.

Having said that, there's also innovation coming and different formats that you talked about, more focus on immediate consumption, where we believe we have big opportunities. And so you'll see us doing a lot of innovative things, a lot more brand-building things. And what's allowed us to do this is the whole DSD exit and the focus on pull and brand-building. So very pleased about where we are, pleased about the investment back into the top line. And we believe we'll see good underlying growth based on the execution of the programming.

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

Operator

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

<Q - Robert Moskow>: Hi. Two questions; one is just on currency. I had thought that you would have a little bit more EPS benefit from currency for the year than what you seem to be intimating here. Is there something happening from across currency standpoint that's, I guess, contradicting that?

And secondly, Steve, it is great to see Europe, Australia stabilizing. But I guess, over the years, we've been trained to, I guess, not quite trust stabilization in those markets. Things happen. And I just wanted to know if you have a good sense of why these efforts that have been made more recently have some sustainability to it? And do you believe that the category in those markets is stable or is it just like what your business is doing is executing better? Thanks.

<A - Fareed A. Khan>: Robert, it's Fareed. I'll start by just your questions on currency. Obviously, we look at the future, just like everybody else. And so this thing can move around a little bit. But our view in 2018 is that we're going to see modestly positive FX impact on the business, and that's what we've given. There's also country mix that factors into there. We look at different parts of our business growing.

And then, our primary exposure is to obviously the dollar, the pound, the Canadian dollar and the Mexican peso and so it's really those are the key currencies that factor into it. But right now, our view is modestly positive for next year. Is that a percentage point? Is it a percentage and a half? That's kind of the range that we're in right now. I'll turn it back over to Steve.

<A - Steven A. Cahillane>: Yes. Robert, thanks for the question. I'm not going to over-promise and say that nothing's ever going to happen and businesses aren't going to fluctuate and go up and down in competitive environments. But what I will tell you is what I've seen in those three core markets has been an execution, a solid execution around, what we call here, the playbook. And again, it's nutrition, brand-building, in-store execution and excellence in execution. And I see that in the three markets. And I can give you some examples of that.

So, for example, in the UK, Corn Flakes has been a business that's been around for a very, very long time, very mature business. And the team there put together a new brand-building idea, a program around what we internally call versatility, but was really a reintroduction to consumers to reconsider Corn Flakes in various dayparts and a real fun way to talk about in a social media way how people enjoy the perfect bowl of Corn Flakes. It went viral. It became part of the dialogue. It became contemporary again and Corn Flakes started growing double digits.

And so you point to things like that and you see things like that, and it fundamentally reinforces to me that this is a business that can grow. The other thing I would tell you is, you'd be hard-pressed to find businesses with household penetration that are almost 100%. I mean, getting it into people's pantries is not difficult, it happens. But getting people excited about it is our job to do. And we can do better in brand-building in the United States, and we've got good programs and good ideas that we're bringing forward.

I guess another thing I'd tell you is it just requires innovation and constant innovation and really pressing ourselves. And if you look at Bear Naked in the U.S., which is now the number one granola brand, it's number one granola brand because it's excellent food, well executed and is really connecting with consumers. So it's up to us to really maintain a high standard of these things and execute with excellence because it's not easy. It's a competitive category. It does respond when it's marketed to well, but if you stumble, you can lose some volume.

So we are bound and determined to grow the three markets that are stabilized, to stabilize our North American Morning Foods business. But as I said earlier to Alexia, it's also you shouldn't look at U.S. Morning Foods and say this is going to be the growth engine for the Kellogg Company. It's all the things that I mentioned earlier around emerging markets, around our other brands and categories, getting bigger in snacking.

I mean, this company over the course of the last five years, has really transitioned itself from primarily a cereal business to much more of an innovative snacking business. And the latest acquisition of RXBAR is just kind of the cherry on top. That's a business that filled a white space for us. And it's doing incredibly well and really connecting with consumers and growing rapidly, has outsized share based on its ACV distribution.

So you'll see us invest wisely around where we see the real opportunities to grow this business, but we will not starve areas of the business that we know are important and we'll do it prudently and wisely.

And I believe we can get all four businesses in a good stable position, but I come around again to say it won't always be perfect. In any business that has the type of excellent portfolio spread wide that we do, they're always going to be areas that are accelerating and doing well and areas that we're working on. We're not always going to have a U.S. Frozen business that's growing double digits, but when we do, we'll invest wisely behind it, try and continue to push that. But we have to be cognizant of all the different portfolio pieces that we have, invest wisely so that we can grow the totality of our business.

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

Operator

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

<Q - Kenneth B. Goldman>: Hi. Thank you. Steve, if you look at the EBIT margin, including the change in pension accounting, I would argue it's a little bit toward the lower side of the peer group, depending on who you're including in that.

Can you talk a little bit, and I know it's still early days for you and maybe you haven't done this full analysis yet, but as you look down the road, how much of a margin opportunity do you see? And if you do see one, where might some of those opportunities come from?

<A - Steven A. Cahillane>: Yeah, Ken, thanks for the questions. I do see opportunities to continue to expand our margin. But the important thing that I see is it's an and thing. We have to continue to expand our margins and we have to grow our top line by continued smart brand-building investment.

Currently, our index versus our peers is higher in brand-building. So that's one of the reasons we're a little bit lower on the operating profit margin. But having said that, we clearly have an opportunity to continue to expand our margins and you'll see us target towards continued top-line growth, continued margin expansion.

The best way that I see of expanding our margins is continuing the great discipline that has happened around this company around cost containment and cost reduction.

You've seen that in Project K. You've seen that in ZBB. You've seen that in zero overhead growth, all which have led to the 250 basis point improvement that Fareed talked about and will continue into this year, allowing us to achieve that 350 basis points, but that's not a finish line.

It's not a finish line, so we'll continue to expand our margin, but the best way to do it, again, is to maintain a good cost discipline and to grow the top line, and do those both types of things.

And you get into a nice algorithm that historically we've seen in this business. And we believe we can get there and it'll be by focusing on both of those things, top-line growth and cost containment leading to good margin expansion.

<Q - Kenneth B. Goldman>: Great, thank you.

Operator

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

<Q - Timothy S. Ramey>: Thanks so much. Steve, your background is considerably different than many at Kellogg. And you didn't really get into kind of strategic [ph] views of capital and fun. (47:15) I know you're not going to in response to the question, but is it something we'll expect you to discuss at CAGNY in a more full way?

<A - Steven A. Cahillane>: Thanks for the question, Tim. We are going to discuss at CAGNY a much more fulsome strategic view of where we see the company going over the course of the next three-plus years and beyond to include many things. What we promised here today is to talk about 2018 guidance, which we've done. And then at CAGNY, we'll be talking about the more strategic questions that you raised.

<Q - Timothy S. Ramey>: Perfect. Thanks.

Operator

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

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

<A - Fareed A. Khan>: Morning.

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

<Q - David Cristopher Driscoll>: I wanted to ask about the reinvestments. It's a bit of fourth quarter question here and a bit of a 2018 question. The Snack business, I think the original projection was a 17% margin by 2019. You hit that number in the fourth quarter here, so clearly an over-delivery, EPS comes in a little bit ahead of consensus.

In a lot of places, you said you reinvested. Is it correct to say that Snacks fairly substantially over-delivered and the company chose to take that over-delivery and reinvest it across the business in the fourth quarter? And then in 2018, can you give us some quantification of the size of this reinvestment? Thank you.

<A - Fareed A. Khan>: Sure David, its Fareed. So we did have a strong Q4. Snacks definitely had a good quarter. We had other businesses that had very strong results as well. And the Snacks success was really the successful execution against the DSD exit. We've been talking about that for several quarters, but the key elements of that fell right into place. And we're starting to benefit from the overhead savings that are flowing through. There was always a plan to invest back in Snacks' brand-building. And as you'll recall, we actually pulled back on some of those investments in Q2 and Q3 to just sort keep promotional activity stable.

And so we are probably light on investments back into those key Snacks brands. That came on as planned in Q4. Those will continue and so we're back at it. And we're actually seeing velocities, and we're seeing some of those brands come back, which is encouraging.

On top of that, because of the strong performance, we did additional investments in very targeted areas, so we looked across the different opportunities. We have some very solid ROI metrics. We looked across opportunities and we probably had somewhere in the order of a $50 million year-over-year lift in brand-building in Q4, which is pretty meaningful, but we were on track for a strong full year delivery. And we're pleased with the outcomes.

As we look into 2018, what we want to do is make sure that we've got fuel in the first couple of quarters to continue to build on that momentum. And so as you think about Q1 and Q2, what you see there is a sort of a run rate incremental brand-building investment like we've seen in Q4.

And, again, it's for sure in Snacks, because that's always the plan. We're also taking a pretty targeted look at other businesses, not just in North American, and around the world. That's why in the phasing, we want you to consider heavy incremental brand-building Q1, Q2 and then going back more to a normalized pace. And then we'll see how the year progresses. Obviously, if the brands are responding, we'll continue to keep the pressure. But we like what we see so far.

<Q - David Cristopher Driscoll>: So it sounds like the narrative is pretty straightforward. You guys have been exceeding your plan. You've taken some of that over-delivery, reinvested it. That'll continue into 2018. I think that's what you just said, but, Steve, maybe you can just comment then on organic revenue forecast. I think it's minus 1% to minus 2%, so just connect the dots for us. When we hear all this reinvestment, it sounds great. When you listen to the organic revenue forecast, it's still weak, minus 1% to minus 2%. Is this just very conservative on your all's part or do you just think it takes that much time before we actually can get back to something positive?

<A - Steven A. Cahillane>: Yeah. Thanks, David. I think I'd point out a couple of things. We still have the headwind of the DSD exit, which continues in the first half, which is worth about a point.

And so we look at the underlying really to be flat to minus 1%. I wouldn't call it conservative. I'll call it prudent. I think it's right down the middle. We've got RXBAR, which will add a point to two. So we're trying to get this business talking about growth, focused on growth. And clearly, we're investing in growth.

Now having said that, I see a lot of opportunities around the world and in North America already growing, we've got Asia Pacific. We've got Pringles globally. U.S. Frozen, which I mentioned, which is really hitting on all cylinders right now, U.S. Specialty with 10 quarters of solid growth. And the emerging markets, which are very exciting to us, with stabilization in [ph] Cari/Cam, (52:27) good momentum in Parati, opportunity to expand Snacks in Asia. And so I get to the point of your question. You say all of those things and say, wow, that sounds exciting, why not a more aggressive growth forecast?

Well, we're going to shoot to do better than that, but we think it's better to be prudent, but we're going to shoot to do better than that. As Fareed said, we've invested in the fourth quarter. We like what we see coming out of that investment.

We're going to put continued pressure in the marketplace. If you take what Fareed talked about in the fourth quarter and you carry that through to 2018, we'll have at least $100 million of additional brand-building pressure in the marketplace.

And I'd love to be in a position where we're talking about exceeding our net sales goals, but right now, we think it's just smart to be prudent since it's still early.

<Q - David Cristopher Driscoll>: I really appreciate the depth of the answer. Thank you.

<A - Steven A. Cahillane>: Thank you, David.

Operator

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

<Q - Matthew C. Grainger>: Hi. Good morning. I just wanted to ask about gross margin outlook, I guess. Fareed, I know you talked about some of the puts and takes, the continued impact from rebasing the margin structure in Snacks and then some benefit from pricing, but can you give us any more quantified view of the gross margin outlook, off of whatever the restated base is ultimately going to be, both on an underlying basis and once we take into account of the DSD exit?

And I guess, just in terms of other specifics, if there's any commentary you can give us on the impact of freight costs and how that's reflected in the outlook.

<A - Fareed A. Khan>: Sure. So let's take gross margins and for the moment peel away the effect of the DSD dynamics. And what we want to see is stable to slightly improving margins. And that's going to come from continuing to innovate and drive products that are mix-accretive, but a big part of that is the efficiency programs that we drive every day.

And so, while we do expect to see logistics inflation be a factor, some of the commodities that go into our products, we see inflationary. Some are the other way, but the most important thing is we've got ongoing productivity and cost savings initiatives that are addressing those and so we see gross margins up to flattish as we go into next year.

Then when you overlay the DSD, there's a mechanical effect of the price adjustments. And there's also a geography impact, where the DSD model of all of those delivery warehouse-related costs flow through overhead. Some of those now flow throughout cost of goods.

So you factor those out, but what you get to is a stable to slightly improving gross margin. And that's primarily driven by productivity offsetting those inflation factors I talked about.

<Q - Matthew C. Grainger>: Okay. And just to follow-up on the last piece, the impact of higher freight costs, obviously, that's something that you can offset with the productivity and the cost savings, but how severe of a discrete headwind is that?

<A - Fareed A. Khan>: It's a factor. With combination of driver shortages and regulation changes, it's something I think that everybody's facing. So it's something that we need to manage. So logistics specifically, we saw double-digit type of increases in Q4. We expect to see high single digits as we go into 2018. How that plays out over the longer-term, [ph] it will be difficult to watch. (56:12) But it's back to really looking at our network and continue to make sure we've got the most efficient network. And part of the DSD logic, again, was to get all of our businesses on one platform. And that creates the basis for continuing to optimize and to move forward. But I think in the near-term, logistics will be a challenge for everybody.

<**Q - Matthew C. Grainger**>: Okay. Thanks for the color, Fareed, appreciate it.

Operator

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

<**Q - Michael S. Lavery**>: Thank you. Good morning.

<**A - Steven A. Cahillane**>: Morning.

<**Q - Michael S. Lavery**>: As you think about brand spending or investments, how do you determine what the optimal level is? And is it benchmarking against peers or a percentage of sales or just some of what your history has been? How do you factor all that in and what drives how you think about what the right increases are?

<**A - Steven A. Cahillane**>: Thanks for the question, Michael. I can tell you what I found when I came in was a very good and sophisticated marketing mix model with good ROI measurements. And so you kind of start there in terms of understanding what you can get for your investment. But there's nothing like a great idea well-executed that builds equity and drives consumer interest, drives trial, drives repeat. And so there's no one model that will tell you where you get to the point of diminishing returns, but great ideas well-funded can do wonders for brands. And we've seen that and we continue to see that here.

Having said that, there's also minimum requirements for brands that are an important part of our stable that we make sure that we don't slavishly just chase where the best ROIs are, but we're also prudent and we give solid brands enough support so that we don't have a tail that we have to address down the road.

So there's a lot of science to it, but there's still some art to it. 25 years ago, it was 80% art, or maybe 90% art and 10% science. Now, you're probably 70% science, and the rest judgment, wisdom, experience and art. And we're trying to put all those things into place as we build plans and then you adjust those plans as you see exactly what's happening and what return you're getting and what's moving the needle.

<**Q - Michael S. Lavery**>: And do you have a commensurate increase in R&D for the innovation to put the marketing dollars behind? Are those coupled at all and how do you think about that bucket of spending?

<**A - Steven A. Cahillane**>: Well, it's an important bucket of spend, because we're very focused on innovation. And you'll see us bringing things in the back half of this year and into 2019 that we're working on accelerating right now that come right out of our R&D group working together with our business units. We've got a terrific R&D facility here, it's inspiring to go through. I've been very, very impressed by the capability that we have. And so it's clearly an area as I look around that's worthy of investment, but it's got to be completely joined up with the rest of the businesses.

And I think from an efficiency standpoint, we can probably do even more with what we have currently. And as we look at the model, it doesn't all have to be in-sourced. It comes through partnerships. It comes through activities like [ph] our 1829 investments. (59:29) It comes from even acquisitions. RXBAR's brought a tremendous amount of new thinking and innovative thinking and entrepreneurial flair to the company. So we look at it holistically. But we are excited when we see the opportunity to put a $100 million of additional pressure behind our brands over a kind of a rolling 12-month basis.

<**Q - Michael S. Lavery**>: Okay, great. Thank you very much.

Operator

The next question comes from Pablo Zuanic with SIG. Please go ahead.

<**Q - Pablo Zuanic**>: Thanks, good morning. It's a bit of a philosophical question, but Coca-Cola Company, where you were before, does a great job in terms of persuading people in emerging markets to drink soft drinks. And do you really

see the potential in emerging markets and cultures, where cereal is not part of a local habit or culture, for Kellogg to really build that business over time, or is your focus going to be more on developing the Snacks business in emerging market, and not emphasize cereal as much?

That's the first question and the second one just related to that, when you bought RXBAR, you talked about pivoting to growth through acquisitions. That was my interpretation at the time. We've seen coffee companies buy soft drinks companies. We've seen coffee companies buy pet food companies. Does that mean that Kellogg, at some point, as it pivots to growth, that it would look at other categories also? Thank you.

<A - Steven A. Cahillane>: Yeah, Pablo, thanks for the questions. First on the cereal in emerging markets, I see a real opportunity to actually develop that in many markets, but it's an and thing. Our bigger opportunity is, I mean, we have a huge opportunity with Pringles and snacks around the world.

I was in Nigeria just a couple of weeks ago. We've just launched cereal there and it was very exciting to watch. It was very exciting to be with the team as they were going through the plans and actually launching the product.

So we see good opportunity. It's affordable. It's healthy. It hits on a lot of trends around health and wellness, around megatrends of emerging markets and growing middle classes. It's, in many ways, just a perfect addition to diets and lifestyles in many emerging markets, but it's an and thing because we have big opportunity with snacks in emerging markets as well.

And the other thing I'd tell you or answer your question around acquisitions, I want to be very clear. They are great opportunities as we look around the world to do acquisitions like RXBAR, where we see a white space in our own company and we see the right opportunity at the right price. And we have to be very, very disciplined buyers as it pertains to M&A, but the single biggest opportunity I see is actually organic growth, both in our North America business but in our out of America North America business, our emerging market business and our Europe business.

So we've got great opportunity with this wonderful stable of brands that we have, to grow them through focusing on the right brand-building activities and, again, leaning forward and investing in the brands, which you're seeing us do with this $100 million of rolling 12-month pressure against them. And we believe this great portfolio of brands can grow, not every single one and not every single geography, but on balance we can get an algorithm of growth that really works for us. And then we can look at bolt-on acquisitions, like RXBAR, as an accompaniment to that. And so that's the way I kind of see our portfolio, and I think it's very exciting. And so thanks for the question.

John Renwick

Unfortunately, we've hit 10:30. So we're going to have to finish the call here. I'm around all day, if you have any other follow-up questions, but thanks for your time and interest. Operator?

Operator

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

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