Company Name: Kellogg
Company Ticker: K US
Date: 2018-08-02
Event Description: Q2 2018 Earnings Call

Market Cap: 24,163.19
Current PX: 69.665
YTD Change($): +1.685
YTD Change(%): +2.479

Bloomberg Estimates - EPS
Current Quarter: 1.124
Current Year: 4.455
Bloomberg Estimates - Sales
Current Quarter: 3398.143
Current Year: 13396.211

Q2 2018 Earnings Call

Company Participants

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

Other Participants

- Michael S. Lavery
- Ken Zaslow
- Eric J. Larson
- Kenneth B. Goldman
- Robert Moskow
- David Cristopher Driscoll
- David Palmer
- Bryan D. Spillane
- Pablo Zuanic

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Second Quarter 2018 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speaker's 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 second quarter 2018 results. I am joined this morning by Steve Cahillane, our Chairman and CEO; and Fareed Khan, our Chief Financial Officer.

Slide 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, August 9. The call will also be available via webcast, which will be archived for at least 90 days.

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

Steven A. Cahillane

Thanks, John, and good morning, everyone. We're pleased with how our 2018 is going. Our top-line performance is clearly improving. If you exclude the mechanical impact of our DSD exit, we delivered a fourth consecutive quarter of organic net sales growth. And our in-market performance is improving as well.

We delivered on our financial expectations for Q2 and the first half, even as we significantly boosted brand building investment and managed through cost inflation and other challenges. More importantly, our progress toward returning to long-term sustainable growth continued.

Firstly, our big brands are back in growth. Pringles is growing across the globe in the United States, in Europe, in Latin America and in Asia Pacific. Other snack brands, like Cheez-It and Rice Krispies Treats, have sustained strong consumption growth, even in the aftermath of our transition out of DSD. Brands like Bear Naked and RXBAR continue to expand.

Frozen Foods brands, Eggo and Morningstar Farms, continue to grow consumption, even as they lap last year's strong acceleration. Around the world, we're growing brands like Coco Pops, Froot Loops, Crunchy Nut and Krave, all through effective brand building activity. Even Special K and Kashi Cereals, which had been down sharply in recent years, are making strong improvements in their consumption and share trends.

Second, we're investing for the future. We increased our advertising and consumer promotion, what we call brand building, at a double-digit rate again in Q2, just as we said we would. This investment, along with investments we are making in new pack formats, speaks to the quality of our earnings and to how serious we are about getting our brands back in sustainable growth.

Meanwhile, we also invested cash in our pension funds, making a voluntary contribution to mitigate potential risk in the future and to take advantage of a changing corporate tax rate this year.

And we're integrating and executing well on recent acquisitions, including RX and our newly consolidated West Africa business. Both of these entities improve the growth profile of our portfolio. And thirdly, we're increasing our full year 2018 sales and earnings guidance.

It's gratifying to see our top-line come in better than anticipated in the first half, giving us the ability to reinvest in the business and still deliver strong earnings growth, even before the tax benefits of U.S. tax reform and pension contribution.

It's also gratifying to see our acquisitions performing well right out of the gate, giving us new platforms for future growth. We know we've got a lot of work yet to do, but Q1 and Q2 results, as well as our full year guidance, should give you confidence that we're on the right track.

Let me now turn it over to Fareed, who will walk you through the specifics of our Q2 and our first half financials. Fareed?

Fareed A. Khan

Thanks, Steve. Good morning, everyone. Slide 4 summarizes our results for the second quarter. It was another good quarter, characterized by improving consumption and sales trends, as well as the substantial reinvestment that began back in Q4 of 2017. Our net sales, obviously, got a lift from our RX acquisition and recent consolidation of Multipro, our West Africa distributor. And both of these businesses sustained their strong growth rates in Q2. We also realized organic growth outside the negative and mechanical impact of the DSD exit. And I'll come back to this in the moment.

We had signaled a few months ago that operating profit would be down year-on-year in Q2, excluding the acquisition impact of newly consolidated Multipro. This was because of our plans to significantly increase our brand building and we did exactly that. It leaves our OP at a low single-digit growth for the first half, which is when our brand investment is the most heavily weighted this year.

And on EPS, we posted another quarter of double-digit growth. Higher interest expense related to our recent acquisitions was more than offset by tax rate favorability. Most of this was due to U.S. tax reform, but we also recorded some additional favorability related to making a voluntary cash contribution to our pension funds, taking advantage of being able to deduct at the higher pre-reform U.S. corporate tax rate.

I should note that we continue to deliver on cash flow. We're comparing against a year ago that was recast for accounting changes, reclassifying certain cash collections to a different section of the cash flow statement. But even excluding that reclassification, our cash flow has been strong enough to enable us to make a $250 million voluntary pension contribution. And excluding both of these items, to be more apples-to-apples, our cash flow is up year-on-year through Q2. So we like where we stand midway through the year. Let's examine the results in a little bit more detail.

Slide 5 walks you through the components of net sales growth in the quarter and the first half. Excluding currency, our net sales grew more than 6% year-on-year. Two acquisitions contributed almost 7 points of growth. We began consolidating Multipro in May, giving us two months of its results in our second quarter. That business continues to grow at a strong double-digit rate. The other acquisition, of course, was RX, which was acquired in October of last year. It, too, continues to post strong double-digit growth in the quarter.

On an organic basis, our sales were off slightly year-on-year in the second quarter, leaving us up slightly for the first half. Keep in mind that for the first half, this organic growth was pulled down by about 2 percentage points by the mechanical impact of last year's DSD exit, specifically the rationalization of SKUs and the elimination of the price premium we used to charge for DSD services.

As discussed previously, this impact was a larger negative in Q2 than Q1, solely because of the very different year-on-year comparisons. So if we strip this DSD impact out, we've now posted 2% organic growth in both the first and second quarters. This gives us four consecutive quarters of underlying organic growth on this basis. It's an indication that our strategy is gaining traction.

Let's turn to our profit margins, starting with gross margin on slide 6. It's helpful to break our gross margin decline into three buckets. Let's start with the first bucket, which is the mechanical impacts of our DSD exit and the consolidation of Multipro. The DSD impact, we've discussed many times, but as a reminder, it's effectively a reset of our gross margins in U.S. Snacks related to our exit from DSD. This includes the downward adjustment to our selling price to reflect no longer charging for DSD services and the shift between line items on the P&L. Specifically, there's the movement of logistics out of SG&A, where they reside in DSD accounting, and into cost of goods, where logistics costs reside in warehouse distribution. These factors mostly anniversaried at the end of July here in Q3.

The impact of consolidating Multipro was new this quarter. As a distributor, Multipro carries a lower gross margin than the rest of our business. We're more than okay with that because it's not cannibalistic to our base business and owning a distributor is a significant competitive advantage for us in emerging markets like West Africa. It also drives strong dollar growth.

And remember, within our West Africa investments, we also own a stake in a [ph] branded manufacturer and joint ventures for Kellogg branded products. (9:00) These carry strong packaged food margins, but only the distributor portion is currently consolidated into our results. We'll have this mechanical impact from including Multipro for three more quarters.

The second bucket is growth-related. By growing our volume, we did see some positive gross margin impact from operating leverage. However, this acceleration in volume also participated in an acceleration in mix shifts that negatively impact our gross margin percentage, a mix shift towards emerging markets, for example, and away from developed markets cereal.

We also experienced a mix shift towards single-serve formats. Now, given their price-pack architecture, you'd expect these single-serve items to be margin accretive, but we've utilized co-packers for many of them in order to get to the market as quickly as possible. This is a smart way to go. And now that demand has been established, our supply chain can catch up to our investing capacity, which will improve margins going forward.

These various mix shifts mainly reflect where our business is coming from, where growth is coming from. We've been leaning into them for top-line growth. Not only is it working, but these shifts haven't been cannibalistic. In-all, a big impact in Q2, but less going forward, and we're addressing some longer-term profitability opportunities within many of these mix shifts.

Meanwhile, there is also a contribution to mix from a year-ago promotional comparisons that will be behind us in the second half. For instance, promotional activity is back to normal for Pringles Europe. And U.S. Snacks will start to lap its own pullback in promotions last year.

The final bucket is ongoing, our costs versus our productivity. The surge in transportation costs has been well documented. We've also seen an increase in inflation for many other cost inputs. We're managing through these. And in Q2, like Q1, we were able to largely offset their impact on margin with our productivity savings. But as this inflation moves higher, we're obviously going to go further on savings programs and on Revenue Growth Management in order to offset it.

Bottom line, there's some good reasons for the year-on-year decrease in our gross profit margin percentage in Q2. We'll lap the DSD impact here in Q3 and the Multipro impact in a few quarters and our mix impact related to our growing businesses and we'll have some supply chain solutions for this. That leaves ongoing cost inflation, where we'll continue to manage through with productivity and Revenue Growth Management initiatives.

Our operating profit margin is shown on slide 7. Operating profit margin decreased year-on-year in Q2, principally reflecting a strong double-digit investment in brand building. This is a third straight quarter of double-digit increases in brand building. A large portion of this increase was in U.S. Snacks, where our exit from DSD has effectively traded declining ROI overhead for higher ROI brand investment.

We've also increased brand building at double digit rates in several other businesses and regions. And while we're investing more, we're also being very selective about where and how we are investing. Clearly, it's already having a positive impact on our top-line performance and we'll continue to lean into reinvesting, where appropriate.

Masked by this increase in brand building is a sharp reduction in overhead, mainly related to the DSD exit, but also reflecting good cost disciplines and Project K savings.

So Q2 was a quality quarter, marked by improving top-line and heavy reinvestment for future growth and even overcoming unexpected headwinds, like the trucker strike in Brazil. This gives us good confidence in our full year outlook.

In fact, as shown on slide 8, we are raising the key elements of our financial guidance for the year. We're raising our guidance for currency neutral net sales, now looking for growth of 4% to 5% year-on-year. We still expect acquisitions, RXBAR and Multipro, to account for 4 to 6 percentage points of growth and both are performing very well.

Organic sales are now expected be flat to down 1%, an improvement of about a percentage point from our previous guidance. Driving this improvement is essentially our first half over-delivery and we continue to take a prudent view towards our second half, especially given the tougher comps we face in European Pringles, U.S. Frozen Foods, and U.S. Snacks, excluding the DSD exit.

We should note that the negative DSD impact, which weighs down our organic growth, is largely behind us by mid-Q3. We are reaffirming our guidance for adjusted operating profit growth of 5% to 7% on a currency neutral basis. Less than half of this growth comes from acquisitions, whose outlook is unchanged. The rest of the gain comes from our underlying business, even after a strong increase in brand investment. To some degree, our decision to leave operating profit unchanged is related to our first half mix impact, but it also reflects our desire to maintain the opportunity to reinvest more.

We're raising our guidance for currency neutral adjusted earnings per share, adding a couple of percentage points to give us a new range of 11% to 13% off a recast 2017 EPS base of $4.00 per share. This increase in EPS guidance is because we are reducing our outlook for tax rate to about 18% to 19%, reflecting Q2's tax benefit from our voluntary pension contribution.

While our underlying cash generation remains on track, the pension contribution does lead to a reduction in our cash flow outlook. This is an investment that not only offers a tax benefit for us this year, but also reduces pension risk over time, so it's a good use of cash.

Separately, we're also increasing our capital expenditure plan for the year by almost $50 million to fund promising growth initiatives, such as capacity for single-serve pack formats and for emerging markets. These are high return investments.

In summary, a good second quarter that leaves us in a strong financial shape as we head into the second half. As you think about the split between Q3 and Q4, keep in mind two important factors. Q3 not only compares against our strongest profit performance last year, a strong double-digit gain, but we also have brand investments to Q3 that was not previously in our plan. So Q3's operating profit may be flattish, while Q4 should be up strongly as it laps last year's sizable ramp-up in brand building.

And with that, let me turn it back over to Steve to walk through our businesses.

Steven A. Cahillane

Thanks, Fareed. Let's start with U.S. Snacks, which is shown on slide number 9. The first thing to note is that we remain ahead of plan on net sales. Yes, Q2's decline was larger than Q1's, but remember that Q1 and Q2 had decidedly different year-ago comparisons on DSD impact. As Fareed mentioned, Q1 compared against a small year-ago net disruption, while Q2 compared against a small year-ago net benefit from pipeline fill. We're actually ahead of where we thought we'd be and we've now recorded four straight quarters of year-on-year growth, excluding this DSD impact.

We're also pleased with where we are from a consumption standpoint. Across all our categories, we saw another quarter of increased velocities, which we've always said would be our lead indicator of improved competitiveness as we get through the initial 12 months of transition.

And as the slide shows, we are also improving our share performance in each category. Pringles sustained its strong growth in Q2, led by our core flavors and immediate consumption pack formats. In wholesome snacks, we recorded another quarter of double-digit consumption growth, led by Rice Krispies Treats and driven by innovation and advertising so effective that we are presently constrained on capacity.

In crackers, we moved into year-on-year consumption growth in Q2, led by accelerated growth in our biggest brand, Cheez-It. And we're seeing improvement in cookies performance as well, with consumption growth in newly supported brands like Keebler Fudge Shoppe, Mother's and Famous Amos. Meanwhile, our operating profit growth and operating profit margin expansion continued in Q2, even amidst substantially increased levels of investment, so another good quarter.

So we're delivering on what we promised when we exited DSD. We've got a stronger line-up on-shelf after weeding out tail SKUs and we're seeing improved velocities as a result. Our brands are significantly better supported today. We can now afford to more fully support power brands like Pringles, Cheez-It, and Rice Krispies Treats. And we could afford, for the first time in years, to support other key brands in our portfolio, brands like Keebler Fudge Shoppe, Nutri-Grain and Special K Bars.

In recent months, we have embarked on the final phase of the project, creating a single retail sales force across our U.S. Snacks and U.S. Morning Foods divisions. This single retail force will be less encumbered by driving time, enabling more time in stores, and it will leverage the benefits of scale. In short, one year after the DSD exit, U.S. Snacks remains right on track financially and with a business that is now more competitive, generating improved top-line growth and it is more profitable than ever.

Now, let's turn to U.S. Morning Foods in slide number 10. Morning Foods' performance in Q2 was similar to Q1. Profit was down, as expected, due, in large part, to increased investment, negative operating leverage and among its tougher comparisons of the year. Net sales decreased at a similar pace as Q1, continuing its moderation this year from last year's decline. But behind these numbers is real progress.

Our share of the cereal category stabilized with our Core 6 cereal brands collectively resuming share growth in the quarter. The cereal category has cut its declines in half from last year, but history shows that it needs more and better health and wellness innovation and communication to get back into growth.

We've been busy in this area and we're pleased with our early progress. Special K continued to grow consumption and share in the quarter, as we tout its inner strength positioning. Raisin Bran returned to consumption in share growth as we launched new food, Raisin Bran Crunch with Bananas, and supported it with advertising that highlights Raisin Bran's health attributes. Similarly, Mini-Wheats stabilized its share in the quarter, with new food and communication that emphasizes its satiety and fiber. We also made some headway in the [ph] taste fun (19:03) segment, with both Frosted Flakes and Froot Loops increasing consumption and share, both aided by innovation that is driving base consumption.

Looking ahead to the second half, our outlook for Morning Foods has not changed. We still expect to see profit pressured by increased investment this year, but with a continuing moderation in sales declines as we work toward stabilizing this business. We've got a strong pipeline of innovation and solid plans for brand building and in-store activity. We like the way our brands are starting to respond. There's still more work to do across more of our brands, but we're on the right track.

Turning to slide number 11, U.S. Specialty Channels continues to post top-line growth, reliably. We recorded growth in most of our channels. Vending was up strongly, as was Girl Scouts. And convenience was up solidly in the quarter as well. Their performance was only partially offset by a modest decline in our sales to foodservice, driven by K-12 schools and military, but offset by growth in commercial restaurants and other channels.

Importantly, we continue to compete well, with share gains in more than half of our biggest categories in each of our major channels. As we have told you on previous earnings calls, Specialty Channels' operating profit in 2018 is forecast to be uncharacteristically down year-on-year, due to changes we made this year in the allocation of costs from other U.S. segments. This is not related to any change in the underlying business, which remain solid.

We have strong plans for the second half, and we expect 2018 to be another year of dependable performance from Specialty Channels, though we do now have to lap last year's unusually strong FEMA orders during the major hurricanes of late Q3 and early Q4.

Let's turn to slide number 12 and our North America Other segment. This segment turned in another quarter of exceptional net sales and operating profit growth, sustaining its performance from Q1. Obviously, the acquisition and rapid growth of RX accounts for most of this net sales growth. In Q2, like Q1, its net sales were up significantly and consumption continued to rise sharply, as we expand distribution within existing and new channels. We've been modifying our Kids bars line and launched a new line of Nut Butters.

We continue to see the benefits of maintaining RX's independence and entrepreneurial approach as well as the benefits of RX's access to Kellogg's considerable resources. We'll leverage this new growth platform more and more in the future.

In our Frozen Foods business, we continued to post solid sales and consumption growth, even as we started to lap last year's sharp acceleration late in the quarter. Eggo gained share, aided by the successful relaunch of our Thick & Fluffy sub-line. And Morningstar Farms also continued to gain share, sustaining double-digit consumption growth behind its core grilling items. Frozen foods are on trend and we have strong brands and solid commercial plans to continue to grow, even as we face tougher comps in the second half.

Elsewhere in North America Other, our Kashi business is steadily improving its performance. Its cereal consumption continues to outpace the category in the natural channel and it is growing consumption and share in the traditional measured channels as well. Bear Naked Granola sustained its strong momentum, but this quarter it was joined by the Kashi brand, which returned to consumption growth. In Canada, we posted growth in sales and gained share and most of our categories. Overall, we expect continued growth for North America Other, led by RX's continued expansion and

Frozen Foods growth, even as we start to lap tougher comparisons in the second half.

So that rounds out Kellogg North America. As you can see on slide number 13, we truly are seeing improved top-line performance in North America; more work to do, of course, but certainly heading in the right direction.

Now let's move to our international businesses, starting with Europe on slide number 14. Europe had a solid quarter, marked by strong top-line growth and higher operating profit, in spite of a very large increase in brand investment. Pringles, again, led the way, continuing to rebound from last year's disruption of normal promotions in some markets and even growing at a high single-digit rate versus the same quarter of two years ago.

Notable in the quarter was media and strong execution of in-store activity around soccer, which provided strong impressions and consumption uplift. Our cereal trends continue on an improved track from last year. Key to this, of course, has been the stabilization of our UK cereal business, which gained share again in Q2.

Importantly, we have meaningfully improved the performance of Special K across the region, with share stable and even growing again in certain markets. Once again, emerging markets were a driver of the Europe region's net sales growth for both cereal and snacks. This was led by Egypt, Russia, and the Middle East. So Europe is in good shape as we go into the second half. Markets remain challenging, particularly in Continental Europe. And we do face tougher comps in the second half on Pringles, but we have gotten key elements of our business stabilized and we've built momentum in others. We feel good about the year for Europe.

Let's turn to Latin America on slide number 15. Latin America's net sales growth accelerated in Q2, despite the trucking strike in Brazil, which essentially halted shipments for close to two weeks. The good news is that shipments have recovered there, but more impressively, in spite of this disruption, we still grew net sales in Brazil in Q2. Parati continued to grow consumption in share in cookies and crackers in Brazil. And we continue to post double-digit growth for Pringles, both in Brazil and elsewhere in our Mercosur sub-region.

Meanwhile, we experience continued momentum in Mexico, our largest market. For Mexico, this marked a ninth straight quarter of year-on-year net sales growth, even accelerating this quarter. Our consumption and share gains accelerated in cereal and we generated good snacks growth, led by Pringles.

We also continued to see good recovery in our Caribbean Central America unit and stabilization in the difficult Colombia market. Aiding our growth acceleration, but holding back operating profit in the quarter, was a substantial increase in brand building investment. We also incurred meaningful one-off costs related to disruption from the truckers' strike in Brazil. We feel good about how our Latin America business is trending. Top-line growth and consumption growth is solid. And we expect to see better profit performance in the second half.

And finally, let's take a look at our Asia Pacific region, shown on slide 16. This was another very strong quarter for this region. Obviously, our reported results were boosted by the consolidation of Multipro. Not only did this add two months of its total sales, but its underlying growth remains strongly in the double digits. This is a terrific business and it has a long runway of growth.

It should also be mentioned that Dufil, the manufacturing arm of our West Africa business, also had another strong quarter, though its results are not consolidated into our sales and profit. However, even excluding Multipro, which we treat as an acquisition, our organic net sales growth in Asia Pacific was plus 5% in the quarter and it was broad-based across the region.

Emerging markets cereal grew at a high single-digit rate, with double-digit growth in our India business. Pringles continued its strong and consistent growth trajectory, up high single digits in Q2. And Australia grew net sales for the quarter, driven by cereal consumption growth. This growth produced another double-digit gain in operating profit, even on an organic basis and despite increased brand building investment. So Asia Pacific is firing on all cylinders right now.

Slide number 17 offers a summary of our top-line performance by our three international regions. Don't lose sight of the growing importance of our international regions and the strong growth they're now generating. Within this international growth, we've got momentum and further opportunity for Pringles. We're expanding in granola in all three regions. We're launching wholesome snacks in Asia. And we've stabilized cereal in core markets like the UK and Australia.

And within this international growth, we've got emerging markets growing at a high single-digit rate organically, with growth in both cereal and snacks. And this emerging markets' growth doesn't even include our West Africa business, which itself grew organically at a strong double-digit clip. So we see continued growth to come for these international regions.

So allow me to summarize with slide number 18. We feel very good about the progress we've made this year, and the results plainly reflect this progress. Our portfolio is more growth-oriented today and we're seeing strong contributions from newly acquired RX in North America and newly consolidated Multipro in Nigeria. Both are strong double-digit growers today and growth platforms for many years ahead.

Our top-line growth is improving, both on a reported and on an organic basis. It's improving in North America and growing year-on-year, if you exclude the impact of the DSD exit. And we're solidly in growth in all three of our international regions. Hence, we're raising our full year guidance for net sales.

Our in-market performance is improving. We've restored strong growth in Pringles around the world. We're improving our velocities in post-DSD U.S. Snacks and showing share gains on supported brands. We've stabilized each of our developed cereal markets, including slowing our declines in the U.S. and we've stabilized our biggest global cereal brand, Special K. Meanwhile, we've sustained strong consumption growth in our Frozen Foods' categories.

Driving this enhanced competitiveness are better commercial ideas supported by another quarter of double-digit increases in our advertising and consumer promotion investment. This investment is working because of the caliber of the ideas and the strength of our execution. And we've got more consumer excitement coming in the second half.

Even as we lean into growth, we're reaffirming our guidance for operating profit growth. We're also raising our earnings guidance. This is the result of taking advantage of changing tax rates and making a pension contribution that reduces risk and raises returns going forward. We're delivering strong double-digit earnings growth, even in a year in which we are ramping up investment, so a good first half with strong plans for the second half.

We're firmly on track toward achieving the balance we strive for over time, the sustainable balance between top-line growth and margin expansion that can deliver attractive and consistent total shareowner returns for you.

The success of our Deploy for Growth strategy depends on our people being a competitive advantage. And it is our dedicated employees who are making this progress happen through their hard work and through their creativity.

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

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Michael Lavery with Piper Jaffray. Please go ahead.

<Q - Michael S. Lavery>: Morning. Thank you.

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

<Q - Michael S. Lavery>: I was wondering if you could just touch on some of the bigger drivers of your revised higher organic revenue growth outlook. And specifically, maybe touch on two things; one, how much of it is the first half that's behind you versus how much you see in further momentum ahead? And then just specifically as well, Latin America had 13% volume growth. That's the highest I can see in any segment in years and years. Despite the Brazil strike, I know you had the easy comp from a couple things last year, but how sustainable is that? And what should we expect looking ahead there?

<A - Steven A. Cahillane>: Yeah. Thanks for the question, Michael. I'll start, and I'll let Fareed build on it. But as I said, we're pleased with our first half performance, right on track to deliver the full year and the full year guidance. As we look at our net sales performance, we are pleased with what's happening in North America with the stabilization of our cereal business, Special K in particular, which if you look back in time, Special K had been a double-digit decliner, and it's back into stabilization in all Core 4 markets. And it's gaining share as well, so that's been very good.

We're going to see RXBAR continue to grow. That'll be part of our organic growth as we get into November and December. Multipro is inorganic, obviously, but across all of our regions we see good, steady performance continuing through the second half.

As you look at each region, there's different comps. So Europe has a more difficult comp coming into the second half. Latin America has a little bit more of a different comp coming into the second half. U.S. Snacks ex-DSD, obviously, that noise is now kind of behind us.

So it's a mix of various things that add up to us being confident in being able to deliver the new guidance top-line.

Fareed, you want to...

<A - Fareed A. Khan>: Sure. Yeah. What I'd add is, again, if you take out the DSD impact and you look at Q1 and Q2, our organic growth rate in both those quarters was right around 2%, and underpinning that is pretty broad-based growth across our whole portfolio.

So Asia, strong growth; Latin America, as you pointed to – and if you double-click on Latin America, you actually do see strong growth across all the regions there. The recent Parati acquisition that we made in Brazil is still growing double digits. And they've weathered the trucking strike, despite the headwinds that, as you could expect, would come with that.

And then to Steve's point about Europe, in the first half, we were lapping some of the challenges around the price increases we were putting through the market and the retailer disruption. And with that also came a pullback in promotions that are relevant for our year-on-year gross margin comps.

And Europe is coming back strongly. The Pringles business in Europe has had a phenomenal run, helped in part by some good promotions around soccer. And cereal, as we have talked about in Q1, we're seeing that business stabilize and very encouraging trends.

And in the U.S., we're in four growth categories. [ph] And the R-tech (33:25) category has significantly improved in terms of its sequential consumption performance. And we like what we see in velocities. We like what we're seeing in share growth now across the brands, and these are very broad-based.

So the outlook reflects how we're running, very encouraging signs kind of at the brand level in terms of how we're performing in market. But it's still early days. And I think we're taking a prudent approach to the second half, recognizing some of the tougher comps we'll have in Europe, in U.S. Snacks coming out of DSD. And also our Frozen business has been very strong, really accelerated towards the end of last year, and we factored that into the outlook as well.

<Q - Michael S. Lavery>: Okay. That's helpful. Thank you very much.

Operator

The next question comes from Ken Zaslow with Bank of Montreal. Please go ahead.

<Q - Ken Zaslow>: Hey, good morning, everyone.

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

<A - Fareed A. Khan>: Hey, Ken.

<Q - Ken Zaslow>: I have one question. What are the key opportunities for you to take pricing to offset some of the higher transportation and freight costs? Can you talk about and give some examples of how you're doing in price-pack architecture, if you're taking list pricing, how you're compensating for the rise in transportation and freight costs? Thanks.

<A - Steven A. Cahillane>: Yeah. Thanks for the question, Ken. I always like say that good suppliers and manufacturers earn price. They don't take price. And we're working very hard to earn price. One of the things we mentioned around kind of the margin compression was single-serve, and so we're driving much more single-serve than we have in the past.

Now, our supply chain has got to catch up to that. So we'll, first and foremost, look to productivity to cover all of our input costs, including transportation inflation and so forth, and Revenue Growth Management to make up the balance of it. And we see good opportunities to continue to do that. Eggo is a good example, Eggo Thick & Fluffy, where we relaunched that line with new packaging, which was much more premium in nature with a new additional food, which was double chocolate. And we got a 12% increase in price and it worked for everybody. It worked for the consumer because they absolutely love the product. It had almost zero elasticity. It worked for the retailer extremely well because it's a higher ring on the same margin for them. It works well for us.

And so those are the types of examples as we think about an inflationary environment, what can we do to add more value to our brands so that we can earn more price in the marketplace? So start with continued productivity to cover as much as we possibly can and earn price on the way back, so that we can continue to expand our margins over time and continue to grow our top-line and strike that right balance.

<Q - Ken Zaslow>: Great. Thank you very much.

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

Operator

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

<Q - Eric J. Larson>: Oh, yes. Thanks, everyone. Getting to kind of the gross margin, you talked about the gross margin cadence, the adverse mix was an issue in the quarter and you are going to be taking up some CapEx to get some capacity in for what would normally be higher-margin product. Can you give us what that impact could potentially be in terms of recovery of gross margins as that mix starts to improve with some better capacity that can capture that?

<A - Fareed A. Khan>: Sure. It's Fareed. Thanks for the question. Let me just remind the drivers, because there are sort of three main buckets. The most significant factor in gross margin was the mechanical effective of the DSD and the Multipro, right. And those will cycle through DSD this quarter and then Multipro will have a few more quarters. So that's sort of a mechanical impact that just reflects those areas.

The other thing I'd point out is that again in Q2, we were able to offset pretty significant cost inflation, especially around logistics, but also in other areas through efficiencies and productivity. And so don't read into our margin that somehow we've got sort of crushed by inflation. It is a watch-out going forward, and I think that's where some of the RGM thinking comes into it.

And then you kind of get into the core. And there's a set of things where we pulled back on some promotions last year in Europe because of the price negotiations, as we were working through those. And also in snacks, as we were in the middle of DSD and so lapping those is part of the headwind. And then the other part, as you pointed out, was just mix. And so emerging markets, we're seeing really strong growth and that has an effect.

And the multi-pack and the single-serve, really seeing strong growth there, which is terrific over time because we are under-indexed on those on-the-go formats and so it's a great broader opportunity. It just came much faster than we were expecting, frankly.

And so we had been using third-party co-packers. We had to soft of adjust very quickly from a supply chain perspective and it, frankly, caught us a little bit off guard in terms of having the process optimization, having the automation in our facilities. And we've got investments against that. We're accelerating it. Over time, those'll be margin accretive, as you would expect. Short-term, it's a headwind.

So those are the main factors. And so as we look at our gross margin performance, I think all of these things over time are addressable, some very mechanical, and I think others just from a mix perspective is what we saw in this particular quarter.

<Q - Eric J. Larson>: Okay. Thanks. And then, just to quickly update us, the Project K savings, are they hitting full stride now this year in 2018, or is it 2019 that they actually get full stride with where you don't really have any more reinvestment? Can you just give us a quick cadence on how the Project K winds down and when we get full benefit of that?

<A - Fareed A. Khan>: Absolutely. I think the headline is that Project K is absolutely delivering against our expectations. And so all the prior guidance we've given around that project is still very much intact. 2018 is the last year of the investments, if you will, whether it's restructuring costs or some of the CapEx that's associated with that. However, we still have some savings that we've talked about half coming in 2018, and a little more than half in 2018, and the remainder coming in 2019.

So we're going to see the upfront costs, the investments finish this year, but we've got another year in 2019 of benefits that we'll wrap. And the most significant item this year was the DSD exit that was part of it, and it was a very significant driver. And you will see that a little bit now, but even more so as we get into the second half of how that is impacting our Snacks business, and the significant reduction in overhead, and then the associated operating profit margin expansion in that business.

Operator

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

<Q - Kenneth B. Goldman>: Hi. Thanks very much. I wanted ask about implied guidance for the bottom line in the second half. The comparison's easier, and I know you've talked about tougher top line comparisons, but the EPS, unless I'm reading it wrong on a pro forma basis trend, got a little better, or it gets a little better for you in the back half. So I'm just trying to get a sense, if I had think of the drivers that are preventing the bottom line from being better in the back half, you mentioned a few things. You mentioned FEMA shipments, higher tax, more investments, things like that. I just wanted to get a sense. If you had to order in magnitude some of those, maybe call them, headwinds, could you help us out with that a little bit, just so we understand a little bit why guidance maybe isn't a little bit better for EPS, given that sales guidance was raised?

<A - Fareed A. Khan>: Yeah. So I think part of that, Ken – it's Fareed – is, I think, the investments that we've been making on brand building. I think if you go back to the Q4, we talked about putting $50 million in Q4 of incremental investment, and another $50 million over Q1 and Q2, and we've actually put more than that against the business. And the logic is, we're actually seeing the results in-market and feel good about the ROIs and the results that are being generated from that.

I think the mix shifts that we talked about, those we can address over time. In the short-term, it takes a while to get process automation, sort through some of the supply chain. So I think there's some of that tail's going to come into place. And then, you're right about, you mentioned the hurricane laps, as well as some of the tougher comps we talked about in Europe, as well as Snacks, and a little bit in Frozen.

There's a little bit of higher interest expense, as well. We took on some additional debt for RXBAR and the Multipro acquisitions, very manageable levels of debt, but that factors in, as well. And then if you step back, we still want to take a prudent approach, right? We really like what we're seeing in the top line. We've been able to cover inflation with savings initiatives for the first half. But as we look forward, we don't see those pressures abating, and we're probably likely to be more in an inflationary environment.

Now, we've got RGM levers and other things that we'll put against that, but we'll have to see how those play out. So I think those are the factors. And then the Q3, Q4 phasing is really all about the timing of brand building last year versus this year, as the most significant factors.

<A - Steven A. Cahillane>: And, Ken, if I can just add to that. We're in a good place as we sit here at the half-year margin, and I think Fareed outlined mechanically very well how we think about the back half of the year. But we're here at the half-year able to say that some of our big brands are growing. And they're growing because of this type of investment that we're putting behind them.

And it's a great place to be able to talk about Pringles, Cheez-It, Rice Krispies Treats, Eggo, Morningstar Farms, RX, Bear Naked, Frosted Flakes, Froot Loops, all growing, all these are big brands. And on their way, Kashi much better performing than it has been historically, as well as Special K, which was a huge leaky bucket, now stabilized. So we said we wanted to restore and increase brand building investment in order to drive the top line, and we are seeing that happening. So at the half-year, we're taking a prudent approach for the rest of the year, but we like where we are.

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

Operator

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

<Q - Robert Moskow>: Hi, thank you. I was trying to tease out the DSD impact on your pricing in North America. And I think what I get to is that your pricing was flat in North America if we exclude that impact. Is that what we should expect for the rest of the year for North America as well or is there any new pricing that you think you have to put through in order to deal with the higher cost environment?

<A - Steven A. Cahillane>: Yeah, Robert, thanks for the question. For competitive reasons, we don't want to give a blueprint to everybody, so we have not been disclosing the impact of price. You can see overall what's happened in terms of the savings coming through. We're not charging for the DSD component anymore, but we're competitive on price and we like where the brands are priced. We like the velocity that we're seeing in the market, and the DSD savings that we had planned are all coming through.

<A - Fareed A. Khan>: I'd just add there's pricing considerations in everything that we do, so as we're launching products, as we're thinking about price-pack architecture, as we're thinking about reformulations, all those are opportunities into how we think about it. Rice Krispies Treats with single-serve formats, the Eggo Thick & Fluffy example I think we used in the last quarter, all ways where you can really bring value to consumers into the channel and, as Steve said, earn it that way.

Now that said, this is something we've got to continue to consider in the context of what's likely to be continued inflationary pressures. And that's absolutely not lost on us and the importance that that could have. So that's about the level of detail we feel comfortable kind of getting into on this call.

<Q - Robert Moskow>: Can I ask a follow-up about this mix impact and just like is there a way to quantify what it represents going forward? I mean, how much business are you introducing into the market that's like single-serve, new format business? Is it $100 million, $200 million of business? Is there a way to think of it that way?

<A - Fareed A. Khan>: So the first thing I would do is I'd think about the country mix, right, and you think about just the strong growth that we're seeing in emerging markets, and so that's a factor. Other brands that are also growing strongly have an effect. The cereal category is one of our stronger margin businesses.

And then, you get into these more kind of short-term things that we've been facing around just very specific single-serve, multi-pack type of formats, and that's something that's very addressable because, inherently, these are very attractive margin profile types of opportunities. And that's just a matter of kind of aligning our supply chain and fulfillment. And, frankly, that's where we've been seeing a lot of growth, not solely, but that's been a stronger growth area than we have expected.

And the other factor which is going to solve itself over time, too, is just the year-over-year differences in promotional types of investments that hit margin as well, where last year we pulled back in a couple of key businesses for different reasons, but as we lap those, that's a headwind, but those will start to normalize as well.

<Q - Robert Moskow>: All right. Thank you.

Operator

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

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

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

<A - Fareed A. Khan>: Morning.

<Q - David Cristopher Driscoll>: I had one follow-up question and then a question on RX. The follow-up is just on your snack DSD exit. I really appreciate the comments about improvements in velocities on slide 9, but can you translate what that means for sales growth in the back half of the year, Q3 and Q4, now that you've lapped the exit? So that's the follow-up piece.

And then on RX, it's a really interesting business, but can you give us some numerical numbers, some numerical figures on this operation? I think it's $120 million in revenues, maybe growing 30%, but I'm really interested, Steve, where you see this brand going, and are you worried about competition? I think some people have launched similar products. How do you defend the business? And just really curious about your thoughts on the size and opportunity ahead for RX.

<A - Steven A. Cahillane>: Yeah. Thanks for the question, David. I think in terms of the Snacks business, I think [ph] it would be comfortable (49:25) if you look at what the category is doing. We should be able to keep up with the category kind of as a basic level to think about.

Ex-DSD, we do have some tougher comps coming in the second half, which you'll take note of, but we're through the DSD transition, by and large. I think the team has done an exceptional job at what was a very, very complex undertaking, and we like where the brands are.

We mentioned Rice Krispies Treats is really on fire, and we're having a hard time even keeping up with production of that. And the big brands, Cheez-It, back in growth. Pringles wasn't part of DSD, but Pringles growing nicely. So we like where the brands are, but if you think about just where the category is, we should grow with the category or better as we think about on a long-term go-forward basis.

In terms of RXBAR, RXBAR's consumption is up triple digits. It's a very strong brand. In terms of measured Nielsen share, it's gone up substantially, more than doubling from year-over-year. It's the fastest growth in the category and is doing exceptionally well with consumers and even as it grows distribution.

In terms of competition, whenever you have something that is as special as RXBAR, as successful as RXBAR, you're going to get a lot of me-too's. And we are seeing that happen. We're not seeing any that are gaining traction right now, but we are far, far from complacent.

Peter Rahal and his team are doing just a fantastic job continuing to build loyalty with consumers. They have just a passionate, passionate consumer base. It's a very authentic product. It's seen as real. And it's the first one kind of in this space. And it's always tough as a marketer to come up and copy something and get the same level of authenticity.

So not at all complacent, always thinking about the competitive environment, but driving very, very hard around innovation with: the Kids line, which is out now; the Nut Butter line, which is just launching. And the business continues to show tremendous velocity and great innovation and great loyalty with consumers.

So we like the business a lot. We like where it can go in the United States. In the back half of this year and early next year, you'll see us introduce it in European markets and in Canada, so we think the brand can travel as well. And we're just very, very pleased with the acquisition. And we're very, very pleased with the team and all they've done to continue to grow that brand in such a substantial way.

<Q - David Cristopher Driscoll>: Thank you.

Operator

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

<Q - David Palmer>: Thanks. Good morning. Just to follow up on all the gross margin commentary you put out there and some of the Q&A, you mentioned co-packer mix on single-serve, the emerging market mix versus developed market cereal, for instance, weighing on gross margins in addition to the distribution costs. Can you give us a sense of how much of the decline is coming, big buckets, from each of these things and just the general outlook for each? For instance, on emerging markets, obviously, you would intend that to grow long-term at a higher rate. How much of that is going to be a longer-term gross margin drag? Thanks.

<A - Fareed A. Khan>: Sure. It's Fareed again. I mean, the biggest factor on margin was the mechanical impact of DSD, which was the single largest, and then Multipro. And think about that as sort of two-thirds, if you will.

The other piece is what you suggested. And if you kind of parse that out, is that we will expect to see our emerging markets business continue to outpace the core. That's our strategy, and so that dynamic will be a factor.

I think some of the quarter-on-quarter promotional differences, those will be behind us. And over time, on the co-packer scenario, as I mentioned, we'll address that. But that's not going to happen in a single quarter, but we're already on that. We started to see that portion of the business really accelerate as we were working our way through Q1, and so it's been on the radar. We've been refocusing some of our investments, and some of the incremental CapEx is going directly at that area.

So I think what we'll see is the DSD mechanical impact coming out this quarter. Multipro, we have a little bit more to lap. The emerging markets growth relative to core, that's going be an ongoing factor. And we'll then really be in the how quickly we can get behind sort of the single-serve and multi-pack. And these are great areas to be growing in, because it's we're under-indexed. It's incremental, and it's sort of where the consumer is going. And so it's the right place to be and the right place to grow. We just got to get our supply chain caught up with the demand.

<Q - David Palmer>: That's helpful. Thanks.

Operator

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

<Q - Bryan D. Spillane>: Hey, good morning, everybody. Thanks for taking the question. Steve, at the end of your prepared remarks, you commented on this year, you've had the ability to both grow earnings and reinvest, right? And that's partly from cost savings. The tax rate's also helpful a little bit, I guess. So I guess as we think about the increases in brand building that are now in your budgets for this year, as we look beyond 2018, is that a good base to work with going forward or is that spending sort of up one time and then comes down a little bit or is there room to actually increase it more? So just trying to get an understanding of that brand building base this year, how it's been expanded and how we should think about that going forward.

<A - Steven A. Cahillane>: Yeah, thanks for the question, Bryan. I think a couple of things. You should think about the snacks DSD exit as a fundamental reset, which we said we were going to do, to go away from low ROI DSD cost into high ROI brand building investment. So that was a significant reset.

On top of that, we've been feeding the brands more to get them back to growth, because we know that the long-term algorithm that we have out there will build significant shareholder value, but you've got to get the top line growing. And all the investments are designed to do exactly that.

So broadly speaking, I think you can look at what we've done and say it's never going to be a steady-state, because we're going to continue to take a relentless approach around are we getting the right ROIs, are we spending the right way, and measuring that constantly to make sure that we're getting the right bang for our buck. But we like where it is right now.

We'll be dynamic and agile as we go forward in the future, so I won't say it's exactly where it needs to be, plus or minus, but we like where we are a lot better than where we've been with the Snacks reset and a lot more good brand building investment around our biggest brands.

And, as I said earlier, it's good to be in a position where we are today, where we can talk at the half-year point about all these big brands growing around the world. And if we can continue that, it's got good positive momentum. And you get the flywheel spinning, and it starts to work and these brands can fund themselves.

So broadly speaking, I think we like where we are today. And it was based on a lot of hard work coming out of the DSD transition, as well as a big lean in the fourth quarter of last year and all through this year, actually spending well above the $100 million that we said and above what we had budgeted.

<A - Fareed A. Khan>: If I could just add, we are coming at this very much kind of brand by brand and bottom up, and so we're learning a lot about how they're performing. And while we like what we see, there's still, you have certain brands, Cheez-It is a great example, where that growth has really come back strongly. And it's responding very well to the investments.

There's other brands that are beginning to turn, but we were still finding that right balance of investment versus return on each of those. And so, that's the level that we're looking at it. And, again, this is new territory because Snacks is in a fundamentally different place than it was a year ago, but the investments behind these seem to be working well in terms of velocity and share. And we like what we see and we'll continue to kind of find that right balance. And I think another quarter or two, we'll learn an awful lot about where the right spot to be is.

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

<A - John Renwick>: Operator, we've got time for maybe one more quick question.

Operator

And that question will come from Pablo Zuanic with SIG. Please go ahead.

<Q - Pablo Zuanic>: Thank you, just a couple questions, so now that you're in a position of strength in the U.S. in snacks, can you talk about the M&A strategy in snacks in the U.S.? I mean, what are the gaps that you need to fill or pretty much you have your hands full with your portfolio and there is no need to add any particular gaps there or cover any gaps?

And then the second question, which is related to this, when I think about overseas snacks business to me, it's mostly Pringles. Yes, you can try to export Cheez-It or RXBAR, but the brands are not known there. And it seems to me that STAX with Lay's in the U.S., it's a small equity compared to Pringles, but overseas, it's more of a direct competitor. So if you could just talk about the challenges that Pringles may face overseas in terms of brand and competition and just room to maybe add other brands overseas. I thought you would [ph] have made a tier in the UK that Hersey's sold (58:56) but it seems that you did not. Thanks.

<A - Steven A. Cahillane>: Yeah, thank you for the question, Pablo. We think about our M&A strategy holistically. And so, a good guide to the way we think about it would be RXBAR in the U.S. filled a white space for us, doing extremely well. And then developing markets, snacks has been obviously a big focus for us with Pringles. And so, if we see those types of opportunities, we would clearly look at them.

And it's a build versus a buy type of thing. So Pringles is doing extremely well all around the world. And we'll continue to drive that, but if we see opportunities that can add shareholder value in the developing markets, we clearly will look at them. Probably more snacks-led in the U.S., more kind of wholesome-led, health and wellness-led and big focus on developing markets, but if we found another RXBAR in a developed markets, we'd clearly be interested in that as well.

<Q - Pablo Zuanic>: Thank you.

Operator

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

John Renwick

Thanks, everyone, for your interest and please feel free to call. I'm around all day.

Operator

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