Company Name: Kellogg
Company Ticker: K US
Date: 2013-05-02
Event Description: Q1 2013 Earnings Call

Market Cap: 22,947.48
Current PX: 63.41
YTD Change($): +7.56
YTD Change(%): +13.536

Bloomberg Estimates - EPS
Current Quarter: 1.023
Current Year: 3.872
Bloomberg Estimates - Sales
Current Quarter: 3850.933
Current Year: 15247.063

Q1 2013 Earnings Call

Company Participants

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

Other Participants

- Matthew C. Grainger
- David S. Palmer
- Ken B. Goldman
- Thilo Wrede
- Greg Hessler
- Andrew Lazar
- Alexia Jane Howard
- Eric R. Katzman
- Jonathan P. Feeney
- Christopher R. Growe

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company First Quarter 2013 Earnings Call. [Operator Instructions] Thank you. At this time, I will turn the call over to Simon Burton, Kellogg Company Vice President of Investor Relations. Mr. Burton, you may begin your conference.

Simon D. Burton

Thanks, Laura. Good morning and thanks, everyone, for joining us today for a review of our first quarter 2013 results. I'm joined by John Bryant, our President and CEO; Ron Dissinger, our Chief Financial Officer; and Brian Huff, President of our U.S. Specialty Channels business. We've been highlighting different business units over the last year and Brian's here to discuss Specialty Channels in a little more detail.

In addition, due to changes in how we account for pensions and other post-retirement benefits, we've provided additional detail in this presentation and in the earnings press release. The press release and slides that support our remarks this morning are posted on our website at www.kelloggcompany.com. As you are aware, certain statements made today, such as projections for Kellogg Company's future performance, including earnings per share, net sales, margin, operating profit, interest expense, tax rate, cash flow, brand building, up-front costs, investments, and inflation are forward-looking statements. Actual results could be materially different from those projected. So for further information concerning factors that could cause of these results to differ, please refer to the second slide of this presentation, as well as to our public SEC filings.

As a reminder, a replay of today's conference call will be available by phone through Monday, May 6, and the call will also be available via webcast, which will be archived for at least 90 days.

With that, I'll turn it over to John.

John A. Bryant

Thanks, Simon. And thank you, everyone, for joining us today. We are pleased to announce a good first quarter and start to the year. Reported sales growth was strong at 12%. Internal net sales growth was 2.2%, broadly in line with our expectations. And most of our businesses around the world posted solid underlying results, so as we will discuss in more detail later. Underlying operating profit growth was also broadly in line with expectations, as we faced the highest level of inflation that we expect to see all year.

We are on track for the full year and, as Ron said his guidance at CAGNY, there were a few items that we anticipated would have an impact on the first quarter. First, we expect to earn $80 million of COGS inflation, net of COGS savings, in 2013. And we saw more than $80 million just in the first quarter. This obviously had a significant impact. Secondly, the devaluation in Venezuela also had a meaningful impact and was larger than we expected. And finally, the process of closing a manufacturing plant in Australia continued in the first quarter, which led to higher year-over-year costs. So we expect more balanced results as the year progresses.

Now, let's turn to Slide 4 and a review of Pringles. We continue to see very strong performance from the business in the first quarter. In fact, organic sales growth for the total Pringles brand was approximately 7%. In all the regions around the world, Pringles continues to do well and, as we've mentioned before, the commercial programs we've implemented since the acquisition have been very well received by consumers. In the U.S. and Canada, we relaunched Sticks, which is off to a good start. In Europe, we saw good growth in much of the region and we saw high single digit underlying growth in the Asia Pacific business, as well.

The integration continues to go well. We have converted Asia and Europe to our systems and the transition went very smoothly. We are currently in the process of converting in the Americas. We're on schedule to complete the integration over the next few months and remain confident that we'll recognize the synergies we expected for 2013.

And talent retention has also been very good. As you saw at CAGNY and our Investor Day, we now have former Pringles employees in very senior roles within the organization. And finally, on Pringles, we'll have some new capacity coming online in 2014, which will add to the excellent work that's being done to improve the capacity in our existing facilities. So we're on track to achieve our full-year guidance.

And with that, I'll turn it over to Ron for more details.

Ronald L. Dissinger

Thanks, John, and good morning, everyone. First of all, I'd like to point out that our underlying results exclude the impact of mark-to-market adjustments. Underlying internal results exclude the impact of mark-to-market adjustments, acquisitions, divestitures, integration costs, and the impact from foreign currency translation. We're also providing details of underlying earnings per share, excluding integration costs, again this quarter.

Slide 5 shows the first quarter's financial results. Reported sales growth was 12.2%. Internal sales growth was 2.2% and included growth across all four geographic regions of the world. Underlying reported operating profit decreased by 3.5%, including Pringles integration costs. Reported operating profit was flat, excluding integration costs. Underlying internal operating profit decreased by 5.8%. As we told you previously, the first quarter included most of our net cost inflation for the year, which is why we had expected that underlying internal operating profit would be down in the first quarter.

Underlying earnings per share, excluding integration costs, was $0.99, broadly in line with our expectations. This includes an impact of approximately $0.03 from the devaluation in Venezuela. So without the one-time impact of the devaluation, our underlying earnings per share would've been $1.02. In addition, we were lapping a $0.05 benefit in the first quarter of last year that resulted from the interest rate hedges related to the Pringles acquisition. Overall, our results are in line with our expectations and we remain on track for the year.

Slide 6 shows the composition of the first quarter sales growth. As I mentioned, reported sales growth was 12.2% and internal sales growth was 2.2%. Volume increased by 1.4 points in the quarter and was broad-based. We grew volume in every region of the world. We also recognized price and mix improvements of 0.8 points in the quarter and we expect a better balance of volume and price mix this year. On a global basis, we grew both Cereal and Snacks. In addition, the U.S. Frozen and Specialty businesses had another strong quarter.

As you might imagine, the addition of Pringles made a significant contribution of 10.8 points to reported sales growth. And, as John mentioned, the performance of the Pringles business has been consistently better than we had anticipated. Finally, as you can see, currency translation reduced sales growth by 0.8 points in the quarter.

Now let's look at Slide 7, which shows our cost of goods sold net inflation for the full-year. We saw more than $80 million of net cost inflation in the first quarter, which is more than the total net inflation we expect for the full-year. As you can see on the chart, we expect continued net inflation in the second quarter and then net deflation in the second half. Obviously, this shaping had a significant impact on our gross profit and our gross margin in Q1. Our underlying reported gross margin declined by 330 basis points in the quarter. Overall, the net inflation and gross margin performance were consistent with our expectations. We are more than 85% covered on commodities and have good visibility into our cost structure for the year.

The inclusion of the Pringles business continued to have an impact on margins. In the first quarter, Pringles lowered total company gross margin by 80 basis points. We are continuing our work to increase margins and we have already seen improvement. Our current outlook on the Pringles business for the year indicates gross margin improvement of approximately 50 basis points. In addition, we have executed initiatives to increase capacity, which will also have a positive impact on margins over time.

Slide 8 details some of our brand building activity. We continued to invest in advertising and other equity building initiatives in the quarter. As you know, brand building, along with innovation, is at the heart of our sustainable growth operating model. We know that when we invest in the business and provide value through our brands and new products, consumers will respond. You can see on the chart just some of the activity that we're executing in the first half. This isn't all we're doing around the world, but it gives you an idea of the focus that we have.

We also strive to be more efficient and effective with our investment dollars. This includes shifting to digital media on brands where it is appropriate, leveraging co-branding opportunities and assessing and maximizing the return on investment on all the activities that constitute our brand building investment. We have increased the way we leverage advertising copy across multiple markets. We've decreased redundancies between agencies, renegotiated some agreements and driven broad-based efficiencies in working media. Looking forward, though, we expect brand building to grow in the second quarter, due to the timing of our innovation launches.

Slide 9 shows the quarterly internal operating profit performance for each of our regions. North America's internal operating profit decreased by 3.5%. We saw strong mid-single digit growth in our Morning Foods, Specialty and North America Other segment, which includes Frozen Foods and Canada. And together, these businesses posted 6% operating profit growth. However, our Snacks business posted a double digit decline, due to sales performance and because it recognized a majority of the regions cost pressure. We are taking actions to improve our performance, including the launch of innovation and, of course, the effect of inflation will decline as we proceed through the year. Consequently, we expect that results will improve during the second half of the year.

In Europe, we saw good top-line growth of 2.6% in the quarter and expect continued growth over the remainder of the year. But the region faced commodity inflation and made some investments in supply chain to relaunch new Special K food in key markets. As a result, internal operating profit in Europe was flat in the first quarter. Obviously, economic conditions continue to be difficult on the Continent and this also impacted our results.

Internal operating profit in Latin America decreased by 5.6%, due to commodity inflation, timing of certain supply chain costs, as well as brand building investments in the region and this was on top of a strong 11% comp in the first quarter of last year. And Asia Pacific posted a decrease in internal operating profit of 30.6% in the quarter, but, as you know, we have a project underway in Australia to close a manufacturing plant.

Slide 10 shows our year-to-date cash flow. Cash flow from operations was comparable year-over-year. Capital spending in the quarter was $102 million, up nearly $40 million from last year. You may recall that I mentioned on our fourth quarter conference call that we saw some capital spending shift from 2012 into 2013, so free cash flow was $236 million, a decrease versus the first quarter of last year, due to the shift in capital spending. Share repurchases this quarter were $44 million, lower than proceeds from options, which were $259 million. And as we have said, we expect to repurchase shares to the extent of options proceeds.

Now let's look at Slide 11, which shows our guidance for 2013. And our outlook for the year remains consistent with previous guidance. We still anticipate that reported net sales will increase by approximately 7% and that internal net sales growth will be approximately 3%. As we told you last quarter, our internal net sales growth depends on the phasing of Pringles' sales across the first and second halves. Our latest outlook is consistent with our original guidance.

Our estimates for cost inflation are unchanged at approximately 5% and we continue to expect cost savings of around 4%. As I mentioned earlier, we saw the majority of the year's net cost inflation in Q1, but we will also see inflation the second quarter. And we expect the third quarter and fourth quarters to be deflationary. We are largely covered on our commodities for the year and have good visibility into our cost structure.

It's also important to note that our productivity savings rate increases as we progress through the year, with less than 4% in the front half and more than 4% in the back half. We continue to expect that reported operating profit growth will be slightly higher than reported earnings per share growth of 5% to 7%. You'll remember that this is because of some favorable one-time items below operating profit that benefited earnings per share growth last year.

Also, recall that our guidance provided on the fourth quarter call included a $0.02 headwind from currency translation. Currency rates were volatile in the first quarter and we saw as much as a $0.03 to $0.05 headwind for the year.

And the Venezuela devaluation was slightly more than we thought for the year. The impact of dilution is also a little greater than anticipated, as a result of the strong share price. Now, depending on what happens over the rest of the year, these two items could put pressure on our outlook. However, we have plans below-the-line to offset the impact.

Obviously, currency translation will remain volatile, so we'll update you regarding the effect of the year as it progresses. The underlying tax rate for 2013 is still expected to be approximately 30% and our estimate for interest expense is between $230 million and $240 million.

Turning to Pringles, we still anticipate $0.12 to $0.14 of integration costs for the year and we remain on track to deliver synergies of $50 million to $75 million in 2013. Annual cash flow is expected to be between $1.1 billion and $1.2 billion, with capital spending still anticipated to be slightly more than 4% of sales. As some of you have asked, I'd like to remind you that this does include the capital investment in the Pringles business we discussed with you previously.

Finally, just a quick word on the second quarter, we expect strong reported sales growth and solid comparable sales growth, but we do anticipate that there will be a continued impact from the softness in the U.S. Snacks business. And we believe that we are not likely to gain traction until the second half of the year. We continue to expect good reported operating profit growth, including the benefit of two months of Pringles' profits. But the shape of net inflation, combined with investment to support innovation launches and the softness in the U.S. Snacks business, could result in internal operating profit being relatively flat in the second quarter. We expect better profit growth in the second half, due to the net cost deflation and the Pringles' synergies I discussed earlier. As was the case last quarter, our guidance for operating profit and earnings per share excludes the impact of mark-to-market adjustments.

And one last housekeeping matter, our Kashi business was previously reported as a component of our U.S. Morning Foods & Kashi operating segment. Earlier this year, we folded the respective Kashi Cereal and Kashi Snacks businesses into our Morning Foods and U.S. Snacks operating segments to better align strategy and execution. The changes to results are not material, but we have provided comparable 2012 data in Appendix 6 of this presentation.

And now, I'll turn it back over to John for a discussion of our segments.

John A. Bryant

Thanks, Ron. Slide 12 shows the internal net sales growth performance of Kellogg North America. As you can see, the first quarter's results remained solid at 1.7% growth.

Slide 13 shows the performance of the U.S. Morning Foods segment. Internal sales growth was 1.6% in Q1. Our Cereal business gained [ph] 0.3 of a point of share (19:07) in the first quarter. This was driven in part by Special K. We've had good innovation on the brand, including Chocolate Strawberry and a re-stage of Special K Protein. All this led to a very successful resolution program, and, in fact, during Q1, Special K saw increased share, consumption, and household penetration. Other brands also did well, including Mini-Wheats and Frosted Flakes, both of which gained share on strong rates of consumption.

Although category growth improved sequentially during the quarter, it has been a little bit slower than we would like in recent periods. While the Kids segment has been doing well, the Adult segment has been lagging. Special K activity I mentioned is helping and we're also doing our part with innovation. We have a lot of activity planned for the middle of the year that will address this further, and which will be supported with brand building. The new products include Raisin Bran with Omega-3, multi-grain Special K, Kashi GOLEAN Vanilla and [ph] Kashi Chia Heart to Heart (20:09), some of which are pictured on the slide.

In addition, we're also expanding the definition of our categories. In the Breakfast segment, the drinkable breakfast products you saw at our Investor Day in November are now expanding distribution. And we've also got hot cereal planned for introduction at mid-year. These are both exciting steps for us and should also help drive adult consumption in the broader category.

And finally, Pop-Tarts again had a strong quarter, with nearly 5% consumption growth and share growth. We also have some great innovation coming, with two varieties of peanut butter flavored Pop-Tarts launching in June. These are great products, which we are sure will contribute to the brand's continued success.

Now let's turn to Slide 14, which details the internal net sales performance of the U.S. Snacks segment. The business posted an internal sales decline of 1.7% in the quarter. The Cracker business posted a slight net sales decline, although the four main brands, Cheez-It, Town House, Club and Special K, in combination, posted low single digit sales growth. And remember that Crackers were lapping a difficult high single digit comparison in the first quarter last year. The sales performance this year was also partially driven by the timing of innovation. We've got increased innovation launching later in the year and expect this to drive better performance.

The Cookie business declined in the first quarter, due, in part, to a decline in 100 calorie packs and the timing of promotions. The Wholesome Snacks business posted 3% sales growth and we saw good growth in the business from innovation, including Special K Pastry Crisps and Nutri-Grain Fruit Crunch. In fact, the whole Nutri-Grain brand is growing, as a result of effective support, and we've got good commercial plans and more innovation planned for the whole segment at mid-year.

As you know, our Pringles business is not included in internal sales. If we had owned Pringles during the first quarter of last year, net sales for the total Snacks segment would have been approximately flat, due to the strong performance of Pringles. We gained nearly a point of share in the Potato Chip category in the quarter, as we benefited from strong commercial activity. Sales increased at a double digit rate, driven by distribution gains and good advertising, and growth was broad-based. The Pringles brand is very responsive to investment and activity and we've got more planned for the balance of the year.

So we're not happy with the recent performance of the snack business. Some of the weakness is due to timing, but core results could be better. The team is working hard and we have plans for improved innovation and support. The business will likely remain challenging in the first half, but we're optimistic that results will improve over time.

Slide 15 shows the performance of the North America Other segment, which includes the Canadian and Frozen Food businesses. The segment posted 7.4% internal net sales growth in the first quarter. In Canada, we saw low single digit internal net sales growth. Cereal, crackers, frozen foods and the new breakfast beverages all contributed. Special K also gained share in Canada in Q1, due to a strong New Year's resolution program and good innovation, much like we saw in the U.S. In addition, other innovation contributed to sales growth, such as Krave, Special K Granola, Nutri-Grain Bakes, and Special K Crisps all did well.

In the Frozen Foods business, we saw very strong double digit growth in the Frozen Breakfast segment, due to good results from innovation and gains in distribution. The new Special K Flatbread Sandwiches are doing very well and they're driving most of the growth in the segment. And Eggo Waffles also grew in the quarter.

We also saw growth in the Veggie category in the quarter. Last year, we advertised MorningStar Farms in the important summer season and saw good lift as a result. Because of this, we're beginning the support even earlier this year and have strong innovation planned.

Slide 16 shows the net sales performance of the U.S. Specialty segment. As you can see, we posted 3.4% growth in the first quarter. We are fortunate to have Brian Huff here today to discuss the Specialty Channels business in more detail. You all know Brian from last year's Analyst Day. Brian is a 22 year veteran of Kellogg. He started with the company in 1991 in sales and became President of our U.S. Specialty Channels business in 2009.

So with that, I'll turn it over to Brian to give you more detail.

Brian Huff

Thanks, John, and good morning, everyone. I wanted to start today with a few slides to provide texture regarding the Specialty business and how we leverage and manage our portfolio across diverse channels. Specialty Channels is comprised of several distinct channels and multiple business segments, representing over $1 billion in annual net sales.

The two largest components of the business are Foodservice and the Convenience and Gas channel. Our go-to-market model focused on business-to-business channels, specifically, venues and customers catering to away from home consumption. As you can see on Slide 18, we have a tremendous foundation for growth, with the largest share across most of our key categories and channels, including Foodservice, Convenience, and Vending. This solid foundation provides us great potential for further expansion and growth.

If you'll turn to Slide 19, you'll see the detail of the categories in which we compete. As you might imagine, we compete in the Cereal, Snacks, Veggie Food and Hot Breakfast categories. Kellogg's strategy is to focus on the unique characteristics of the various away from home venues and to adapt and innovate across our portfolio to bring our brands and food to life. It's this combination of a strong and diverse product portfolio and channel focus that provides us with the ability to better serve our customers.

Slide 20 provides a brief history of the Specialty Channels business. As you can see, our Specialty business has evolved over time through a combination of acquisition and innovation. This progression has broadened our base and provided expansion opportunities across categories and venues. Our 2008 acquisition of Gardenburger, in combination with MorningStar Farms, was pivotal, as it provided us a center of the plate offering that is important to success in away from home venues. Most recently, our extensions into savory snacks and beverages will provide substantial opportunity for growth and expansion across all of these channels.

Now let's turn to Slide 21. At the core of our strategy is the expansion of reach and brand impressions across the consumer landscape. The channels in which we compete provide Kellogg with significant opportunities to do just that, with over 2 million points of consumer intercept. We see opportunities in many of the venues and believe that our expanded portfolio brands and Kellogg's unique offerings have great consumer relevance in these locations.

Slide 22 shows the longer-term sales performance of our business. And you can see we've experienced good and consistent net sales growth over the past several years. Some of the key business drivers of this success have been excellent volumetric growth in the Convenience and Foodservice segment, robust innovation across the business, winning in K-12 schools, growth in the Frozen Breakfast category, expanding the footprint of our Veggie Foods business, and driving our largest brand, Special K, in single serve options and offerings.

So starting with Slide 23, I'd like to discuss some of the opportunities that we see in the business and some of the ways in which we think we'll drive future growth. We see significant opportunities for expansion into new categories for us, specifically, Savory Snacks and Beverages. These two categories represent huge revenue across the industry and are currently under-represented at Kellogg. Bringing great brands, such as Pringles, Kellogg's and Special K is a huge opportunity for us, as well as our customers.

We will continue to drive revenue growth by focusing on three key areas, by driving and expanding our core brands through incremental marketplace reach, establishing a Single Serve Beverage business, and driving increased placement of savory snacks.

While all of those opportunities are exciting, Slide 24 details some of the potential that we have as a result of the acquisition of Pringles. Pringles has been a great addition to our brand line-up and provides a strong anchor and a sandwich accompaniment that is critical in away from home venues. In combination with Special K and Cheez-It, these three strong brands bring diversity and variety to the category and provide accretive revenue growth for us and our customers.

Pictured on Slide 24 is a merchandising display that features all three brands in single serve packaging. We utilize this in multiple venues, including healthcare, convenience, college, university and business and industry.

Slide 25 highlights our Convenience and Gas channel, which, as you can see, is one of the fastest-growing channels in North America, which is fueled by product expansion and innovation. The channel continues its transformation and is improving its food offerings. This aligns extremely well with our brands. Special K is our fastest growing brand in this channel, with excellent growth in Protein Bars, Chips, and Beverages. In the future, our strategy will continue to focus on expanding our core portfolio and reach and investing in innovation to drive continued category growth.

Now let's turn the Slide 26 to review our K-12 School business. Keeping our brands relevant and available to the 55 million K-12 students in the U.S. is a priority for Kellogg. We continue to invest in innovation and renovation of our brands to meet and even exceed USDA guidelines. A recent success in this channel has been our Eggo Mini Pancakes and Waffles. These products have allowed us to expand in the Frozen Breakfast category and bring one of our best-selling equities to K-12 schools. We know that children who start their day with breakfast perform better in school during the day and we're committed to this important business and the role our brands can play.

Slide 27 shows the opportunities that we have in veggie foods across the away from home channels. Center of the plate offerings are critical to this business and we have two powerhouse brands in Gardenburger and MorningStar Farms that have been doing extremely well. The Veggie category remains on trend with consumers and offers us long-term sustainable growth and is currently under-represented in away from home outlets. Consumers continue to seek meat alternatives and we have terrific foods and brands that fill this marketplace need across our channels. Many growth opportunities remain in both commercial and non-commercial locations and our strategy centers around the expansion of distribution and reach in both of these areas.

So in summary, on Slide 28, I'd like to say that we remain very committed to and excited about our great Specialty Channels business. We have a long history of strong growth and we've seen acceleration in recent years. We have number one share positions in most of our businesses and categories. We've now got the power of the Pringles brand and we've got great products in exciting new categories like Savory Snacks and Beverages. And we have more great innovation planned for introduction in this business, which have great economics.

I am very proud of what the team has achieved and would like to thank them all for all of their hard work. Our success is due to them and we're all committed to continuing our focus on these important channels, businesses, customers and consumers.

And now, I'll turn it back over to John.

John A. Bryant

Thanks, Brian. Now, let's turn over to Slide 29 and our International business. The European business posted internal net sales growth of 2.6% in Q1, which continued the improved results we've seen since the back half of last year. And we gained category share in a number of the countries in the region during the quarter. We saw excellent growth in the UK, the largest business in the region, as we gained Cereal category share and posted strong double digit sales growth in the Kellogg's Snacks business.

Our Crunchy Nut brand saw very good performance, driven by increased media and innovation. Other innovation also contributed, including Special K Cracker Crisps and Biscuit Moments.

On the Continent, our French Cereal and Snacks businesses performed well and grew share. And we saw improved performance in Italy behind the restage of our Special K Cereal brand. This initiative will roll-out across the rest of the region in the coming months. However, Spain continues to be the most difficult country in Europe for us, driven by economic conditions. We are taking a number of actions in this business, including increasing commercial activities and changes to packaging and pack sizes. This business will remain challenging, but we're optimistic regarding its long-term potential.

Like most regions around the world, Europe posted strong Pringles consumption growth in the quarter and this was achieved while the business was executing the integration into Kellogg's systems, so very good performance from the team in Europe.

Internal net sales increased by 0.3% in Asia Pacific in the quarter, although we saw strong 4% growth in consumption across the region. The difference was driven by a trade inventory reduction in Australia. However, underlying performance was strong in Australia, where we gained two points of growth of category share in Cereal and 1.5 points in Snacks. We launched breakfast drinks in Australia earlier than we did in the U.S., which also contributed to the business' sales growth.

Sales in India and Southeast Asia both increased at a double digit rate. And Pringles also posted strong growth in the region, with underlying sales up at a high single digit rate. We saw some softness in results in South Africa, due to timing, and in South Korea, due to the competitive environment, but we're pleased with the underlying performance in the region and expect good results across the balance of the year.

The Latin American business posted 7.4% internal sales growth, as a result of strong price mix gains and better volume performance. Most of the businesses in the region contributed to the overall growth. Sales growth in Mexico lagged the average in the quarter, but Cereal consumption in Mexico was strong and regained share in the quarter. You remember that we are lapping an inventory build in the first half of last year in Mexico, which made comparisons this quarter more difficult. We'll also face difficult comparisons in the second quarter, but they'll get easier in the second half of the year. We also saw good growth elsewhere in Latin America. The Brazilian business posted good sales growth, as a result of both price realization and improving volume performance, as we increased distribution. The Venezuelan business also did very well in a difficult economic environment.

Now, let's turn Slide 30 and the summary. The first quarter was a good start to the year, with good overall sales growth. Overall operating profit results were also as anticipated and included the most significant net inflation we'll see all year. We saw continued strong performance from Pringles in most regions of the world and the integration continues to go smoothly. And we're on track for the full year.

So finally, I'd like to thank the 30,000 Kellogg employees around the world for all their hard work and dedication and we'll open up for questions.

Q&A

Operator

[Operator Instructions] And our first question is from Matthew Grainger of Morgan Stanley.

<Q - Matthew C. Grainger>: Hi. Morning, everyone. Thanks for the question.

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

<A - Ronald L. Dissinger>: Morning.

<Q - Matthew C. Grainger>: Could you give us a sense of what level of upfront costs you're expecting for the full year? And given that you're coming off a year slightly below average investment there, should we expect to see an above normal level of upfront cost this year, particularly with the [ph] 9% inflation (37:31) outlook you're guiding us to in the second half?

<A - Ronald L. Dissinger>: Matthew, our upfront costs are very consistent in 2013 with what we spent in 2012. So we're somewhere in the range of $0.10 to $0.12 of upfront costs for the year.

<Q - Matthew C. Grainger>: Okay, thanks, Ron.

<A - Ronald L. Dissinger>: Sure.

<Q - Matthew C. Grainger>: And just one follow-up on Europe, I believe in the prior year, you had a business disruption in the first quarter, which was quickly resolved, and I'd assume that comparison flattered this quarter's results in Europe, to some extent. As we're revisiting our assumptions for Europe for the balance of the year, can you give us a sense of what underlying trends would have been in Q1, excluding this factor?

<A - John A. Bryant>: Yeah, we feel very good about our performance in Europe in the first quarter. It was actually in line with our expectation, if not slightly ahead, of what we had expected to deliver in Q1. If you look in the UK, we did actually did see some strong growth and see share gains in both Cereal and in Snacks. Same is true in France, we saw gains in Cereal and Snacks share.

We do have some softness in Southern Spain – sorry, in Spain and Italy continuing. Even though we gained share in Italy, we continue to see weakness in Spain. So if you look at Europe in the first quarter, it was very much in line with our expectations. The operating profit margin is very similar to what we expect to see for the entire year. We're still tracking to grow sales and profits across 2013. And we're happy to say the Pringles integration is continuing to go very well also. So while I agree it's a weak comparison, we're actually tracking right where we thought we would track and are on target for the year.

<Q - Matthew C. Grainger>: Okay. Thanks again, everyone.

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

Operator

And the next question comes from David Palmer of UBS.

<Q - David S. Palmer>: Morning, guys.

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

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

<A - Brian Huff>: Morning.

<Q - David S. Palmer>: You portrayed the input cost inflation being a picture of two halves, with the second half of 2013 being down, and that seems to mirror the grains inflation that we would suspect many food companies will be experiencing. Does that seem to be setting up, barring some sort of major weather shocks come from in this grain crop coming up, for a down into 2014 picture? And, if so, this feels a lot like the second half of 2009, where all participants, and even retailers, are sensing that this is a rather benign period? How do you see the competitive picture shaping up? And do you see participants sort of dialing up the promotions or perhaps people are acting more rational than they did this time in the cycle last time?

<A - Ronald L. Dissinger>: Matthew (sic) [David] (40:18), first, on the grains, it's a bit difficult for us to predict into 2000 – or sorry, David, on the grains, difficult for us to predict on the grains going into 2014. We've got two crops that'll need to be planted and harvested. We do have good visibility, though, to 2013. As I mentioned, we're largely covered across our grains, at this point in time, so feel very comfortable with our outlook on input inflation for this year.

<A - John A. Bryant>: David, I can't talk to what the competitive environment might be in the future, but if you look at our results over the last few years, we've come under pressure from increasing commodity prices, so as we go into a more benign environment, we'd hope to see margin improvement as we go forward from here.

<Q - David S. Palmer>: And then just one quick question on cereal, I think you mentioned adult cereal being a little more sluggish than you would've liked. As your thinking about that category and the weakness that has seemed to persist, are you getting any further thinking about why that category may not be as strong as one would've hoped this time in the pricing cycle?

<A - John A. Bryant>: Yeah, I think if you look at the Cereal category, it is a little softer than what we would like it to be, but you break apart in different segments. So Kids, we're actually growing in Kids and the category is growing in Kids. In All Family, we're growing, but the category's a little soft. But we feel okay about where All Family is. It's really Adults, where the category and ourselves, are both down about 5% in the first quarter. And that's where the opportunity for future growth lies.

What is also interesting, David, is if you take the category and you break it out by income, the category's actually growing with low income consumers, but is actually declining a little bit with high income consumers. So you boil it all down and say the big opportunity in the Cereal category right now is high income Boomers. And so what are we doing to address high income Boomers? We have innovation coming out this year around Raisin Bran Omega-3, [ph] Heart to Heart Chia (42:19), Special K Multi-Grain. So we have a range of innovation targeted at those adult consumers. Plus, we think we have a very strong adult portfolio between Special K, Kashi, Bare Naked. And if we can get those brands all driving on all cylinders, I think we could really drive older adult consumption in the category.

<Q - David S. Palmer>: Great, thanks, John.

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

Operator

And our next question will come from Ken Goldman of JPMorgan.

<Q - Ken B. Goldman>: Hi, good morning.

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

<A - Ronald L. Dissinger>: Morning.

<Q - Ken B. Goldman>: I wanted to ask the flipside of the question on grains, because I know it's early, but we are seeing the latest plantings of corn in history, really, at this point. So on the one hand, it's early, right? I mean, there's not much of a correlation between late plantings and higher corn prices and yields and so forth, but, on the other hand, we're getting to a point where most analysts, I think, who are looking at corn say, we have about two weeks left before we – it's time to get really concerned. So I'm just wondering, Ron, what are your people seeing? What is your take on that? I know it won't affect you at all until 2014 at the earliest, but when do you start maybe worrying about the late plantings and how that might affect your longer-term commodity outlook?

<A - Ronald L. Dissinger>: It's difficult to predict. Some of our folks have told us that years previous when there been late plantings, we've actually seen record harvests. So it's difficult to predict, Ken, at this point in time. Obviously, we're going to continue to watch the markets. And, as you know, we use – take appropriate coverage when we think it's the right time. So we'll provide guidance as we get into the fourth quarter call on 2014.

<Q - Ken B. Goldman>: Nothing that you're overly concerned with yet at this point?

<A - Ronald L. Dissinger>: Not at this time. No.

<Q - Ken B. Goldman>: Okay. Thank you, Ron.

Operator

And next we have a question from Thilo Wrede of Jefferies.

<Q - Thilo Wrede>: Good morning, everybody.

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

<Q - Thilo Wrede>: I actually had a question for Brian. Brian, you showed a slide in your part of the presentation with joint marketing or displays for products like Pringles and Special K. Can you talk a little bit how such a display is actually driving sales for the brands, because, in my view, the Pringles consumer and the Special K consumer, they're different people? The products have different brand equities, different attributes. So I'm just trying to how to understand how the sales booths really works.

<A - Brian Huff>: Yeah, no. Thanks for the question, too, by the way. As we're looking at it, it's fairly early in our stages of – with our Pringles integration and our strategy, which truly is about ubiquitous distribution, as we're looking at our business and building our commercial plans. But as we've seen here in the short term, we're getting significant growth and revenue from not only the Pringles business, which in the first quarter was up over 30% on an organic basis, but also the halo effect that that's having on Special K, as well as our Cheez-It business. And truly, it all comes down to choice and consumer choice. So we're very excited that we have a great diversity and variety of product out in the marketplace that really do help drive that consumer choice and meet multiple consumer needs.

<Q - Thilo Wrede>: So is the benefit coming from the halo effect or just from the fact that you have a – and for lack of a better word, an excuse to put up these displays a little more prominent in the store?

<A - Brian Huff>: Well, we're also always looking for excuses to put up more displays and showcase our brands. But what I will tell you is a big piece of what we're seeing is having our brands out there in front of the consumers. We have dynamite brands in the strength of Pringles, Special K ,as well as our Cheez-It brands, and the more that we can showcase and focus them to the consumers, the better off our business performs.

<Q - Thilo Wrede>: All right. Appreciate that. Thank you.

Operator

And the next question is from Greg Hessler of Bank of America.

<Q - Greg Hessler>: Hi. Thanks for taking the question. My question is just on future capital allocation, given the buyback announcement today. It looks like you're reducing debt through the quarter. Are you planning for further debt reduction? And, if so, how do you expect to balance this with the buyback plan? And then I have one follow-up.

<A - Ronald L. Dissinger>: Sure. In relation to the $1 billion buyback plan that we just announced, I wouldn't read anything into that. Our expectations for 2013 are very consistent with what we've communicated previously. We intend to buy back shares to the extent of options proceeds. The $1 billion authorization does give us the opportunity to, in 2014, buy back shares. The authorization goes through the end of April, at this point in time. So our capital allocation remains the same. From the end of the second quarter last year, around the time that we purchased the Pringles business, we reduced our debt by about $700 million by the end of the first quarter here, so expectations very consistent with what we've previously communicated.

<Q - Greg Hessler>: And then it looks like leverage is still somewhat elevated relative to pre-Pringles levels. Is it the company's goal to continue to reduce debt and try to hold onto the high BBB credit rating or are you kind of looking at it and, with rates where they are today, maybe mid-BBB is a better target? How do you guys think about the overall credit rating?

<A - Ronald L. Dissinger>: At this time, we like our BBB+ credit rating and our intent is to try to maintain that credit rating and pay down our debt associated with the Pringles acquisition.

<Q - Greg Hessler>: Okay. Thanks very much.

Operator

And the next question comes from Andrew Lazar of Barclays.

<Q - Andrew Lazar>: Good morning. Just one quick clarification and then a broader question, Ron, on the underlying gross margin down 330 basis points, is that putting the mark – is that impacting the mark-to-market impact all in gross margin or is it broken between gross margin and SG&A?

<A - Ronald L. Dissinger>: The mark-to-market impact, first of all, we mark-to-market on pensions at the end of the year and commodities, obviously, we'll do quarterly. We did see some hang-over from the mark-to-market on pensions that carried into the first quarter. There's a portion of that that relates to our manufacturing facilities. It gets capitalized into inventory and it comes back out in the first quarter of the year, very consistent with what happened in 2012.

In terms of the impact to our gross margin performance, the mark-to-market really had very little impact. The two key items that impacted our gross margin performance, Andrew, were the net inflation. That was more than 200 basis points of impact and, in addition to that, the dilution from the Pringles acquisition, having that for the three months of 2013 versus it not being in our numbers last year. There were a few other small items that related to up-front costs in our Asia Pacific region and I talked about the investments in supply chain to relaunch Special K in Europe, as well. The margin performance was very consistent with our plan.

The other thing I would mention, our outlook for the entire year also is very consistent. So we communicated previously that we expected for the year to be down around 50 basis points. That's essentially driven by the dilution from Pringles. Our underlying, or base business, gross margin is expected to be flat in 2013.

<Q - Andrew Lazar>: Okay. Thanks for that. And then, John, if we look at just the organic sales growth in Morning Foods in the quarter, I think it was up 1.7%. And I think in the fourth quarter, it was up a little over 6%. And I know some of that was a buy-in in the cereal arena. But it certainly, at least sequentially, decelerated, despite pricing coming in quite a bit relative to where it was in the fourth quarter. And I guess the big sort of industry thesis, but Kellogg as well, is as pricing wanes, volume kind of starts to come back. And that was the big impact last year on volume. And, I guess, are you concerned that we're either not seeing that play out or just not seeing it play out as dramatically as I think everyone, including the industry, would like to see, trying to get a sense of if I'm reading that right?

<A - John A. Bryant>: Well, if I look within the Cereal category, as I said before, we're actually seeing strength with low income consumers, strength with kids. We're doing well in All Family categories, a little soft. It's really adult where we are seeing weaknesses. It's high income adults. I don't think they're really that price-sensitive. It's not about as prices come up, we'd normally expect volume to just naturally to follow with high income Boomers. I think the real issue there is our innovation and the innovation in the category needs to be more nutrition and benefit-oriented and, quite frankly, less about pricing and merchandising. And that's the opportunity I think we have as a company and I think the category has as well. And I think the more we drive into that, the more we're going to grow the business.

In addition to that, when you think about the weakness in the Cereal category, we're also doing things to give people the benefits of cereal outside that normal definition of ready-to-eat cereal. So we have cold to-go shakes and we have the breakfast biscuits and we have also hot cereal in there, as well. That's also all driving our cereal consumption, but not getting captured in the RTEC data. If you look in Q1, our Morning Food sales growth is up 1.6%, 1.7%, and the consumption for cereal's actually down. Our Cereal sale's actually down a little bit in Q1, and the difference there is very strong Pop-Tarts performance in the first quarter. That's what's driving the difference between consumption and shipments in Q1.

<Q - Andrew Lazar>: Okay. Thanks very much.

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

Operator

And the next question comes from Alexia Howard of Sanford Bernstein.

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

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

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

<Q - Alexia Jane Howard>: So within the U.S. Snacks business, I think there was a comment that there were some timing issues and the core results were somewhat weak, could you maybe just give us a little bit of an elaboration on that? And is that likely to persist into the next quarter?

<A - John A. Bryant>: Yeah, Alexia, Snacks top-line was down 1.7% in the quarter. If you see within that, look at the different businesses, Wholesome Snacks actually performed pretty well, with shipments up about 3%. We held share. We had some good strength behind Special K and Nutri-Grain, both up double digits. So we feel okay about Wholesome Snacks in Q1. On Crackers, the sales were down slightly, but we're lapping a big 9% growth in the first quarter last year. We had a huge Special K Cracker Chips resolution program. As you look in 2013, our innovation is more in the second quarter and we have two large new products coming out with [ph] Cheez-It Zingz (53:21) and Town House Pita. So we expect a much better Cracker performance in Q2 as we go through the year. So that's really more the timing, if you like, within Crackers.

The one business that's probably softer than we like is Cookies, where consumption's down about 5.5% in the first quarter. Within that, we do have more innovation coming out in Q2. We have two simply made SKUs coming out, a butter cookie and a chocolate chip cookie, which have basically just eight ingredients, more homemade. Plus, we have new pack design and we have improved merchandising planned. So I think we've got programs in place on Cookies. That's the one area that we were a little weaker than we would like to be from the consumption perspective.

The good news is Pringles continues to do extremely well. In fact, the Pringles consumption, when you include Sticks, was up 13% in the first quarter, so a very strong performance there.

To answer your question about phasing in the year, probably a little bit better in Q2 and much better as we go through the back half of the year, because that innovation will start to hit towards the back part of Q2.

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

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

Operator

And next we have a question from Eric Katzman of Deutsche Bank.

<Q - Eric R. Katzman>: Hey. Good morning.

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

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

<Q - Eric R. Katzman>: A couple of questions, I guess just kind of following up on Alexia's questions, you said I think, Ron, that the bulk of the impact of inflation in the quarter was in Snacks. Did that limit your competitiveness to the extent that Mondelez is getting more aggressive in Cookies and Crackers?

<A - Ronald L. Dissinger>: No. We did see more input inflation in Snacks in the first quarter, but that didn't have any impact on our in-market plans, necessarily, Eric.

<Q - Eric R. Katzman>: Okay. And then I guess another question, you answered I guess it was more of a bond-oriented question around the buyback as being nothing different, but you also indicated that if currency, in general, and the hit from the Venezuelan devaluation, as well as, I guess it was somewhat higher shares due to the stock price and the dilution, that you could offset that and had some flexibility? Doesn't that go against what you just said about the difference in the repo?

<A - Ronald L. Dissinger>: Not necessarily. I mean, we're buying back shares to the extent of options proceeds. So what I talked about was potentially a little bit more volatility in the currencies. We said we've seen as much is $0.03 to $0.05 of headwind, but it depends upon how that plays out for the balance of the year. And, yes, we are seeing a little bit more dilution as a result of a higher share price. But we have plans and are working on items below-the-line to improve our performance. Those items include tax and interest cost, Eric. So when you look at our tax rate, I communicated we might be at approximately 30%. That could come down slightly, based on the plans that we're working on, and same with interest costs. I communicated we could be in a range of $230 million to $240 million. We could be more towards the low end of that range, based on the things that we're working on, if we saw currencies continue to stay adverse. Now, what we've seen just over the past couple of weeks is currencies have – international currencies have actually started to strengthen.

<Q - Eric R. Katzman>: So what's the right share count that we should use for the year, given your plans at the moment?

<A - Ronald L. Dissinger>: We're still seeing one to two points of impact from share dilution.

<Q - Eric R. Katzman>: Okay. And then last question and I'll pass it on, John, I guess you've got this – hopefully this bucket of deflation that will give you some flexibility in the second half. You've put a lot of money back into the business in the last couple of years, whether it's on the supply chain side or on the advertising and new product side. What's – I mean, what's your sense in terms of putting that into promotion to drive sales or seeing a balance with a greater EBIT growth? Maybe you could talk a little bit about that and I'll pass it on.

<A - John A. Bryant>: Well, Eric, I think what we've said today is we're on track for our guidance for the year. So we are looking for – to deliver that guidance, which has some margin expansion implicit in it with – particularly within the back half of the year. And within that, obviously, we continue to be committed to driving our brands. As I said before, talking about the Cereal category, I think it's more to do with benefits to the consumer and communicating those benefits, rather than additional promotional activity or pricing and so on, that would be an alternative way of investing the money.

Operator

And our next question is from Jonathan Feeney of Janney Capital Markets.

<Q - Jonathan P. Feeney>: Good morning. Thanks very much. John, you mentioned the opportunity here in innovation at the high end and I can't argue with that if you're having success at the low end, but when I look at your volume over the past five or six years, it's down both in North America and globally, at a time when pricing's up about 20% and 18%, respectively, for those regions. And I'm just going off the organic numbers you've given us over that time. So correct me if I'm wrong, but gross profit has to be way up. And I guess I'm wondering does – gross profit per unit I'm talking about. Do you – I guess, do you – has that been consistent, that the low end's been doing better than the high end over the past couple of years? And is it possible that you could accelerate even more by taking pricing down or is it really just that you haven't done enough on the high end in messaging?

<A - John A. Bryant>: Yeah, Jonathan, I think if I go back to when we were really doing well in the 2000's, we were driving Special K and Kashi very aggressively and were seeing good growth in that business and that, in turn, then drives the category performance. I think that's our opportunity as we go forward here.

<Q - Jonathan P. Feeney>: Okay. Thank you.

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

<A - Simon D. Burton>: I think we'll take one more question, if we can, please.

Operator

Certainly. Our final question will come from Chris Growe of Stifel.

<Q - Christopher R. Growe>: Just made it in. Thank you.

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

<Q - Christopher R. Growe>: Good morning. I have two questions for you. I wanted to ask, first of all, in relation to the gross margin performance, you indicated around – over $80 million of net inflation, if I heard that correctly, meaning that that constituted the majority of your gross margin decline for the quarter. Pringles, I assume, also was a bit of a drag on the gross margin, so I know it's not fair to call it underlying, because the inflation is part of the business, but it would sure seem like the underlying business, if you will, getting past that inflation, was pretty solid in the quarter. Would you agree with that viewpoint?

<A - Ronald L. Dissinger>: That's a very fair statement. So more than 200 basis points of the gross margin impact was this net inflation impact and then, as I mentioned, 80 basis points from Pringles. So the underlying health of the business really was quite strong.

<Q - Christopher R. Growe>: Okay. And then just a question regarding promotional spending overall, you had positive price realization. And I'm just curious how you – if you could characterize promotional spending in your categories and how Kellogg's promotion was in the quarter. I know there's been a couple of questions around this, but I wasn't clear on how – if your promotion was up in the quarter or down versus the price realization?

<A - John A. Bryant>: We always compete in intensely competitive categories. And I'd say that all of our categories, while they're competitive, they're reasonably rational. So I think that we continue to operate according to our plan and our plan comes back to really brand building and innovation and driving and exciting the consumer. So we're staying competitive out there, but I – and I'm not seeing any increasing competitive pressures that overly concern me.

<Q - Christopher R. Growe>: Okay. Thanks very much for the time.

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

Simon D. Burton

Okay, thank you, guys, for joining us, look forward to speaking with some of you over the course of the next few days.

Operator

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