Company Name: Kellogg
Company Ticker: K US
Date: 2017-02-09
Event Description: Q4 2016 Earnings Call

Market Cap: 26,819.68
Current PX: 76.43
YTD Change($): +2.72
YTD Change(%): +3.690

Bloomberg Estimates - EPS
Current Quarter: 1.036
Current Year: 3.976
Bloomberg Estimates - Sales
Current Quarter: 3371.333
Current Year: 12946.176

Q4 2016 Earnings Call

Company Participants

- John Renwick
- John A. Bryant
- Paul T. Norman
- Ronald L. Dissinger

Other Participants

- Kenneth B. Goldman
- Andrew Lazar
- David Cristopher Driscoll
- Matthew C. Grainger
- Alexia Jane Howard
- David Palmer
- Michael Lavery
- Christopher Growe
- Robert Moskow

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company 2016 Fourth Quarter and Full Year Financial Results. [Operator Instructions] Thank you.

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

John Renwick

Thank you, Gary. Good morning and thank you for joining us today for a review of our fourth quarter 2016 results. I'm joined this morning by John Bryant, Chairman and CEO, who will give you an overview of our business results and priorities; Ron Dissinger, Chief Financial Officer, who will walk you through our financial results and outlook; and Paul Norman, President of North America, who will give you an update on our North America business.

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.

As a reminder, a replay of today's conference call will be available by phone through Tuesday, February 14. 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 John and slide number 3.

John A. Bryant

Thanks, John, and thank you everyone for joining us. Please turn to slide 3 and a quick summary of the quarter and year. Q4 results showed a sequential improvement, as promised. We generated sequential improvement in net sales with currency neutral comparable growth in Q4 on top of year-ago growth, even excluding Venezuela.

We saw sequential improvement in price mix, gained a flat after having been down the first half and providing evidence of revenue growth management starting to take hold. We saw improvement in our gross margin in Q4 as our savings start to offset headwinds like adverse transactional currency and country mix.

We saw sequential improvement in our operating profit margins and growth, both coming in ahead of our expectations in the high end of our guidance. We also came in higher than our expectations and guidance on EPS and cash flow. Behind these results is continued progress against our 2020 Growth Plan, our 2016 priorities, and our 2018 profit margin target. In the U.S., we collectively gained share in our Core Six cereal brands; we steadily improved our sales performance in U.S. Snacks and we overhauled food and packaging in Frozen and Kashi.

We continue to expand Pringles globally. We grew in emerging markets even as we added scale in these markets through acquisitions and joint ventures and we delivered and expanded on our productivity initiatives including Project K and Zero-Based Budgeting.

We also launched revenue growth management and other initiatives to win where the shopper shops. We recognized that we have some key areas yet to stabilize. UK Cereal, Special K Snacks and Kashi Snacks, for example, but we have made good progress overall and we did what we said we were doing.

This kind of progress will continue in 2017 toward our 2018 goals. Financially, as indicated on slide 4, this progress should manifest itself in a few ways. Gradual improvement in net sales performance. It won't be immediate. In fact, Ron will discuss the negative impacts of trade inventory shifts and other factors in Q1. But over time, the efforts to strengthen the fundamentals behind our core brands from our investments in food and packaging to development of new sales and marketing capabilities to price realization from revenue growth management will show through as improved top-line performance.

We also see strong operating profit margin expansion. We have increased confidence in our ability to reach our 2018 OP margin target because our productivity programs are working and because we're adding to them and we'll be increasing our cash flow. This is a result of combining increased earnings with continued working capital improvements and prioritized capital expenditure. And we're also constantly looking for new ways to transform our business. Yesterday, we announced that we'll be exiting direct store delivery from U.S. Snacks moving completely to our warehouse distribution system as part of a broader strategy to transform that business unit. This is a significant move and, obviously, a decision like this doesn't come easily or quickly.

The DSD organization has been at the heart of our crackers and cookies business from its start, but times have changed in the form of consumer habits and customer landscape, and we believe that this shift from DSD to warehouse will allow us to compete more effectively in today's market environment. Simply put, as we [ph] close the year (05:33) at U.S. Snacks business, it became clear that moving fully to a warehouse distribution system offered the best part to more profitable growth going forward. This is a difficult decision in light of its near-term impact on the organization but it is the right long-term decision.

We invited Paul Norman, President of Kellogg North America to explain in more detail the rationale and implications. Paul?

Paul T. Norman

Thanks, John. Good morning, everyone. When we say we're getting out of DSD, we mean that we will no longer ship product directly to our customers' stores but we will rather ship product to our customers' warehouses. This takes advantage of both of our warehouse systems.

Before I go into the rationale on slide 5, let's ground ourselves on what exactly we sell through DSD today. First of all, in the U.S., DSD is only in our U.S. Snacks business unit, and through DSD, we sell cookies, crackers, wholesome snack bars and fruit-flavored snacks and only to the grocery and mass channels. This means there is already more than one-third of U.S. Snacks, including these same categories through other channels and all of Pringles that is distributed through our U.S. warehouse system plus the rest of all our U.S. business. So, warehouse distribution is something we already do for more than three-quarters of U.S. sales, and it's something we already do at scale with high effectiveness.

At the root of our decision, though, is the change in today's customer and shopper habits, and what those habits are doing to the retailer landscape. This is depicted on slide 6. As you all know, there are significant shifts in shopping patterns happening, and they are altering our retailer landscape. As shoppers shop in more and different channels, as click and collect grows rapidly and as consumers receive brand communication in different ways, we need to invest in our business in different ways too.

Right now, much of our U.S. Snacks resources are dedicated to a distribution system, DSD. That doesn't allow us to invest enough in the pull-oriented activities that resonate better with today's consumer and to drive our categories [ph] in select (07:58) brand building, shopper marketing, new package formats.

The shift out of DSD allows us to take advantage of our warehouse distribution system in which we already have scale and in which our retailers already have sophisticated technology and replenishment capability.

By improving margins for our customers and freeing up resources ourselves, we can invest in the activities that take us from a push model to a pull model that is more effective in today's environment for the packaged foods like the ones we make.

Slide 7 emphasizes this move improves both our effectiveness and our efficiency. It improves our effectiveness by redeploying resources from trucks and distribution centers to pull-oriented investment across more of our brands by improving our service levels through more frequent deliveries being made to more stores, and by enabling cross-category execution of commercial activities as our entire portfolio will now go through the same warehouse distribution system. Let's be very clear. We will continue to have significant presence in store. We will have feet on the street just as we do in Morning Foods today.

We also think moving to warehouse distribution will improve our efficiency by leveraging scale and technology that we and our customers already have. This means more full truckloads and it means better inventory management and by creating value jointly with our customers as we improve profitability and asset utilization for both of us, allowing us to invest more to grow our business together.

These are just a few of the reasons why warehouse distribution can make U.S. Snacks more effective going forward. We can already see this even within the Snacks business unit, today, we realize higher service levels in the categories and channels we sell-through warehouse distribution, and we have higher shares in these channels too.

Slide 8 shows how we're thinking about the timeline and the impact of this transition out of DSD. As you can all imagine, an undertaking of this size is extremely complicated. It involves a large number of employees. It involves transferring inventory and it involves closing distribution centers. We're not going to go into much detail today, but rest assured we are approaching this in the same disciplined manner we would employ for integrating a major acquisition or restructuring, complete with a transition team and governance mechanisms.

From a P&L perspective, we are planning on this DSD exit to be neutral to a comparable basis operating profit in 2017 as we work through the transition, and then it becomes accretive in 2018. It will alter the shape of our Snacks P&L, and therefore, the company's P&L too. Specifically, volume will be impacted, not only by optimizing our assortment but also at least in the near-term through some inevitable disruption as we make this transition. List prices will be adjusted, reflecting the elimination of DSD services that we are providing to our retail customers today.

So there's a bit of a reset to the U.S. Snacks net sales in 2017 and 2018 before we see acceleration in growth. Between the impact to net sales and the shift of distribution costs into cost of goods sold, there will also be a reset to U.S. Snacks gross profit margin. These impacts will be offset by a reduction in [indiscernible] (11:54). Ron will walk you through what this means for the company's 2017 guidance in a moment.

This action demonstrates just how serious we are about creating a more competitive and faster growing Snacks business. We can generate more growth by shifting resources to brand building whilst improving margins for both our retailers and our sales. In a couple of weeks at CAGNY, you will hear in more detail how this move contributes to a broader transformation of our Snacks business.

I'll finish by reiterating what John said. This was a very difficult decision, as our DSD organization has been so integral to our Snacks business for so long. But we firmly believe this is the right move for our business as we look forward at changing consumer, shopper, and retail trends.

With that, let me turn it over to Ron, who will walk you through our financial results for Q4 and our outlook.

Ronald L. Dissinger

Thanks, Paul, and good morning. Slide 9 shows highlights for the financial results for the fourth quarter and the full year. Describing our results and outlook, we will be referring to them on a currency-neutral comparable basis unless otherwise noted. And in many cases, we will also give you the same metrics excluding Venezuela. Of course, the appendices to our presentation provide you with the detail on our GAAP and non-GAAP performance.

Our net sales in the fourth quarter grew year-on-year. The shipments volume growth was ahead of consumption, so there will likely be some trade inventory reduction in the first quarter. Nonetheless, the results point to continued sequential improvement and we saw the sales growth in every region except Europe.

Operating profit grew strongly in the fourth quarter ahead of our expectations and finished the year with comparable growth of nearly 7%, excluding Venezuela, which is above the high end of our guidance.

Project K and Zero-Based Budgeting delivered more than expected, contributing to an increase in gross margin and operating margin and we finished the year with currency-neutral comparable profit growth and margin expansion in every one of our four geographic regions.

Earnings per share also came in above our fourth quarter expectations and full-year guidance both on a comparable and currency-neutral comparable basis. Note that after running a few pennies negative each quarter during Q1 through Q3, excluding Venezuela, currency translation went more severely negative, a $0.07 headwind in the fourth quarter driven mainly by the weakening of the British pound.

Before I turn to our comparable basis earnings guidance, let's look at slide number 10, which shows our revised estimates for Project K. To date, we have been managing the upfront costs and cash outlays very efficiently, and they have come in at the low end of our guidance. We have also delivered on our estimated savings. Now, with the exit of DSD and other initiatives, we are expanding Project K with savings now extending into 2019. This requires additional up-front costs like severance and discontinued leases but also generates additional savings.

The chart on this slide shows our new estimates for the overall project. As you can see, our up-front costs rise for the program in roughly the same amount as our savings, indicating an improved ratio of savings to up-front costs. And this is particularly the case when you compare the incremental savings to the incremental cash portion of up-front costs, which are only floating up to the high end of our initial guidance range. These are good, high-return initiatives that will reduce our cost structure and add to our confidence and our margin expansion target. In 2017, specifically, we expect up-front costs of about $400 million to $450 million or $0.80 to $0.90 per share.

Slide 11 shows our guidance for currency-neutral comparable sales and profit in 2017, all excluding Venezuela. The DSD exit is expected to have a meaningful impact on U.S. Snacks net sales due to reducing list prices to the retailers and to the volume impacts of initial disruption and rationalization of skews. Our initial estimate is that this will pull down the company's comparable sales by more than a point in 2017.

Outside of U.S. Snacks, the rest of our business is forecasted to be flat to down 1%, and this is essentially in line with our collective categories and still has us improving from recent year's performance led by price mix improvements from revenue growth management.

Because of trade inventory shifts between years and elasticity in Europe, we could get off to a slower start with the sales decline in the first quarter from improvement should be evident as the year goes on.

Price realization efforts and productivity initiatives should increase gross margin even if partially offset by the pricing impact and structural changes of exiting DSD. Overhead should come down as a percentage of sales owing to Zero-Based Budgeting efficiencies and later in the year to the reduction in selling and distribution expenses related to the DSD exit.

On operating profit, we continue to project high single-digit growth, even after incorporating the DSD exit, that suggests an operating profit margin expansion of more than 100 basis points, keeping us well on pace towards the 350 basis point increase we targeted from 2015 through 2018.

Also, you've seen in our press release that we have deconsolidated our Venezuela operations as of yearend 2016. This doesn't impact our operating profit growth or margin guidance as they have always been on an ex-Venezuela basis. It is important to note that this is an accounting change only, and we will continue to operate in this market.

Slide 12 shows our earnings per share guidance for 2017. Below operating profit, we see a collective impact on earnings per share that adds up to a point to currency neutral comparable growth. Specifically, interest expense is expected to be roughly flat year-on-year excluding last year's bond tender costs. We will have increased earnings contribution from acquisitions and joint ventures, and our tax rate should be higher year-on-year as we lap several 2016 benefits and shares outstanding should be down slightly, though the impact of resumed buybacks in 2017 is partially offset by curbing buybacks in the fourth quarter of 2016 when we were funding our acquisition in Brazil.

This translation to currency-neutral comparable earnings per share growth of roughly 8% to 10% were $4.03 to $4.09, and note that Venezuela deconsolidation reducing our base by $0.02.

To get to the comparable basis earnings per share that most of you forecast, we have to make an assumption for currency translation. As you know, we have seen significant appreciation in the U.S. dollar, particularly for us against the British pound, and this impact expanded in the fourth quarter. We believe transaction currency – or translation currency could be about $0.12 per share in 2017. This is higher than we had been anticipating previously and probably higher than you had been projecting too.

After currency then comparable EPS could range from $3.91 to $3.97. And recall that we expect the acquisition of Parati in Brazil to be neutral to comparable basis earnings per share. This excludes roughly a $0.01 of integration cost, which together with the remaining integration costs from other acquisitions should be in the range of $0.01 to $0.03 per share in 2017.

And, finally, a word on cash flow. We finished 2016 with a little over $1.1 billion, and we project $1.1 billion to $1.2 billion in 2017. Driving this increase should be higher net income, continued improvement on working capital and capital expenditure remaining in our targeted range of 3% to 4%.

These improvements are largely offset by approximately $300 million of incremental cash for Project K driven by primarily by our exit from DSD.

And, with that, I will turn it back to Paul to take you through the North American business results and outlook.

Paul T. Norman

Thanks, Ron. Let's start with U.S. Morning Foods on slide 13, Morning Foods recorded a slight decline in net sales in Q4 as it lapped its toughest comp of the year. Cereal sales were flat, Pop-Tarts were up, and the entire decline was related to drinks and non-core products. So, good sequential improvement in net sales even if we did get some benefit from trade inventories probably at the expense of Q1.

Our cereal consumption was in line with category in Q4. For the year, the category and Kellogg were down a little more than 1%, very clearly a moderation from recent years. Lost share was flat for the quarter and for the full year, but in both time periods our Core Six brands collectively gained 20 basis points of share. Meanwhile Morning Foods leveraged Project K and ZBB deliver exceptional margin expansion in Q4, just as it had all year long. The result was double-digit growth in operating profit for the quarter and the year, a strong performance. As we look to 2017, we expect to see some trade inventory come out in Q1 but otherwise we expect another sequential improvement in sales performance in the year and another year of strong operating profit margin expansion.

Let's turn to Snacks on slide 14. Snacks continued its sequential improvement, growing net sales year-on-year in Q4. Equally important was the sequential improvement we saw in consumption. Crackers gained share in Q4 led by the collective growth of the Big 3 brands, Cheez-It, Club, and Town House. Cookies saw moderating share declines on stabilizing base sales.

In wholesome snacks, we gained share in Q4 on Rice Krispies and Nutri-Grain. Our Pringles consumption continued to grow picking up a bit, as we lapped some SKU continuations like fat-free. So, snacks is clearly turning the corner.

In 2017, underlying sequential improvement in net sales will be masked by the negative volume pricing impact of the DSD exit. Nonetheless, snacks should record strong operating profit margin expansion as we set the platform for future growth.

Let's now turn to our U.S. Specialty Channels business on slide 15. This unit has delivered six consecutive quarters of sales and profit growth. It turned in accelerated sales growth in Q4, continuing to grow in our key channels. We held or gained share in Q4 in cereal, crackers, wholesome snacks and veggie in the food service channel, and in cereal, crackers and frozen breakfast in the convenience store channel. Importantly, we continued to realize price and margin expansion, and we expect more of the same in 2017 with steady net sales growth and continued operating profit margin expansion.

On slide 16 is our North America Other segment, which is comprised of U.S. Frozen Foods, Canada, and Kashi. This segment has undergone some major changes from SKU lineups to food and packaging overhauls to new pricing strategies. Q4 saw some modest sequential improvement in the top-line but substantially better profit and profit margin performance.

Frozen in Q4 posted its second quarter of sequential improvement in net sales performance with Eggo growing consumption and share and Morningstar Farms beginning to stabilize its sales. Canada too recorded a second quarter of sequential improvement by growing net sales in Q4. Elasticity seemed to be stabilizing after raising prices earlier this year in order to offset adverse transactional currency.

Net sales in our Kashi business continue to decline in Q4 pulled down by the soon to be renovated wholesome snacks business. But we continue to gain momentum in cereal in the natural channel and declines moderated again in traditional measured channels.

North America Other's profit growth and margin expansion were driven by savings from Project K and ZBB, and we believe we are now on a path to steady improvement going forward. So while we expect to gradually stabilize net sales in this segment during 2017, we expect to expand operating profit margins meaningfully throughout the year.

John will now discuss our international businesses. John?

John A. Bryant

Thanks, Paul. Turning to Europe on slide 17. Europe's net sales were down 1% against its toughest comp of the year. However, we recorded strong profit margin expansion in Europe both for the quarter and for the year as Project K savings and early Zero-Based Budgeting savings flowed through the profit.

From the top-line standpoint, Pringles continued to grow in the quarter finishing the year with solid mid-single digit growth and we continued to see strong growth in emerging markets in all categories: cereal, wholesome snacks and Pringles. In fact, we finished the year with double-digit internal growth in our Mediterranean Middle East business as well as in our Russian business.

Our sales decline was almost solely attributable to the UK where a deflationary retail environment persists in our categories. Clearly, we have work to do in this market. In 2017, we utilized revenue growth management to improve price realization in the UK. This will be accompanied by concentrating more of our investment behind our priority brands. We expect some challenges early in the year as we work through [ph] customer sell-in (27:35), but the expectation is to improve in-market results as the year goes on.

Meanwhile, for the region as a whole, we will be renovating Pringles and continuing our emerging markets expansion and we expect another year of strong operating profit margin expansion behind key initiatives like Project K, Zero-Based Budgeting and revenue growth management.

Slide 18 summarizes our performance and outlook for Kellogg Latin America, excluding Venezuela. Latin America recorded its third straight quarter of sequential improvement in top line, yielding its best year-on-year growth of year in Q4. We generated growth in both cereal and snacks with notable growth in the Andean market and also in Mexico.

Our Pringles business grew at a double-digit clip, a strong finish to a great year. Driving the sequential improvement are improving price realization [ph] as we cover (28:32) the impact of adverse currency, and also focus on kid cereal brands, the expansion of affordable formats in high-frequency stores and the benefits of some distributor changes for Pringles.

Latin America's operating and profit margin expanded significantly in Q4 as pricing covers more of the cost impact from adverse transactional currency as Latin America launches Zero-Based Budgeting. In 2014, we anticipate continued low-single digit net sales growth from this region and continued operating profit margin expansion.

Remember, all of this excludes the impact of Parati, which we'll be integrating during 2017. Parati is our biggest ever acquisition in Latin America and it transforms our business in Brazil, tripling our scale there and shifting our Latin American portfolio toward snacks. It's a great business that is already growing. Parati grew at a double-digit rate in the fourth quarter. This is going to be an important growth driver for us in the years to come.

And, finally, slide 19 discusses our Asia Pacific business. Asia Pacific net sales were up more than 1% in the fourth quarter, a little less from full year growth, owing to some short-term economic disruptions in a couple of markets including demonetization in India.

Nonetheless, we posted continued sequential improvement in Australia's net sales performance. Stabilizing this developed market was a key priority this year, and we're very pleased with the progress, particularly with respect to our improved in-market performance.

We recorded strong double-digit growth in Sub-Saharan Africa. Pringles continued to deliver share growth in the region and finished the year with strong with mid-single-digit growth in net sales and our joint ventures in Nigeria and China both continued to grow rapidly in Q4. Given that our share of these JV sales is roughly half the size of our Asia-Pacific region, you can see that our growth will be significantly higher if they were consolidated into our results.

In 2017, we expect to see continued net sales growth from Asia-Pacific, driven by Pringles and emerging markets' growth, and we expect improved operating profit margin expansion.

Turning to slide 20 and our transition to a new Chief Financial Officer. As you'll recall, Ron announced his retirement several months ago in order to give us time to make a thorough search for his successor. But I can tell you that Ron never once let up on his relentless drive to put us on a path to 350 basis points of margin improvement. Ron, thank you very much for your 30 years of dedicated service to the Kellogg Company, we will all miss working with you.

As we announced a few weeks ago, Fareed Khan is joining Kellogg as our next Chief Financial Officer. Many of you may know Fareed who has been the CFO of the foodservice distributor, U.S. Foods. He comes to us with an impressive varied background and a track record for being a change agent. We look forward to Fareed starting working with us in a couple of weeks. Many of you will get a chance to meet him at CAGNY.

Let me wrap up with slide 21 and a few key messages we'd like to leave you with today. Regarding 2016, Q4 was strong with top line and bottom line growth and expansion of both gross margin and operating margin.

For the full year, we would like to have generated more top line growth, but we are pleased with our operating profit, EPS and cash flow performance, all of which came in ahead of our expectations and guidance. While we have more to do, we made clear progress in several key markets and categories.

Looking ahead to 2017, we are making major moves to continue to transform our business. This includes our announcement to exit DSD in U.S. Snacks, a difficult decision but absolutely the right thing to do for this business. Our 2017 plan and outlook puts us squarely on track to our 2018 profit margin goals, while driving strong earnings and cash flow growth. And aside from U.S. Snacks and the impact of this DSD exit, we expect to see continued improvement in our top line.

We are solidly on our way to enhanced competitive earnings power. I'd like to close by thanking our employees for their hard work and sense of urgency to make this happen.

And with that let's open the line to Q&A.

Q&A

Operator

We will now begin the question-and-answer session. Please note, this call is being recorded [Operator Instructions] Our first question comes from Ken Goldman with JPMorgan. Please go ahead.

<Q - Kenneth B. Goldman>: Hi. Good morning. And, Ron, best of luck. Thanks for your help over the years.

<A - Ronald L. Dissinger>: Thank you.

<Q - Kenneth B. Goldman>: I just wanted to make sure I understand some of the puts and takes for guidance next year. There's a table in the press release, in this table you're guiding to minus 4% sales and an EPS $3.91 to $3.97 inclusive of your estimated currency. I know it's just an estimate. But at the bottom of the table you highlighted benefit of sales and EPS, you have 1.4% in sales and $0.08 from net acquisitions. I just want to make sure I'm understanding how that 1.4 % in sales and $0.08 in earnings flows into your $3.91 to $3.97, is it included or excluded, in other words, should we effectively add back $0.08 to that range if we want to include the impacted deals in 2017? Maybe I'm missing the obvious, but it's a bit of a unique way of presenting these figures. I just want to make sure I'm getting it the right way.

<A - John A. Bryant>: Sure, Ken, and you're probably aware these are required disclosures by the SEC where we need to walk from our comparable guidance that we provided to reported expectations, so we obviously had the impact of translational currency embedded within the sales and operating profit and earnings per share guidance.

And then we show $0.08 from acquisitions and dispositions, it's important to note that that is a pre-tax number and, of course, that does not include – that's primarily Parati. That does not include the impact of reducing our share buyback program at the end of 2016 to fund that acquisition. All along we've said that Parati would be relatively neutral to earnings per share in 2017, and accretive thereafter and it's essentially on track with those expectations.

<Q - Kenneth B. Goldman>: Okay. Maybe I'll follow up online afterwards just to make sure I understand. But quick follow-up for me, can you give us a sense how much your list prices will be dropping on [indiscernible] (35:03) product, or is it too early to say?

<A - John A. Bryant>: So, as we go from DSD to warehouse, obviously the retailers are taking on activity through distribution of the products, and as we do that, we will reduce prices to the retailers to compensate them for that activity. We are not going to disclose that level of detail on this call. So it is built into outlook but it's not something we want to get into detail on, Ken.

Operator

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

<Q - Andrew Lazar>: Good morning, everybody.

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

<Q - Andrew Lazar>: I guess two things; first off, John, you reaffirmed obviously your 2018 operating margin target, which embeds obviously a pretty significant jump in margin. I'm curious, given the economics of this move to warehouse in snacks, it seems like they could be pretty compelling, again, once fully implemented. I guess I'm curious why that doesn't seem to be playing into maybe a higher operating margin target going forward or at least in 2018, given some of that will flow through in 2018?

<A - John A. Bryant>: So I think we've given in the guidance a sense of how much benefit there is long-term from the shift to warehouse and as we said, we would bring the operating margin of the Snacks division up to in line with the North American operating margin for Kellogg Company. That will happen in 2018 and 2019. So, it does not occur in 2018. When we gave the guidance of 350 basis points of margin expansion operating margin, we had a path to get there. We had a number of areas that we wanted to investigate as we go along that path. This is one of those areas, we did lot of work before we ended on this conclusion, but it was somewhat taken into account in our thinking as we set that goal before. That doesn't mean that we can't do better than 350 basis points in 2018, but I'd say that at this stage we'd say that's part of the guidance for 2018 and we hope to continue to expand margin as we go into 2019 and beyond.

<Q - Andrew Lazar>: That's helpful. I appreciate that. And then just a quick one, I think Paul mentioned that you will still have a very significant presence, obviously, in-store in terms of feet on the street with respect to those that are already doing some of that work for your cereal business and things of that nature.

I guess, I'd always been under the impression that certain snacking categories, maybe biscuits, with different sort of velocity off the shelf metrics and obviously the end of – all the display space and things, the impulse nature of it sort of required a somewhat greater effort right around sort of in-store.

I guess, are you seeing that that's not necessarily the case anymore at this point where your folks that are in-store for cereal and other things can put that extra effort in and around the category like cookies and crackers? Thanks so much.

<A - Paul T. Norman>: Andrew, it's Paul here. Yes, you're right. We will still have a significant retail sales force dedicated to snacks. We also have one dedicated to Morning Foods here. And if you look at the data, what we see is our warehouse categories have very strong presence in stores when you look at feature and display data, when you look at quality merch data, we support the fact that our warehouse businesses get great display and our feet on the street enable us to drive that performance in store at all times. We also see through our warehouse-delivered businesses, better service levels and better in-stock levels and I think that's where we also see a benefit.

<Q - Andrew Lazar>: Thanks very much.

Operator

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

<Q - David Cristopher Driscoll>: Great. Thank you. I'd like to ask Paul, can you just walk us through the pitch to the retailers on the DSD change? You kind of put a little teaser in your comments that the margin to the retail is better. So can you frame that up a little bit more detailed, because I think this might go a long way to even people's concerns about such a big change.

When the retailer sees this move, is this really a very positive thing from their perspective because they make more money on the biscuits from Keebler and can you just maybe walk us through some of the math on how the retailers look at it?

<A - Paul T. Norman>: That's an interesting question, Dave. I'm not going to go into a lot of detail around all those conversations. Suffice to say that this is a major strategic move where, as John said, our retail partners will now take on the work of taking out products from their warehouses through their systems to their shelves, and we will compensate obviously what we used to do.

Now, that will go towards the retailer, so we want to make sure that our retailers have everything they need to be able to run the business better. I think when you get to the story with our retailers, who by the way, we spoke to a large percentage of our sales so far, they're aligned, they've agreed this is the right strategic move.

The real benefits come from a push to a pull. So they love the fact we're investing more in our brands. The fact that we can leverage our systems and our customers' systems and our customer replenishment systems have come a long way in the last 10 years. We can drive better service and higher in-stocks, which for us and them is improved performance in real terms in terms of sales.

And then as we serve on one platform going forward, everything we make comes out of one platform, a warehouse distributed platform, the shared efficiencies down the road because a dollar's a dollar at the end of the day. If we can take miles of transportation out and become more efficient with our retailers that's significant joint value creation benefits, and then you get the scale benefits of a one Kellogg company on one platform and what we can do to drive impact to the center of store. But that's the fundamentals of the discussion we've been having with our retailers.

<A - John A. Bryant>: So maybe just...

<Q - David Cristopher Driscoll>: Okay. And one...

<A - John A. Bryant>: Sorry, Dave. If I could just add just some proof-points behind the DSD transition here. As you say, we had good support from retailers to do this. Now, retailers have pushed over the years why this category needed to be in DSD. It's not a high-spoilage category. It's not date code sensitive. So it is a system that can go through warehouse and, in general, cookies and crackers around the world actually in developed markets deliver to warehouse systems. Today 40% of our sales in the U.S. for Snacks already goes through the warehouse system. And where it does, we have higher growth, higher share, better margins, and better service to our customers.

We have a world-class warehouse system in the U.S. As Paul said, we have feet on the street. The merchandising conditions in cereal are as good as we get in snacks – in cookies and crackers. So we can demonstrate it through a merchandising system that – through a warehouse system we can get good merchandising in this area.

And then, as Paul said, we're investing back into brands to drive pull systems, to drive both businesses going forward, our retail partners' business and ours. So there is a lot of support for this and we believe it's absolutely the right move.

<Q - David Cristopher Driscoll>: We really appreciate those comments. One follow-up on U.S. Cereal, and I missed it in the comments if you said it. But do you expect U.S. Cereal to produce revenue growth in 2017?

<A - Paul T. Norman>: David, my outlook for the category is to be flat to probably down 1% in 2017, which I think is a slight improvement on the stabilization we've seen in the past two years. And we hope to be driving that.

<Q - David Cristopher Driscoll>: Okay, great. Thank you. I'll pass it along.

Operator

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

<Q - Matthew C. Grainger>: Hi, good morning, everyone. Thanks for the question and, Ron, best of luck. Just two questions. First, I wanted to follow-up on the inflation commentary. I guess, I was a little surprised, not completely, but given the inflation outlook in energy and wages and a few commodities like rice and sugar that you're expecting modest net deflation for 2017. So if you could just elaborate on what's driving the decline there, how you're hedged, and how you see inflation sort of trending sequentially through the year?

<A - Ronald L. Dissinger>: Sure, Matt. So as we said, we expect gross margin to expand in 2017, and that does include some headwind from the price reductions we'll take in the U.S. Snacks business. And as you alluded to, we are seeing some deflation on materials overall, so net deflationary environment. We've got the strong productivity from both Project K and Zero-Based Budgeting flowing through to our margin performance, and also all the actions we're taking from a revenue growth management standpoint.

But remember in 2016 and then as well in 2017 we're continuing to invest in our food through both renovations of our food and innovation in our food. We're also seeing some transactional currency exposure, not to the extent that we saw in 2016, but it is still a headwind for us, particularly in the European market with the devaluation of the sterling.

And then there is some other general inflation that we're seeing within our business in wages and logistics costs. I think you mentioned some of those things, [ph] energies (44:43) as well. And then we've got a little bit of negative country mix flowing through, particularly as our emerging markets grow faster. But put all that together and we do expect to expand our gross margins as we move through 2017.

And in terms of how it's going to roll through 2017, there is no one quarter that is significantly different than the other in terms of gross margin performance, I should say. And, Matt, at this point in time, we're about 75% covered on our materials, which is pretty comparative to where we've been in prior years.

<Q - Matthew C. Grainger>: Okay, great. Thanks for all that. And just one follow-up on the sales guidance. So you talked about an expectation for the business, excluding the DSD transition to be flat to down 1% and in line with categories. I'm just curious, sort of holistically, how that category trend if we're sort of looking at that zero to minus 1% compares to what you saw in 2016 and given some of the weakness we've seen in scanner data, which may or may not be a perfect read for what's going on in the market as a whole. How sensitive are your margin and EPS assumptions to potential shortfalls in overall category consumption trends?

<A - Ronald L. Dissinger>: Yeah. So as you alluded to, we said overall down 2% in sales, with a little bit more than 1 point coming from the exit of DSD, and we did say flat to down 1% on the rest of our business. That'd be a little bit better. So we're showing improvement as we move into 2017 versus 2016 expectations. Of course, we've taken into consideration any volatility we may see in our top line. We believe we have sufficient financial flexibility to achieve our guidance goals.

<A - Paul T. Norman>: If you look across 2016 across our major categories. We basically weighted average those categories. It was essentially flat on a global basis. If you look at P1, I think many of you've commented on the weak scanner data coming out in the U.S. in general across a number of categories. If you look at within period one, the first week was obviously impacted by the timing of some holidays year on year. And if you look at our business, we actually strengthened as we went through the period. So obviously not the sort of scanner data you want to see to begin the year, but there are some reasons for that and we do expect the business to continue to strengthen as we go through the year.

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

Operator

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

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

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

<Q - Alexia Jane Howard>: Okay. So couple of questions. This improvement or expected improvement in the margins on the U.S. Snacks business, I think the comments in the release suggested an 850 basis-point improvement in U.S. Snacks. Is that almost entirely due to the exit of the DSD system? And I appreciate that that's only on part of the business. So does that mean that the margin improvement or the cost associated with that DSD model were even higher?

And then I guess the question is you talked about that also including a reinvestment back in the business. How much is that reinvestment in that U.S. Snacks or more broadly across the company? Where is it going to be focused? Is it going to be more ad spend, promotional activity, sales people, innovation? Could you just give us an idea there? Thank you.

<A - John A. Bryant>: So just to clarify in terms of the guidance. What we said is the margin in the U.S. Snacks segment is going to come up in line with North American average. I think that number is closer to 400-plus basis points. So I'm not sure what numbers you're looking at there, Alexia. That's a net impact. So obviously there's a lot of moving pieces in there. There's a shift of activity out of SG&A into a price reduction to retail to reflect the transfer of activity. Retail is now picking up and there's also investment into a stronger pull model. And, Paul, maybe you'd like to talk a little bit about some of the pull model ideas that we have there in terms of where we're going to reinvest in the marketing area.

<A - Paul T. Norman>: Hi Alexia. When you mentioned several areas of reinvestment, it is all of the above, and I think it's driven by how the shopper shops in more channels, but also how the shopper shops when it comes to click and collect in our mainstream retail channel.

We need to get more of our resources, especially behind big brands like Cheez-It, Pringles, Rice Krispies Treats, which have really differentiated offerings. We need to get more investment behind those brands to go meet the consumer and the shopper how they're shopping. And spend less of that money, if you like, in a distribution system, and move more of that money to pull quite frankly in those brands, when you look at their incrementality, their profitability, there is a lot of growth to be had that we can't get at today, because of the focus of our resource, quite frankly. So it is all of the above, including new package formats, more investment in food, more advertising, more shopper marketing. That's where we're leaning.

<Q - Alexia Jane Howard>: Great. And...

<A - John A. Bryant>: So [ph] let me clarify there (49:55), it would be more brand building driven as opposed to promotional, the word you used, not trade spend but more of a pull perspective.

<Q - Alexia Jane Howard>: Great. Thank you very much I'll pass it on. And great working with you, Ron.

<A - Ronald L. Dissinger>: Thank you. You too.

Operator

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

<Q - David Palmer>: Thanks. I'm just wondering with regard to the move to warehouse in snacks, how are you thinking about the competitive and customer reaction to this? I mean, ultimately how varied are your scenarios for merchandising activity, out of stocks and sales, particularly given the fact that your competitors are still in the old way or many of them are in DSD? And I have a follow-up?

<A - John A. Bryant>: So we can't comment on what our competitors will do. This is the right decision for us. And it's the right decision for us, again, because 40% of our sales today are already through warehouse. We're seeing better share, better growth, better service to our customers in that warehouse system.

We also have a world-class warehouse system here in the U.S., which is very capable and very good at servicing high merchandising categories like cereal and Pop-Tarts. So we believe that we are well positioned to make this transition, and this transition is not dependent upon what our competitors do. It's the right thing for us to do.

<A - Paul T. Norman>: And on the customers side, the customers – I spoke to a lot of customers, David, and they are aligned and in agreement that it is the right strategic move. If you talked to customers you know how much their retail environments are changing. There is a seismic shift in how they have to move to meet shopper needs and how they're working hard in their replenishment systems. Quite frankly, this felt exactly like the right time for our business to make a big strategic move like this. Yes, there will be disruption. Yes, there will be competitive action, but I think this is exactly the right thing for us to do with a forward-looking lens on how the shopper shops and our how our customers are changing to meet shopper needs.

<Q - David Palmer>: The other thing that I wanted to follow up on is that DSD is often looked at as a 15 percentage point to 20 point percentage margin spend and your Snack business is about a third of sales. And I think that's what's driving the curiosity that the 350 basis point margin improvement that's baked in your guidance through 2018 now looks very conservative. So is it right for us to think that your most conservative side of your scenario analysis now represents that guidance now with this change or how should we think about that?

<A - John A. Bryant>: There's, obviously, a margin benefit to the company of moving from DSD to warehouse, but, remember, we had to invest back into a stronger pool model into the marketing element. We still have to invest in the warehouse model. So while there's some percentage of sales of DSD there's also a percentage of sales required to support the warehouse model. So there's a number of moving pieces here. We think the guidance we've given on the margin improvement in snacks is appropriate and gives you the right ballpark of where we'll end up.

<Q - David Palmer>: Thank you.

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

Operator

The next comes from Michael Lavery with CLSA. Please go ahead.

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

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

<Q - Michael Lavery>: You mentioned the deflationary pricing environment in the UK but obviously you also have some transactional currency headwinds there. Can you just talk on, maybe, how you might offset some of those, and what the pacing of that looks like, and maybe some sense of the magnitude?

<A - Ronald L. Dissinger>: So, yeah, we did talk about the deflationary environment to the UK and I mentioned earlier that we're seeing some transactional currency exposure, particularly because we import Pringles into the UK from the Eurozone.

We've also talked about revenue growth management across the globe and specifically in Europe we're taking some actions around revenue growth management to manage our profit and loss performance. And you may recall within the prepared remarks, I mentioned something about the Q1 maybe a little bit slower start as a result of elasticity in Europe and we're referring specifically there to potential price elasticity as we work with retailers on pricing actions we're working through the marketplace.

<Q - Michael Lavery>: And the $0.12 currency impact you gave, that's just translational. Can you give any sense of what the transactional piece might look like?

<A - Ronald L. Dissinger>: Yeah, I mentioned earlier the transactional piece is certainly lower than what we saw in 2016. In 2016, I think I quantified it as about 50 basis points of sales. So somewhere between 0 basis points and 50 basis points is what we're looking at in 2017. And, yes, the $0.12 is specifically translational currency impact in 2017.

<Q - Michael Lavery>: Okay. Thanks. And then just a follow-up on the DSD transition, if it's the list prices that are changing, I know you talked about a 2Q and 3Q transition, but would that be rolling or do those come all at once? Any sense of just when we should expect that in our models?

<A - John A. Bryant>: It will occur through the second quarter and the third quarter. so, as we go through this transition, not every customer is transitioning at once. We're working with each individual customer based upon their readiness for the transition to enable them to have the transition as effective and efficient as possible. So across the second and third quarters these transitions will occur, and you'll see more of a run rate happening in Q4.

<Q - Michael Lavery>: Okay. Thank you very much.

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

Operator

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

<Q - Christopher Growe>: Hi, good morning.

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

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

<Q - Christopher Growe>: Ron, I wish you all the best as well. And I just have two quick questions. The first one will be, as you think about the cost savings coming through in 2017 from project – maybe if we could put the DSD exit aside, but just ZBB and Project K type cost savings have you quantified or can you quantify what we should expect in 2017?

<A - Ronald L. Dissinger>: Yeah. So let me tell you how to think about those, Chris. First of all in 2017, we have our normal strong base productivity savings coming through our profit and loss statement. We've discussed those over the years.

We also have Project K. Remember, we've extended that program now through 2019. The original run-rate savings were $425 million to $475 million. New range is $600 million to $700 million. Through 2016 we've saved approximately $300 million cumulatively. So low end to high end of the new range, we've got $300 million to $400 million that will come over the next three years, 2017 through 2019.

On Zero-Based Budgeting, we originally communicated a target savings range of $450 million to $500 million from 2016 to 2018. We are still on track to deliver against that macro-savings expectations. For 2016, we said we would deliver in the range of $150 million to $180 million. We actually delivered a little bit more than $180 million. So we have very strong savings visibility over the next several years coming from Zero-Based Budgeting.

The combination of these items gives us good cost-savings visibility and confidence in hitting that 18% margin goal along with the other things we've talked about today by 2018.

<Q - Christopher Growe>: Okay. Thank you for that color there. And just a quick follow-up on the revenue-management actions, we've heard that associated with the U.S. and I know I've heard it with Europe on the call today. I'm just trying to understand kind of where you stand in that implementation and then should this flow through in terms of its benefit to the P&L in mix, better revenue growth, if you will. I wonder if you could help understand the magnitude of that if possible.

<**A - John A. Bryant**>: So, revenue growth management covers a number of areas. It covers both more effective trade spend but also pack-price architecture, brand mix, et cetera. And we started the implementation in 2016. Across 2016 you can see the improvement in price mix. It was negative in the front half. It was more stable in the back half. In 2017, we do expect positive price mix at a consolidated level, despite the adverse impact of the DSD transition from DSD to warehouse. So still on a consolidated basis, we still expect positive price mix. As I said, it's a combination of four or five different variables. It's not just one item that's going to drive that improvement.

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

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

<**A - John Renwick**>: Operator, I think we have time for one last call – one last question, rather.

Operator

The last question will come from Robert Moskow with Credit Suisse. Please go ahead.

<**Q - Robert Moskow**>: Hi. Thanks for the question and Ron, best wishes to you. In prior calls you've talked about Special K and kind of the drag that's had on your mix internally. Can you talk about what your expectations are for 2017 and maybe, are you past the headwinds that you have been facing from a mix standpoint on that?

<**A - Paul T. Norman**>: Hey, Rob, it's Paul. I think you're probably talking more about the wholesome business in the...

<**Q - Robert Moskow**>: Yes?

<**A - Paul T. Norman**>: ...more recent past. Yeah. If we look at our wholesome business, as I said, Rice Krispies Treat is doing great. Nutri-Grain is doing well. Those two parts of the business are doing fine. K was still a drag through last year. As we come into the beginning of this year, we've renovated even more of our food. Where we have renovated so far, we've seen better performance. But we do have some legacy foods that are part of our wholesome snack platform that is still going to be there. But we have new Protein Bites and Protein Bars coming here in January. I think there's eight different items.

And we're back on air in February, or at least digitally, talking to consumers again around the Special K brand from a wholesome point of view. So the whole restage is continuing. We're bringing more new food to life. And our aspiration this year is we can go from being down double digits to down low-single digits to flat on Special K as we reinvest in the brand for food and advertising.

<**Q - Robert Moskow**>: Did you say the aspiration is to be down low-single digit to flat on Special K.

<**A - Paul T. Norman**>: On Special K wholesome snacks is to, yes, significantly cut the decline this year as we go forward. It will be down double-digit last year, if you look at the Nielsen data. And, yeah, our aspiration will be somewhere less than 5% this year and flat if we're good.

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

Operator

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

John Renwick

Thanks, everyone, and please don't hesitate to call 269-961-9050. I'll be around all day.

Operator

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