Company Name: Kellogg
Company Ticker: K US
Date: 2018-10-31
Event Description: Q3 2018 Earnings Call

Market Cap: 22,658.52
Current PX: 65.36
YTD Change($): -2.62
YTD Change(%): -3.854

Bloomberg Estimates - EPS
Current Quarter: 1.079
Current Year: 4.478
Bloomberg Estimates - Sales
Current Quarter: 3348.867
Current Year: 13532.294

Q3 2018 Earnings Call

Company Participants

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

Other Participants

- Christopher R. Growe
- John Joseph Baumgartner
- David Cristopher Driscoll
- Kenneth B. Goldman
- Alexia Jane Howard
- Rob Dickerson
- Jonathan Feeney
- Vivek Srivastava
- Pablo Zuanic

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Third Quarter 2018 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question-and-answer period. [Operator Instructions] Thank you.

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

John Renwick, CFA

Thank you, Brandon. Good morning and thank you for joining us today for a review of our third quarter 2018 results. I'm joined this morning by Steve Cahillane, our Chairman and CEO; and Fareed Khan, our Chief Financial Officer.

Slide number 2 shows our usual forward-looking statements disclaimer. As you are aware, certain statements made today, such as projections for Kellogg Company's future performance, including earnings per share, net sales, profit margins, operating profit, interest expense, tax rate, cash flow, brand-building, up-front 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 side of this presentation, as well as to our public SEC filings. A replay of today's conference call will be available by phone through Thursday, November 8. The call will also be available via webcast, which will be archived for at least 90 days. As always, when referring to our results and outlook, we will be referring to them on a currency-neutral adjusted basis, unless otherwise noted.

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

Steven A. Cahillane

Thanks, John, and good morning, everyone. Q3 was another quarter of good progress under Deploy For Growth. We said we would increase our investment in brands and capabilities, and we did. We continued to improve consumption trends worldwide across most of our categories in the United States and in other developed markets around the world. We sustained our accelerated organic growth rate in our emerging markets. And we continued to expand distribution and consumption for single-serve pack formats, which are outpacing our categories.

Now, I recognize that the first thing many of you will notice about our third quarter results is that our operating profit came in short of our guidance. This was due to choices we made during the quarter to invest in our budding momentum. We again increased brand-building investment and we again leaned into single-serve items, even though they generated higher costs. Most of the shortfall from these factors was in a single business unit, which is U.S. Snacks, but these did not reflect any deterioration in our fundamentals in that business unit or elsewhere.

As the quarter progressed, we elected not to offset these investments and costs just to deliver a targeted operating profit. For instance, we could have lifted our foot off the gas pedal on our expansion of single-serve on-the-go items, many of which are co-packed and require additional transportation in a high freight cost environment, but we chose not to, instead leaning into these pack formats that are meeting key consumer occasions and incremental to our brand's growth. Again, this principally took place in our U.S. Snacks business where on-the-go is a critical occasion for us to win.

Similarly, at any time, we could have pulled back on brand-building investment, but we chose not to, instead increasing brand-building at a strong, high single-digit rate year-over-year because that is what is getting our brands back on firmer growth footing. A great example is RX, where we moved ahead with its first-ever national advertising campaign, even before realizing its full distribution expansion and on top of rolling out a new nut butters platform and a relaunched kids' line.

What's important is that these investments are working. You can see this in the improvement in our consumption and net sales growth this year. We generated organic growth, despite the remaining mechanical impact of our DSD exit and despite notably tougher second half comparisons. Improved consumption growth brings improved net sales growth, and we're seeing both. We also really like what we see going on in our portfolio, which we're shaping through investment decisions, SKU rationalization and M&A.

The Q3 benefits of these portfolio improvements are summarized on slide number 4, and will be described in more detail in the coming slides. Our consumption trends are improving around the world, including in the United States. And many of our biggest brands grew share in the quarter, as did many of our smaller challenger brands. Post-DSD U.S. Snacks is now stronger, thanks to a rationalized SKU lineup, increased brand investment and a deliberate expansion of on-the-go offerings. And in Q3, it continued to improve its velocities overall and gain share in key supported brands. Frozen Foods is sustaining its solid momentum. Our cereal business in core international developed markets have stabilized, and we showed signs of improvement in our U.S. cereal business in Q3.

Also in Q3, we sustained an accelerated growth rate in our expanding emerging markets. This acceleration comes not only from adding West Africa to our consolidated results this year – and that business continues to grow rapidly, by the way – but also from accelerating our organic growth rate across our emerging markets, sustaining a high single-digit growth rate that is meaningfully higher than in recent years. This emerging markets growth is contributing to, but not solely responsible for, good growth in net sales and operating profit across all three of our international regions. So these are the elements to listen for as we get into the details of the quarter.

And we'll start with Fareed taking you through the specifics of our Q3 and year-to-date financials.

Fareed A. Khan

Thanks, Steve. Good morning, everyone. Slide 5 summarizes our results for the third quarter. Tough comps and increased investment may have restrained profit and earnings growth, but it was another quarter of net sales growth, driven by both organic growth and acquisitions and of improving consumption and sales trends. Our net sales obviously got a lift from our RX acquisition and recent consolidation of Multipro, our West Africa business, both of which continued to grow strongly in Q3. We also realized organic growth, even after the remaining negative and mechanical impact of the DSD exit.

Our operating profit was down modestly, reflecting the unusually strong double-digit growth in the year-earlier quarter, as well as incremental brand-building in this year's Q3 and costs related to our support of our expansion of single-serve pack formats. And EPS growth was aided by U.S. tax reform, net of headwinds like: higher interest expense, related to funding acquisitions; lower pension income, related to our decision to reduce our expected rate of return on plant assets; and lower equity earnings, partly related to shifts in our joint venture stakes earlier this year.

I should note that we also continue to deliver on cash flow. Excluding the voluntary pension contribution we made in Q2, our year-to-date cash flow remains above last year's before the subsequent accounting reclassification.

So let's examine the results in a little bit more detail. Slide 6 walks you through components of our net sales growth in the quarter and first nine months. Excluding currency, our net sales grew more than 9% year-on-year. Two acquisitions contributed almost 9 points of growth. These were: Multipro, which we consolidated in May; and RX, which we acquired in October of last year. Both these businesses continued to show strong sales at double-digit growth rates.

On an organic basis, our sales were up by nearly half a percentage point year-on-year, and we remain up slightly for the first nine months. Because we've lapped last year's DSD exit about midway through the quarter, its negative impact from SKU rationalization and elimination of the price premium we used to charge for DSD was only about half a percentage point in Q3. Excluding this DSD impact, our organic growth remained solid, but you'll notice that it was modestly slower than our first half growth. This is because, as we've pointed out previously, we face significantly tougher comps in the second half than in the first half as we lap last year's second half accelerations in Frozen Foods, European Pringles and ex-DSD U.S. Snacks, not to mention last year's Q3 hurricane benefit. But when you wrap it all together, our Q3 offered yet further evidence that our stepped-up brand investment is gaining traction, and we're getting back into sustainable top-line growth.

Let's turn to our profit margins, starting with gross margin on slide 7. We'll break down our gross profit margin decline into three buckets, just as we did last quarter, because we think it's helpful for understanding the various puts and takes. I'll start with the last bucket on the side, which is our ongoing input costs, net of productivity. Once again, our productivity and Project K savings were able to offset the margin impact of higher transportation, packaging and other costs. Cost inflation is sustaining at higher levels than we had anticipated. And we recently executed some initial Revenue Growth Management actions in several countries to help cover it as we go into 2019. But so far, we've managed this well.

The biggest impact in the quarter came again from the bucket that represents the mechanical impacts we've discussed previously. The impact of our DSD exit was much smaller in Q3 than it has been in recent quarters as we lap the year-ago exit during the quarter. So that's now behind us in Q4.

The other mechanical impact, the consolidation of Multipro, became a larger headwind in Q3, solely because it was in our results for a full quarter. That headwind remains with us through April of next year.

The bucket we call growth-related had a bigger impact than we had expected, albeit with similar drivers to what we experienced in Q2. These were principally two mix shifts that had the effect of pulling down our gross margin percentage. First, we had another strong quarter of growth in emerging markets businesses, which don't yet have the scale of developed markets and, therefore, carry lower percent margins. This growth is not cannibalizing any of our other businesses. As we grow our scale and shift our mix towards more value-added products, we will improve emerging markets margins.

The second notable shift was toward single-serve and on-the-go pack formats, which are depicted on slide 8. Deploy For Growth emphasis on winning occasions has us innovating new pack formats, particularly in the area of single-serve and on-the-go. In developed markets, this includes immediate consumption offerings and multi-packs. In emerging markets, this includes single-serve sachets with more affordable price points. Both are important opportunities for future growth.

Leaning into occasions, we developed and expanded these pack formats across the breadth of our portfolio for various channels, particularly in our U.S. Snacks business, where on-the-go is now running at more than 10% of sales. The good news is that demand is strong. You can see it in the scanner data, where our on-the-go offerings are growing rapidly, and the growth has accelerated faster than we had anticipated. We'll show you some figures on this in a moment. However, where these new pack formats are new for us, and where we were capacity-constrained on existing pack formats, we have relied on co-packers. Obviously, co-packing costs money, as does the related movement of product, particularly in a high freight cost environment. So while we like the incremental growth these pack formats bring us, they do represent a cost and margin headwind for us in the near-term.

We do have plans in place to address this for the medium-term. As I mentioned last quarter, we are investing in in-house packing capabilities for some of these pack formats, which will reduce manufacturing costs and transportation needs, but this will take a few quarters to get fully ramped up.

Getting back to the total company's results, we are not overly concerned about decreases in our percent margins. We know what's driving it, and we have plans to offset it. And we know these mix shifts are driving net sales dollars today, and are incremental to operating profits over time.

Our operating profit margin performance is shown on slide 9. Operating profit margin decreased year-on-year in Q3, reflecting the mechanical and growth-related impacts on gross margin, as well is nearly double-digit increases in brand-building year-on-year. In fact, in dollars, this year-on- year increase in brand-building was significantly greater than our year-on-year decline in operating profit.

Recall that we're comparing against our biggest operating profit and operating [ph] profit growth of (12:44) the quarter last year, when we were exiting DSD overhead, but had not yet fully ramped up brand-building. You'll also recall that we made the decision several months ago to add even more brand-building than originally planned to Q3, because it was working and because we had strong ideas to invest behind.

A large portion of this increased brand-building was behind key U.S. Snacks brands and RX, and the impact on consumption has already been positive. We're willing to make that trade-off between near-term profit and reinvestment for top-line growth that's sustainable. And it's already having a positive impact on our top-line performance. So Q3 was another quarter of investment and improving top-line performance.

So now let's turn to our full year guidance, as shown on slide 10. We're moving our guidance for currency-neutral net sales growth to the high-end of our previous guidance, or roughly 5%. This reflects our year-to-date improvement and also reflects our consumption trends' continued improvements across the portfolio, as our brands respond to increased investment and improve execution. If anything, we think we can do better than this, but we're leaving the possibility for trade inventory reductions in Q4 in a couple of post-DSD Snacks categories. Nonetheless, we obviously feel good about the top line.

We're bringing down our guidance for currency-neutral adjusted operating profit growth. Some of this reflects Q3 results, but also reflects similar dynamics anticipated for Q4. We're putting more investment dollars to work in certain businesses and capabilities. And we've decided to continue to expand single-serve, even in a high freight cost environment.

Again, as Steve mentioned, we could pull back in these areas in order to preserve operating profit, but that would go against what we're trying to do: build momentum for our brands and develop capabilities that will help us sustain sales and profit growth well into the future. This reduction in OP guidance brings our currency-adjusted EPS growth back down to about 7% to 8%. We still expect interest expense to be up year-on-year on borrowing related to acquisitions made over the last 12 months, and other income to be down due to our reduced expected return on assets assumptions in our pension and post-retirement plans. However, recent tax benefits should enable us to finish the year with effective tax rates at the low end of the 18% to 19% range we've been guiding to. We're not make any changes to our cash flow guidance, despite the lower operating profit.

So in summary, our financials reflect that we're doing what we would said we'd do, leaning into investments, both in brand-building and capabilities. We're seeing the positive impact on top-line growth. And we're choosing to continue to lean into these investments, even if it means less profit for Q4 than previously planned. And with that, let me turn it back to Steve to walk you through our businesses.

Steven A. Cahillane

Thanks, Fareed. We'll start with North America, which is summarized on slide number 11. We remain on track for a markedly improved organic net sales performance this year, with and without the mechanical impact of last year's DSD exit. That DSD exit impact was nearly a percentage point of headwind to North America's sales growth in Q3 and close to 3 percentage points year-to-date.

As you read left to right, you see a market improvement in Morning Foods; still work to be done, but much improved, especially in Q3. You see that United States Snacks has picked up its growth, excluding the DSD impact. Specialty Channels is lapping some unusual factors from 2017, like FEMA orders during last year's hurricanes. North America Other has sustained a dramatic improvement in organic growth, and that doesn't even include RX as of yet. So Kellogg North America is clearly improving its performance this year.

Of course, the better indicator of the improving health of our business is consumption. Slide number 12 aggregates our nine largest categories in the U.S. and compares our consumption growth to that of our categories. What it indicates is that we have improved our consumption trends in the U.S., particularly coming out of our DSD transition in mid-2017. Across our portfolio and business units, not only has our increased investment in brand-building and on-the-go pack formats helped our categories, but our execution has helped us to stabilize our share.

This chart only shows our biggest categories in the U.S., but the same share recovery story is true in Canada and in key measured markets around the world. This is why we feel so strongly about continuing to lean into these investments, because they are working.

Slide number 13 summarizes U.S. Snacks. Because we exited from DSD at most of our customers by the end of July last year, this is the last quarter of year-on-year mechanical impact from DSD on net sales. And it came in at roughly negative 240 basis points to U.S. Snacks net sales. Excluding that impact from both years, our comparisons in Q3 were the toughest of the year.

Beyond shipment timing, however, consumption data showed continued improvement. Led by our Cheez-It and Club brands, our crackers consumption growth accelerated, resulting in a solid share gain in the quarter. Pringles also accelerated its growth, continuing to gain share in salty snacks. In wholesome snacks, Rice Krispies Treats continues to gain share, even with supply constraints. And in cookies, resumed investment support behind Keebler Fudge Shoppe, Keebler Grahams, Mother's, and Famous Amos is bringing these key brands back into consumption and share growth, stabilizing our share overall. Across our snacks categories, we like what we're seeing in base sales and velocities, not to mention restored display activity.

Importantly, especially for these snacking categories, our on-the-go offerings grew consumption at just about a double-digit rate in the quarter. As I mentioned earlier, many of these pack formats are co-packed, either because we don't currently have the packaging capabilities for those particular formats or simply because demand is outstripping our supply. This cut into U.S. Snacks year-on-year operating profit growth in Q3 and will do so again in Q4. But we're investing for long-term growth, and building demand and scale for on-the-go is a strategic priority for us. We're also not waiting to find solutions to offset and reduce these costs. For instance, we're investing now in in-house packing capacity, which will come online during 2019.

So we feel good about the direction we're heading in U.S. Snacks. Fareed mentioned the possibility of trade inventory reduction in Q4, which is a precautionary stance, but we're very pleased with our in-market performance and expect that to continue. And while we're leaning into investment in brands and on-the-go pack formats, this is the right thing for the long-term growth of this business.

Now let's turn to U.S. Morning Foods and slide number 14. Morning Foods' net sales declined by less than forecast in Q3, continuing a trend of moderating declines.

In cereal, our consumption in share was pulled down by the temporary absence on shelf of Honey Smacks, which accounted for [ph] 40 basis points of our overall 20 basis point decline. (19:59) Remember, this brand had been manufactured by a third-party until June. And while we were transitioning it back to in-house production, we did not have Honey Smacks on shelf during the third quarter. In Q4, in-house production has commenced and the brand is returning to shelves, as we speak.

But behind this Honey Smacks impact is good improving in-market performance. Our Core 6 brands collectively gained share in the quarter. In the taste fun segment, both Frosted Flakes and Froot Loops grew consumption and share.

But more important for the category will be stabilizing the wellness-oriented adult segment. Stabilizing adult brands Raisin Bran and Mini-Wheats was a priority for us this year. And our efforts to amplify the wellness attributes of these brands are clearly resonating with consumers. Both brands posted growth in consumption and share this quarter.

Meantime, in toaster pastries, Pop-Tarts returned to consumption growth on the strength of food news such as new Pop-Tarts Splitz and Gone Nutty!. This is what drives this important brand, and we have good plans ahead for it.

So getting back to our playbook is yielding improved results in Morning Foods. It's requiring increased investment, but this is important as we work toward stabilizing this business. As I've said before, there's still more to do and across more of our brands, but recent consumption trends show that we're making progress.

Turning to slide number 15 and U.S. Specialty Channels, U.S. Specialty Channels posted an unusual net sales decline in Q3. The business lapped year-ago FEMA shipments related to hurricanes and we experienced trade inventory reduction in convenience stores and vending early in the quarter. But, frankly, this was less of a net sales decline than we had expected, as we continued to see good execution and promising innovation across these channels.

Indeed, we've had success testing new innovations in Specialty Channels before expanding their launches into other retail channels. We'll have another quarter of lapping FEMA shipments in Q4, but we feel good about our underlying fundamentals in this business.

As we have told you on previous earnings calls, Specialty Channels operating profit in 2018 is forecast to be down year-on-year, due to changes we made this year in the allocation of costs from other U.S. segments. This is not related to any change in the underlying business, which remains solid.

Let's turn to slide number 16 and our North America Other segment. RX obviously contributed much of this segment's year-on-year growth. This business continues to expand, with triple-digit consumption growth and ACV distribution now exceeding 70%, up from less than 30% a year ago. During the quarter, we launched our first-ever national advertising campaign aimed at increasing this brand's awareness, while also relaunching kids' flavored bars and launching new nut butters.

Even excluding RX, North America Other's organic growth was about 3% in Q3, another strong performance led by U.S. Frozen Foods. Eggo's consumption and share growth continue to be strong, even as we lap last year's mid-year acceleration, on a strong core and the success of our relaunched Thick & Fluffy line.

MorningStar Farms consumption slowed in the quarter, as the brand and the overall category lapped last year's market acceleration, but it continues to have favorable consumer trends and a strong pipeline of innovation and marketing ahead.

Canada's net sales increased year-on-year. We held share in cereal and snacks, led by effective innovation around wellness offerings like Vector and Kashi, and we grew share in Eggo. Kashi's net sales declined slightly in the quarter, but by much less than was forecast and by much less than last year. Our cereal consumption continued to grow as the Kashi brand cereal accelerated its growth, led by GOLEAN and the launch of Kashi by Kids.

Meanwhile, Bear Naked continued to add to its leading share in granola. A key for the overall Kashi business will be stabilizing snack bars, and that work is well underway, including innovation and expanded distribution for our Pure Organic brand. So these businesses are all pointed in the right direction as well.

Now, let's talk about our international regions, starting with slide number

17. This slide shows what a difference a year makes, with accelerated organic growth in 2018 across all three regions. And remember, this doesn't even include Multipro, our fast-growing business in West Africa, which is accounted for as an acquisition.

As we build up our scale and portfolios in emerging markets, these regions become that much more important to our growth algorithm. And in Q3, we continued to see a combination of elevated organic net sales growth in emerging markets, snacks growth and stabilized cereal performance in developed markets. Let's take each in turn.

We'll start with Europe on slide number 18. Because of last year's first half promotional disruption on Pringles, net sales growth comparisons in the second half of 2018 are markedly more challenging than they were in the first half, and yet we continued to post growth in this region. Pringles sustained its momentum with double-digit consumption growth in Europe, led by share gains in big markets like the UK and France. Cereal sales were off slightly year-on-year, principally on category softness in the UK and France. However, our consumption declines moderated in the quarter as another share gain in the UK and a stabilization of share in France gave us a higher overall share across Europe for the quarter.

Once again, emerging markets were a driver of the Europe region's net sales growth for both cereal and snacks. This was led by Russia, Egypt and the Middle East, so another solid performance for our Europe region. Markets remain challenging, particularly in Continental Europe, and we do continue to face tougher comps in the second half on Pringles. But Kellogg Europe continues to deliver growth anyway.

Let's turn to Latin America on slide number 19. Already strong in the first half, Kellogg Latin America's net sales growth accelerated further in Q3. This strong performance was again driven: by Mexico, where our cereal consumption and share growth remained impressive; and in Mercosur, where Parati sustained its growth momentum and biscuit share gains in Brazil. Meanwhile, Pringles continued to grow in key markets across the region. And our Caribbean/Central America subregion continues to rebound. So in a region that is no stranger to volatility in currencies and politics, we continue to see the benefits of well-established brands, an experienced management team, and a portfolio that has been shaped toward snacking.

And finally, let's take a look at our Asia Pacific region shown on slide number 20. Our net sales growth was boosted by a full quarter of consolidating Multipro. Recall that this is the distributor portion of our partnership in West Africa, in which we acquired a consolidating stake in early May. Treated in our results like an acquisition, this business also continued to post strong double-digit growth of its own in Q3. We'll talk more about this exciting business and the competitive advantage that Multipro gives us in West Africa at our Day@K investor event in a couple of weeks.

But Asia Pacific also grew strongly on an organic basis, which excludes Multipro. We've increased cereal consumption in emerging markets, led by India and Southeast Asia, as well as South Africa. Impressively, we also grew cereal in developed market Australia, where the category has returned to growth and we've continued to gain share. Pringles sales momentum continues, with growth in Q3 led by double-digit gains in India and South Africa, along with sustained growth in Australia, Japan and Taiwan, so very strong fundamentals for us in Asia Pacific. We're proving that we can stabilize and grow in a developed market like Australia, and we continue to expand in promising long-term growth markets like India and Africa.

So allow me to summarize with slide number 21. We feel very good about the direction we're heading. Our portfolio is being shaped toward growth. We made some very good acquisitions in recent years, and we've successfully integrated them. Some fill in white spaces in developed markets. Others have boosted our presence and scale in fast-growing emerging markets.

We've also shaped our portfolio through investment. Could we have pulled back on some investment in Q3 and delivered more profit? Yes, of course. But we're leaning into investment right now, both behind our brands and behind honing our capabilities. And I really don't want to slow that down, because these investments are the essence of Deploy For Growth and they're already gaining traction. Look at our improved net sales performance. Witness our improved consumption and share performance, and see how broad-based these improvements are across our portfolio and geographies. Behind this is better, higher ROI brand investment, enhanced capabilities and increased competitiveness.

So, we're willing to deliver a little less operating profit in the near-term because we have investment ideas with strong ROIs that can solidify our path to sustainable long-term top-line growth, and we feel very good about that. And it's not just investments that will help improve our trajectory. We've made some big, bold moves in recent years, and it has changed our cost structure, our portfolio, and our operating approach.

We'll talk more about these at our Day@K investor event in a couple of weeks. These are exciting times for Kellogg Company. And I hope you are as excited about our future as we are. As always, I'd like to take this opportunity to thank our employees who are creating this future for us.

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

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Chris Growe with Stifel. Please go ahead.

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

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

<Q - Christopher R. Growe>: Hi, just had a question for you in relation to the gross margin, a couple data points you gave throughout the presentation and discussion, but you had input costs were offset by productivity savings, if I heard correctly. You had obviously some higher inflation, but productivity offset that. You had the DSD and Multipro effect. And the end result was kind of the underlying gross margin being down 70 basis points. What I'm trying to get to is basically the mix effect on those co-packing costs. I know you talked a lot about those, but is that the totality of the decline in the gross margin? And then, when do you think you can bring these co-packing products into your own manufacturing facility to reduce that cost?

<A - Fareed A. Khan>: Yes, Chris, it's Fareed. I think you got the buckets right. Really year-to-date, we've been offsetting pretty high input cost inflation through productivity. And that's the ongoing work that we do, day-in, day-out, as well as benefits from Project K that continue to come through. And that was true again in Q3.

Where we've seen the most inflation has been around the transportation area, and that's an important factor when we get into the single-serve dynamics that we've talked about. So on single-serve, basically we're seeing a lot of growth in those categories. We like that growth. Long-term, it offers terrific potential. It's already a sizable part of our snacks business, so think about 10% of sales. And even with that percentage, we feel we are under-indexed to where that business could be. And so we like the growth opportunities. We are pursuing it. A lot of our product innovation is in that space.

Now, the co-pack challenges really are solved through investments in the supply chain, many of which are in place. They just don't happen overnight. So we could see some of these pressures continuing through the first half of next year, as we get co-packing centers put in place, as we have more streamlined back-ends to some of our production lines, and we have the capacity to meet the demand growth that we have in place. Very solvable, it just doesn't happen overnight. And, we're on that, both with investments and with organizational focus. What we didn't want to do was do anything to get the way of that growth because, that's where the consumers' going, and very important for our brands to tap into those opportunities.

<Q - Christopher R. Growe>: And just to be clear, then, you would quantify that gross margin challenge in the quarter and some of the overall profit challenges as mix and co-packing. And those are somewhat one and the same, but also there's a mix factor in there as well. Is that right?

<A - Fareed A. Khan>: They're connected, because it's the customers, it's the way those products get to customers, but the biggest single factor is just the format and the complexity of either single-serve items or mixed items that again go to the same sort of consumer dynamics, but that's right.

<Q - Christopher R. Growe>: Okay. Thanks so much.

Operator

Our next question comes from John Baumgartner with Wells Fargo. Please go ahead.

<Q - John Joseph Baumgartner>: Good morning. Thanks for the question. Fareed, just wanted to come back to the North American businesses. Price increases seem to be a theme across the space, especially now from your largest competitor in snacks, but your strategy seems geared more towards pack size and mix at this point, so can you speak a bit more to your opportunities to take pricing as well? I mean you touched on the [ph] NRM (34:11) activities in your comments, but just more broadly about U.S. limiting factors on line pricing here? Thank you.

<A - Steven A. Cahillane>: Yes, John. Thanks for the question. This is Steve. We do see an opportunity broad-based for Revenue Growth Management, so not just pricing, but the other things that you mentioned. We've already taken several RGM actions in 2018 in the United States, Europe, Asia Pacific and Latin America. We've announced others, including in the United States, but they won't be effective until later in Q4.

Obviously, we don't discuss any prospective 2019 pricing actions, but you've heard me and all of us talk in the past about earning price in the marketplace. We continue to really drive that mentality. We're coming with more innovations next year, which we think are very exciting, which will come with the ability to earn more price in the marketplace. So it's broad-based Revenue Growth Management, but it's very, very important to us moving forward into 2019 because we are seeing, as everybody is seeing, a more inflationary environment out there.

<Q - John Joseph Baumgartner>: And I guess is it your perspective the consumer can handle the higher mix or the higher prices overall going forward?

<A - Steven A. Cahillane>: Yes, it is. And particularly if you're delivering more value, right? And so we've given examples in the past where we've improved food. We've innovated around food, around packaging, around formats. And if you get the consumer value equation right, then you can definitely earn the price from the consumer, which is what the retailer's looking for, right? You want to moderate your elasticities as much as possible and we do see that opportunity.

<Q - John Joseph Baumgartner>: Great. Thanks, Steve.

Operator

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

<Q - David Cristopher Driscoll>: Thank you and good morning. So I just wanted to understand the fourth quarter implications and what's happened. I think that the guidance changes will result in like a 20% reduction in the consensus EPS forecast. So the changes here, Steve, seem to be quite substantial.

Could you just explain a little bit in the evolution of why is this such a big change? Certainly, it's been the strategy to do these single-serves for a long time now, so I don't perceive that the growth in single-serve was shocking to the

Kellogg Company, but I feel like you guys really had a big change of understanding your cost structure of what those products mean. But I'd just kind of like to understand why that changed so much.

And then just to build on that, in the Q1 and Q2 of next year, I think, Fareed, you said that it's a similar magnitude event of what those impacts would be, but could you just confirm that? Thank you.

<A - Steven A. Cahillane>: Yes. Thanks, David, for the question. I'll start and Fareed will go deeper. I'd say if you look at the broad implications of our results and our guidance, in your parlance, I'd say we chose a high-quality miss versus a low-quality make. We could have cut back, but the hardest thing to do in consumer packaged goods today is create demand and drive growth. And key to our Deploy For Growth strategy is returning to top-line growth. And it's happening, and we're pleased with it. And we're going to continue to work on the margin, without a doubt.

If there's a mea culpa, the single-serve demand creation happened faster than we anticipated, and a good bit faster than we anticipated, at the same time that the supply chain costs and the costs of shipping multiple products all around multiple networks accelerated at the same time. So it was little bit of a perfect storm of better demand creation, which we like. That's a good problem to solve and much higher logistics costs than were anticipated.

And rather than cut back in areas like brand-building to manage towards a different outcome, we like the fact that we'll return to top-line growth and are willing to invest against it. You want to -

<A - Fareed A. Khan>: Sure. David, a couple of points around Q4 and then we really don't want to get into 2019 guidance on this particular call, but I'll give you some factors. First of all, the underlying fundamentals that we talked about on the brands on consumption around top-line, we think are solid and we expect those to continue into Q4. We pointed a little bit of risk in the sense of potential trade inventory reductions.

We'll see how that plays out, but you have a couple of factors that played out in Q3 that will continue into Q4. The first of those is our Deploy For Growth investments to really accelerate the top-line. And, as Steve mentioned, that's a choice. Those investments, even in brand-building alone, were greater than the OP decline in the quarter, right, so continue to be fairly significant.

Some of those are around our core brands, some innovation that's coming down the pipeline. We've got some pretty exciting new RX platforms that we're leaning into. Globally, high-frequency occasions, on-the-go themes are also important, as well some capabilities. Those investments are working and we don't want to take our foot off the gas.

The second factor is the single-serve dynamics that we've talked quite a bit about. And, as I mentioned, those don't get fixed overnight. But over time, as we optimize and streamline some of the supply chain co-pack areas, those margins will come up. That's probably more of a second half of next year phenomenon. So if you take those together, that's sort of about two-thirds to three-quarters of the pressure.

Now in Q4, we do expect continued inflationary pressures in transportation. From where we saw it at the beginning of the year, it's actually more significant than we expected. We have RGM initiatives on that, as well as other cost pressures. But in Q4, you've got sort of a timing balance between those two that are going to play out. And also, we're starting to see some hedging in some of the procurement commodity areas rolling off. And that creates some pressure.

And the last thing I'll mention is that we did a nice job really all year around controllable costs. So we're spending in brand. But if you look at our ZBB program, if you look at our overhead productivity, all the cost savings that we expected from the DSD exit are flowing through, and so we like that. So Q3 also benefits from some pretty solid cost actions. And while we'll continue to see some benefits, we don't see sort of the same rate of offset coming in. So you put all that together, that says Q4 is going to be a little bit more challenging than where Q3 came out. And that really sort of shapes our guidance.

<Q - David Cristopher Driscoll>: Thank you for the comments.

<A - Fareed A. Khan>: Thanks, David.

Operator

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

<Q - Kenneth B. Goldman>: Hi, thank you. I don't think I heard you guys talk about updated gross margins for the year. Obviously, it won't be at quite as good as you thought previously. But could you give us some idea of where you expect them to come in for the entire year?

<A - Fareed A. Khan>: Yeah. What I'll say is the dynamics that we talked about for the quarter will continue to play out. So the mix effect will be rolling off in Q4, the mix impact from the DSD exit. But the Multipro dynamics will still stay with us. The mechanical impacts will sort of be about 150 basis points. And then on the single-serve issues, those we expect to continue. And that's sort of the primary two dynamics. And so we put that in the category of kind of mix, which when sort of sized, is maybe 100 basis points on top of that.

<Q - Kenneth B. Goldman>: Okay. And then, follow-up for me, you had called out a substantial increase in marketing in your North America Other segment. And you called out the first national ad campaign for RXBAR, but, at least the numbers that we saw, RXBAR sales weren't any higher this quarter than last quarter. Is this just because it takes time for ad campaigns to work? I know sometimes there is a lag effect. And if so, when should we start expecting RX sales in this segment to really start ramping up?

<A - Steven A. Cahillane>: Well, we're actually very happy with RX sales. They continue at a torrid pace. And so, the whole idea behind the national advertising campaign was when you go from circa 30% ACV distribution to 70% ACV distribution, you want to keep the demand as strong as possible, because typically what happens is your sales per point of distribution will go down because you're expanding that ACV so dramatically. And we didn't see that. So the customer support we're getting is very strong. The brand health scores that we're seeing are very strong. Unaided brand awareness is growing very, very nicely. Brand loyalty is growing very nicely. So we really like what we see with RXBAR. The customers like the support, based on the incredible increase in ACV distribution we're getting. So there's typically a lag, as you point out, when you're building brand awareness and you're building equity. But we really like what we see in RX.

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

Operator

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

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

<A - Steven A. Cahillane>: Good morning, Alexia.

<A - Fareed A. Khan>: Morning, Alexia.

<Q - Alexia Jane Howard>: Hi. You've mentioned the trade inventory reductions a couple of times that I think are going to hit in Q4. Can you just elaborate a little bit more on what those products are and why those inventories are being reduced? And then, just a quick follow-up, how much was advertising spending up year-on-year this quarter? Thank you, and I'll pass it on.

<A - Steven A. Cahillane>: Thanks, Alexia, for the question. I'll start, and Fareed may want to go deeper. In terms of inventory, when we exited DSD, obviously, it was a major transition that we've been talking about for some time now, where the inventory went from our system into the customers' warehouse system. And over time, we expected that they would have a higher level of inventory as they got used to, obviously, carrying a whole new line of goods, and that would be optimized over time, which you would expect.

So we've been expecting inventory to come down, and it has not come down. So we're not calling that it will come down in Q4, but it may because we're just expecting that retailers, like us, would look for optimal levels of inventory.

So we're not saying that it will happen, but just to be precautionary, we're pointing out that it is possible at some point in time. And it's U.S. Snacks that we're talking about.

In terms of brand-building, we're not going to get into the details, but I can tell you it's up high single digits. And so that's why I say you see other companies would pull back if profit's under pressure. We like the growth that we're driving. We like the demand creation that's happening. And so, if anything, we've leaned into brand-building this year in a high single-digit way. I don't know, Fareed...

<A - Fareed A. Khan>: And Alexia, the only thing I'll add is that brand-building in dollar terms was greater that our OP decline on dollar terms, so pretty significant in the quarter. But it's working, and we see that in the brands. And we're being very focused about where that investment goes. We like the ROIs, which is why we continue to focus on that area.

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

Operator

Our next question comes from Rob Dickerson with Deutsche Bank. Please go ahead.

<Q - Rob Dickerson>: Great. Thank you. I just had a question on non-U.S. business. Given currency headwinds you're experiencing and it would seem like expect to continue to experience through, kind of, early next year, first half of next year, can you just, kind of, briefly explain a bit, kind of, the way you're thinking about pricing in non-U.S. markets? Because, I mean, as of now, right, we're not really seeing the pricing. Therefore, it's not offsetting the currency. But from others, we're seeing it. So I'm just curious if there's a disconnect between how you're thinking about pricing relative to currency versus others or if you think this is more of a short-term effect in Q3 and likely as we get into Q4 next year, you would look to potentially take some pricing in non-U.S. markets. Thanks.

<A - Steven A. Cahillane>: Yeah. Thanks for the question, Rob. So we look at, first, from a high-level perspective, pricing at a consumer level, right? So we have to be competitive in the marketplace. We have to earn the right price in the marketplace, and we have to sell the consumer. So we can't look just at currency and say, currency moves, therefore the consumer is going to pay more. Because if you're sitting in a country, obviously, you're thinking about consumer goods in your own currency. Now, having said that, we look at RGM opportunities everywhere around the globe, and we've seen good opportunities to do that.

We're not big in some of the hyperinflation economies that some are talking about at all right now. So we think currency is very manageable. We think there's RGM opportunities. I mentioned some of them in Europe, Asia Pacific, Latin America, that we've already taken in 2018, and we'll continue to look for opportunities going forward, but, again, with the consumer at the heart and soul of our planning process.

<Q - Rob Dickerson>: Great. Thank you.

Operator

Our next question comes from Jonathan Feeney with Consumer Edge. Please go ahead

<Q - Jonathan Feeney>: Good morning. Thanks so much for the question. So I noted the total expense in Morning Foods, and that's maybe there's a lot in there, but it's just sales less operating profit, as you disclose it, was up for the first time since the segment peaked six years ago, year-over-year. When I look back, you've taken out about $200 million expenses from that segment, even as recently as 2015, about $80 million. So I guess maybe a question and a half in here. Some of that has to be discretionary investment. So what gives you the confidence that you're spending enough on the right things right now? And is this sort of a bottom? Should we expect continued investment and lower margin in that segment, I guess, as you reported that big profit pool at North America going forward? Thanks so much.

<A - Steven A. Cahillane>: Yeah. Thanks for the question, Jon. I'll start, and, again, Fareed can go to deeper. Morning Foods, we've said, U.S. Morning Foods, that we want to stabilize, and that it won't be a growth engine, doesn't need to be a growth engine for the company. But we want to stabilize the business, and we know we've got great brands. And we are investing double-digit in brand-building to make that happen. And we're liking what we see in a number of the big brands in our Core 6 in terms of now stabilizing and growing share and again cutting the decline fairly dramatically from where it was. And so we are investing in capabilities as well. It's a very important business for us and we like what we're seeing early days in terms of our goal towards stabilization. You want to add?

<A - Fareed A. Khan>: So what I'd add is that in Morning Foods, which is true of all of our businesses, the investments back in the business, one, discretionary, and, two, in a very focused way around supporting big brands that are responding well, building capabilities, and also innovation. And we've got a couple of interesting platforms coming out in Morning Foods around the gut health space. An we think that's kind of a very interesting area where the cereal category and Kellogg, in particular, can have a lot to say around health and wellness, and the importance of the biome.

And so all these investments reflect pretty focused areas. We've done a lot of work around measuring how those are responding, are we getting the ROI. And the fact that we're continuing to make those investments basically says that those are positive, and we like what we're seeing in terms of top line.

All the discipline around cost and efficiencies are as much today as they were a few years ago. And, in many ways, that's fueling some of the investments we're putting back into the business, as I mentioned. The DSD savings are coming through. Ongoing productivity savings are coming through. And that's allowing us to offset, at least year-to-date, some of the inflationary pressures that we've been seeing. So the investment's across all the platforms in a targeted way, and the returns have been positive.

<Q - Jonathan Feeney>: Fair enough, thanks very much.

Operator

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

<Q - Vivek Srivastava>: Thank you. This is Vivek Srivastava speaking on behalf of Jason English. My question is on trade spend versus brand-building. So recently, a few of your peers have talked about shifting dollars for marketing to trade, while you have been stepping up brand-building aggressively. How are retailers responding to this? And do you expect the same strategy to go forward or are probably put more in trade? Thanks.

<A - Steven A. Cahillane>: Yes, thanks, for the question. We don't break out brand-building in terms of trade and above the line and so forth for competitive reasons. But brand-building for us is not trade. And when we say brand-building is up double digits, we mean things that are directly addressed at the consumer. So think TV, think digital, think advertising and promotion. So it is real investment against building brand equity with our consumers.

And I can tell you that our retailers are pleased with it because we are leaning in. And when you improve the velocity off their shelf, obviously it's a win-win. And so, that's what I talked about in Morning Foods, getting those brands stabilized and several of them back to growth. It's an incredibly important category with high household penetration, so they're pleased with that.

The Snack business going from DSD into the warehouse allowed us to substantially increase our brand-building, and you can see, and we talked about and pointed out, the velocity improvement and the SKU rationalization, so our shelf sets are so much more productive than they were. So again, retailer likes that. And the innovations that Fareed mentioned, that we're bringing require investment. And, again, retailers are very welcome to innovations in the categories in which we play.

Operator

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

<Q - Pablo Zuanic>: Good morning. I have two questions, but a comment first. This is a quarter where you increased sales guidance, actually beat in terms of sales estimates for the third quarter in terms of organic growth. And we look at the scanner data and your trajectory is better, right? But then the stock is down 9%. And obviously, that's because of gross margins. I won't harp too much on brand-building because it's up high single digits in the third quarter, but it was up a lot more in the first half, you know double digits year-to-date. So brand-building is not why the stock is down 9% today.

So what I want to ask, the first question is very simple. You're not getting credit for the sales growth momentum because we don't know [ph] where margin is going to be next year, so can you give more color in terms of how we should think about EBIT (53:46-53:55) margins for next year? Or at Investor Day on November 11 (sic) [November 13] (53:57), are you going to be quite specific about 2019 guidance? That's the first question, and then I have a follow-up.

<A - Steven A. Cahillane>: Okay. Pablo, I'll start. First of all, I don't know what the market is doing, but we don't manage the stock price on a day-to-day basis. We manage the long-term health and growth of this business, as if we were owners in it. And the most important thing that we can do for this business is return it to top-line growth in a responsible and sustainable way.

And so we're pleased with what's happening with our brand-building investments. And you can see another quarter of organic sales growth, which we haven't had for quite some number of years. And so we have problems that we need to solve clearly around how that demand is being supplied to the marketplace in terms of all the single-serve challenges that we've talked about. But the single hardest thing to do in consumer packaged goods, which I mentioned, is really return to top-line growth if you're actually in decline. And so that requires a level of investment.

And over the long-term, we will get back to our algorithm that we've talked and that we talked about a while back at CAGNY, which, again, is low single-digit top-line growth, mid-single-digit OP growth. And, ultimately, that leads to double-digit total shareholder return growth. And then the stock price will take care of itself. And so that's our commitment. That's our strategy.

In terms of 2019 guidance, we'll give some more directional, where we're heading at our Day@K, but what we can tell you is we like what we're seeing in terms of the brand-building investment. We like that we're returning to top-line growth. We've got a lot of brands that are responding quite well.

Fareed mentioned the headwinds in some detail that we faced and that we're facing down. That's not going to change dramatically going into 2019, the shape of 2019. Just because you turn the calendar page and it's January and not December doesn't immediately fix things. So the shape may resemble 2018, but the fact that we're getting back to top-line growth, ultimately, is very, very important.

<Q - Pablo Zuanic>: Agreed. And just a quick follow-up for Fareed, you said that on-the-go snacks was 10% of sales. Was that of total sales, because that would mean 40% of snacks, if you can clarify that? And my question really is more once these co-packing issues are solved and you take care of supply chain issues, let's say, by middle of next year, on a more normalized basis, would on-the-go snacks be more profitable than your packaged snacks in a normalized basis? Thanks.

<A - Fareed A. Khan>: Yes, sure. On the first question, we didn't give sort of an overall percentage, so that 10% was 10% of the U.S. Snacks business. Now, we have on-the-go formats and on-the-go SKUs across all of our businesses all over the world. And so, we haven't given the total percentage points. But it's the U.S. Snacks business where these co-pack pressures are.

As so, that's still a very sizable business. So if you think about transportation costs, multiple shipping, handling by third parties and you can pretty quickly envision how contribution margin from a pretty sizable business would erode as that business grew. And that's really the pressure that we're seeing in that area. And could you just remind me the second part of your question? Sorry.

<Q - Pablo Zuanic>: Once that normalizes, are on-the-go snacks more profitable compared to the rest of snacks?

<A - Fareed A. Khan>: Yeah. Yeah. So you think about impulse purchases, convenience channels, there's no reason to believe that these things shouldn't be at least in parity with the rest of our margins. And again, one thing to also point out about the Snacks business, as we've talked about post-DSD, the Snacks' operating margins coming up to the North America average. All those DSD savings in terms of structural savings are still coming through. And so we've got this what I'd say is a medium-term challenge around co-pack single-serve. That will get addressed. But the fundamentals of the business over the, let's call it, latter part of next year should be right on track. We just got a little bit of delay as we work through this co-pack issue.

<Q - Pablo Zuanic>: Understood, thank you.

John Renwick, CFA

Operator, I think we are out of time for any more questions. I will be around all day if anyone has any further follow-up questions.

Operator

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