Company Name: Kellogg
Company Ticker: K US
Date: 2014-02-06
Event Description: Q4 2013 Earnings Call

Market Cap: 20,925.69
Current PX: 57.7743
YTD Change($): -3.2957
YTD Change(%): -5.397

Bloomberg Estimates - EPS
Current Quarter: 1.057
Current Year: 4.054
Bloomberg Estimates - Sales
Current Quarter: 3882.000
Current Year: 15209.059

Q4 2013 Earnings Call

Company Participants

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

Other Participants

- Thilo Wrede
- David C. Driscoll
- Matthew C. Grainger
- Robert B. Moskow
- Kenneth B. Goldman
- John J. Baumgartner
- Andrew Lazar
- Eric R. Katzman
- Varun S. Gokarn
- Alexia Jane Howard
- Christopher R. Growe

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company fourth quarter 2013 earnings call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Please note this event is being recorded.

Thank you. At this time, I will turn the call over to Mr. Simon Burton, the Kellogg Company Vice President of Investor Relations. Mr. Burton, you may begin your conference.

Simon D. Burton

Thanks, Michelle. Good morning and thank you for being with us today for a review of our fourth quarter and full-year 2013 results. I'm joined here by John Bryant, President and CEO; and Ron Dissinger, Chief Financial Officer.

The press release and slides that support our remarks this morning are posted on our website at www.kelloggcompany.com.

As you are aware, certain statements made today, such as projections for Kellogg Company's future performance, including earnings per share, net sales, margin, operating profit, interest expense, tax rate, cash flow, brand building, 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 Monday, February 10. The call will be also be available via webcast, which will be archived for at least 90 days.

And now I'll turn it over to John.

John A. Bryant

Thanks, Simon, and thank you, everyone, for joining us.

As you have seen, we reported fourth quarter and full-year 2013 results today. Full-year reported sales growth was in line with our previous expectations. Internal growth was a little lower than we thought, driven by the cereal category weakness in developed markets that we've seen much of the year.

Better than expected results below the line offset this impact. And full-year comparable earnings were $3.77 per share, in line with our expectations. And cash flow was $1.170 billion for the full year, toward the high end of our range.

We have been making very good progress throughout the quarter on Project K, our significant multiyear efficiency and effectiveness program. I'll give you some more detail on this in a minute, but I'll say that I'm pleased with the progress we've made so far and I am encouraged by the plans we have in place.

And finally, we also provided guidance for 2014 today. This guidance reflects the realities of our categories and the work required to drive growth in the future. While Project K is just part of the solution, it is important as it will provide fuel for growth over the next four years. We will not only invest Project K savings back into the business, but we'll also look to improve the effectiveness of our existing investment.

Our goals for 2014 are to set realistic targets and to invest back into our categories and our brands. We've got a lot of work to do, but we also see a lot of opportunity. You will hear more on this later today and at CAGNY as we return Kellogg's to profitable growth over time.

And now if you'll turn to slide four, you'll see an update on Pringles. Pringles posted high single-digit internal net sales growth for the full year and double-digit growth in the fourth quarter. Europe, Asia-Pacific, Canada, and especially channels in the U.S. all posted double-digit growth in the quarter as innovation and core products drove results. As we have mentioned before, the integration has gone very smoothly, is on track, and is largely complete.

This has been a great acquisition for us. Sales and profit growth have exceeded our expectations in every quarter since the transaction closed. The integration has transformed our global snack business and significantly increased its growth potential. We now have category teams based in each of our regions to drive future growth.

We launched an exciting innovation in 2013, including Tortilla Pringles in the U.S. late in the year. We've been capacity constrained since completing the acquisition, but we have more capacity coming online in 2014 in Europe and in 2015 in Asia, which will help us manufacture closer to demand and supply future growth. In addition, we also recently announced that we are planning to add capacity for Pringles in China with our joint venture partner, Wilmar. Sales growth in China has been good. The JV has been going well, and this is an exciting step for us in this important region.

Now let's turn to slide five and a quick update on Project K. We've made quite a few announcements over the last few months. We expect that more than half of the cost savings we will realize over the next four years will come from supply chain, and that has certainly been the initial area of focus for us.

One of our goals is to optimize our supply chain network. And as a result, we've announced plans to close or reduce capacity in plants in large developed markets such as the U.S., Canada, and Australia. Also, we're continuing to focus on emerging markets, which is an important part of our corporate strategy. So we're increasing the snacks capacity at our plant in Thailand. And as we've already mentioned, we're also adding cereal capacity in India and capacity for Pringles in Malaysia and in Poland. To be clear, this is capacity we're adding to service international demand. It is not product that will be shipped to North America.

In addition, we're also making good progress with our move to global business services. So we've got a lot underway, and we'll provide a further update at CAGNY in a few weeks.

The primary goal of Project K is to enable us to invest behind the business, and slide six shows the framework which highlights the various areas of this reinvestment. We think of the purchase model in three distinct phases, desire, decide, and delight. The first of these, desire, is the area of investment we normally associate with our advertising investment. Decide is about winning in store and includes engaging consumers at the shelf, packaging, assortment, and in-store merchandising. And delight really closes the loop. This is about the consumer experience and is largely about our product offering and quality. Project K has been investing back into all three of these areas.

So first, let me give you some examples in desire. We will invest back behind our brands and specifically to address some of the category issues we see today. This is not about more money behind the existing work. It is about better allocating investment and adding additional resources as part of Project K behind an initiative designed to restimulate category growth. We will do this by leveraging the strongest brand in the category worldwide, and that is the Kellogg brand itself.

Over the last six months, we've been working to create a calendar of initiatives, including a campaign to reinforce the values of cereal and the role Kellogg plays in bringing that to the consumer. We will be initiating campaigns in our core markets by the second quarter under the idea of, "Kellogg's, see you at breakfast." We are excited by these ideas and work we've seen so far.

The next step is decide which is the conversion of the shopper in the store. This includes investment in things like packaging, shopper programs, mobile, in-store ads, and display. We can't only have brands that respond well to display and in-store theater, and we're working to improve our vehicles for better presentation to the shopper. We have some industry-leading in-store partnerships with ESPN GameDay, the Olympics, and key movie properties. In addition, as part of Project K, we're increasing our investment in our coverage model for DSD [Direct Store Delivery] in our U.S. snacks business, including investing in better technology for our reps.

And finally, we will also invest back in our food to delight consumers. There are various ways we can do this. We realize the ground continues to shift rapidly in consumer sentiment around nutrition and the value that is being placed on food. So we will continue to develop new foods that address these evolving consumer requirements, like Raisin Bran with Omega 3s and Special K Nourish with quinoa. We will constantly strive to maintain and improve the quality of our products. We will do more with our packaging and we'll develop new ideas like our new granola in resealable bags.

So as you can see the scope and scale of the whole path to purchase model and that we have an opportunity to drive significant growth through further investment in all these areas. I recognize that because we're planning to invest in advertising, in-store execution, and in the design and quality of our food, it will be more difficult for you to track the investment. However, each of these areas will help drive future returns and are the right places for us to focus. Again, we'll come back at CAGNY with more detail regarding what we're doing.

And with that, I'll turn it over to Ron for a review of our quarterly and full-year financial results.

Ronald L. Dissinger

Thanks, John, and good morning.

Slide seven shows our performance for the quarter and the full year and excludes charges related to Project K and mark-to-market for pensions and commodities. Internal net sales for the full year increased by 0.3%. We delivered solid sales growth in Europe, Latin America, and Asia-Pacific in the quarter and for the full year, but sales declined in our two key U.S. businesses, impacting both quarterly and full-year revenue growth.

Underlying internal operating profit increased by 1.3% for the full year and increased by 8.8% in the fourth quarter. The strong quarterly result was largely due to net deflation in cost of goods sold, the timing of brand building as we were lapping significant growth in the fourth quarter of 2012, and a lower year-over impact from our base upfront costs, excluding Project K.

Comparable earnings per share, which exclude integration costs, mark-to-market adjustments, and Project K costs, were $0.83 per share in the fourth quarter and $3.77 per share for the full year, in line with our expectations. The comparable results in the quarter benefited from a lower tax rate due to some discrete items that concluded late in the fourth quarter.

Reported earnings per share for the full year were $4.94. This included a substantial benefit from the mark-to-market accounting for pensions due to both asset returns and movements in interest rates. This was partially offset by $0.13 of Pringles integration costs and $0.42 of costs related to Project K.

Slide eight shows the components of the full-year and quarterly sales growth. For the full year, reported sales increased by 4.2%, and internal sales growth was 0.3%. For the fourth quarter, reported net sales declined by 1.7% and internal net sales declined by 0.9% on top of a 5% comp. This was primarily due to the weakness in the U.S. cereal and snacks businesses I mentioned earlier. Internal volume declined by 0.5 point for the full year and 1.6% in the fourth quarter. While we experienced softer volume in some developed cereal markets and in U.S. snacks, we saw strong volume growth in snacks outside the U.S. and in our U.S. frozen foods business.

We also posted improvements in price/mix in both the quarter and for the full year. And of course, Pringles was most of the 4.6% full-year growth from acquisitions. The impact of currency translation reduced sales growth by 0.7% for the full year and by 0.8% in the fourth quarter.

Slide nine shows our gross margin performance during 2013. As we expected, we saw good margin improvement of 60 basis points in the quarter. As we discussed earlier in the year, our productivity savings built throughout the year, and savings in the fourth quarter were approximately 5% of cost of goods. And we also saw moderation in gross inflation to approximately 4% in the fourth quarter. So we experienced net deflation and benefited from the timing of upfront costs.

We did see some offset from reduced operating leverage due to the sales softness in our U.S. categories.

Full-year gross margin declined by slightly more than 1%, approximately in line with our expectations. Net cost of goods inflation of approximately one point and lower operating leverage were key drivers of our performance, resulting in around 70 basis points of decline on a comparable basis. The full-year impact of the inclusion of the Pringles business in the results was a decline of around 40 basis points.

Slide 10 shows the operating profit performance for each of the regions in the fourth quarter. The operating profit growth on the chart excludes charges for Project K. As I mentioned earlier, underlying internal operating profit for the total company increased by 8.8%. North America's underlying internal operating profit decreased by 2.9%. And this was primarily driven by sales declines in morning foods, snacks, and Canada.

Underlying internal operating profit increased by 15.3% in Europe. This was the result of good sales growth and the impact of comparisons. Underlying internal operating profit in Latin America decreased by 4.7%. While we recognized solid sales growth in the region, we experienced some disruption to our product supply due to the difficult operating environment in Venezuela. This resulted in higher cost of goods sold and reduced operating leverage. And in Asia-Pacific, we saw a significant increase in underlying internal operating profit due to solid sales growth and a significant investment in upfront costs in the region in the fourth quarter of 2012.

Now let's turn to slide 11, which shows our cash flow performance. Cash flow from operations before capital spending was $1.807 billion for the full year, in line with our expectations. This was an increase of $49 million over 2012. And remember, 2012 included a one-time benefit of approximately $150 million from the Pringles acquisition. So we're pleased with our cash flow generation in 2013, which was towards the high end of our guidance range.

Capital spending for 2013 was $637 million, a year-over-year increase of approximately $104 million, so slightly more than 4% of sales. And you'll recall that we were expecting capital spending this year to be greater than the high end of our long-term target range, as we invest in additional capital for Pringles and a new plant in India and because of some shift of investment we saw from late 2012 into 2013.

We purchased $544 million of shares in 2013. We do expect to go back to our normal share repurchase activity in 2014 and that we'll reduce the overall average share count by between 1.5% and 2%.

And finally, we have made progress on reducing debt levels since the acquisition of Pringles. In fact, we've decreased our levels of debt by approximately $900 million over the last 18 months.

Slide 12 details our guidance for 2014. We're giving pragmatic guidance for growth for the full year. Project K will provide some funding to increase investment in certain businesses and categories in which we compete. We expect that internal net sales will be up approximately 1% in 2014. This excludes any impact from integration costs, the impact of currency translation, and this year's 53rd week. The 53rd week should add a little more than one point to reported sales growth.

We continue to expect moderate material-related inflation in 2014. Total cost of goods inflation is estimated to be in the range of 3% to 4%. This is before the benefit from productivity, which we estimate to be toward the high end of our long-term target range of 3% to 4% of cost of goods. In addition, we will recognize some savings from Project K in cost of goods sold. So we expect a moderate amount of net deflation overall. As a result, we anticipate that underlying reported gross margin will increase by approximately 40 to 50 basis points, including the benefit we'll realize from Project K impacting our supply chain.

Underlying internal operating profit is estimated to be flat to up 2%. We expect that brand building will increase faster than sales growth, including the reinvestment of savings from Project K. We also have a little more than a point of headwind from incentive compensation due to our performance in 2013. And we're planning for some impact from the new food tax in Mexico and a more difficult regulatory environment in the Latin America region.

Finally on operating profit, the 53rd week should add approximately 1.5 points to two points to reported operating profit growth for the year. We expect that currency neutral comparable earnings per share will increase at a rate between 1% and 3% in 2014. The underlying tax rate is estimated to be between 29% and 30%, and interest expense will be between $225 million and $235 million.

Our reported EPS was $4.94, including the impact of mark-to-market in 2013, and there's a walk in the appendix that shows all the components of our results. Slide 13 shows our EPS walk for 2014. First, we have adjusted our 2013 base earnings per share to remove the upfront costs of $0.08 per share incurred in 2013. While we will continue to invest in productivity initiatives, we are bundling all our upfront costs into Project K for simplicity's sake and will exclude them from our underlying results.

Earnings per share growth of 1% to 3% puts us in a range of $3.89 to $3.97 a share. We currently estimate that currency translation will not have an impact on results, although it's important to note that this doesn't include the impact of any significant currency devaluations we might see during the year, for example, Venezuela. In addition, we estimate that the 53rd week will add approximately $0.08 per share.

We expect one more year of costs related to the integration of Pringles, and we estimate between $0.07 and $0.09 per share in 2014 primarily related to our go-to-market model. This puts us more towards the high end of our original estimate for integration costs, but synergies have exceeded the high end of our $50 million to $75 million range too. And we expect that incremental savings from Project K will be in the range of $50 million to $60 million for the full year, approximately 40% of which will come from cost of goods. As John said, it is our intention to reinvest these savings in growth initiatives.

Costs related to the project are estimated to be approximately $300 million to $350 million, or $0.60 to $0.65 per share in 2014, with approximately one-half in cost of goods sold. But I should point out that we could see initiatives shift between years as we progress through the project, and obviously we'll update you if this occurs. Our estimate is that total pre-tax costs over the life of the project will be between $1.2 billion and $1.4 billion, and our estimate is that annual savings will be between $425 million and $475 million by 2018. Both of these estimates are unchanged from our initial guidance last quarter.

We expect that cash flow in 2014 will be between $1 billion and $1.1 billion. This includes capital spending and additional cash required by Project K. This will be partially offset by an initiative in accounts payable to reduce our working capital. This is already underway. We anticipate that total capital spending will be in the range of 4% to 5% of sales, as we mentioned last quarter, and this will include investment in Project K and the additional capacity for Pringles.

Last, a few comments on the first quarter of 2014; we expect that the sales trends we've seen in several of our businesses in 2013 will continue into 2014, and first quarter sales could be down slightly. We also expect that underlying gross margin in the first quarter will be flat to down slightly, driven by operating leverage and the timing of our productivity savings during the year. This will lead to lower underlying operating profit and comparable earnings per share including currency in the range of $0.95 to $0.98 a share. Of course, our guidance on operating profit and earnings per share excludes the impact of mark-to-market adjustments, integration costs, and Project K costs.

Now I'll turn it back over it to John for more detail on the operating segments.

John A. Bryant

Thanks, Ron.

Now let's look at slide 15 and some more detail regarding morning foods. Sales declined by 4% in the fourth quarter, although we're lapping mid-single-digit growth, the most difficult comparison of the year. Consumption in the cereal category remained lower than we had initially expected, as merchandising and display were down. The adult segment of the portfolio remained weak and we saw lower year-over-year retail inventories, which had an effect on shipments in the quarter.

We saw some good growth in parts of our portfolio. For example, Raisin Bran grew strongly, driven by innovation and advertising as part of our Healthy Dividends campaign. This program is aimed at baby boomers and highlights the health benefits of our products. It's a campaign that has resonated with consumers and is an example of the type of activity that we'll be doing more of in the future.

We've got more activity planned in 2014, including new product introductions such as a new Special K Chocolate Almond, the Crave cereal, Touch of Fruit Mini-Wheats, Bare Naked granola, and new Kashi cereals, including three varieties of Organic Promise, all of which are GMO free.

You'll see on slide 16 that we're very happy to be celebrating Pop Tarts' 50th anniversary in 2014. This is an iconic brand that has just completed its 31st consecutive year of growth. Core and new products continue to drive this, and the brand feels as young today as it ever has. Pop Tarts gained 0.6 point of a share over the last 52-week period, while consumption growth was 3.4% and full-year category share was 84.4%. The two peanut butter Pop Tarts we launched in 2013 continued to do well in the fourth quarter and also contributed to full-year results. We have bigger commercial plans coming in 2014 as part of the Olympics program and a Crazy Good summer campaign.

In some of the other categories in morning foods, we're following up last year's launch of our drinkable breakfast products with new Coffee House versions. These new flavors include Chocolate Mocha and Vanilla Cappuccino and will make a great addition to our existing lineup. In addition, the new Special K hot cereals we launched last year have also been doing well.

Finally for morning foods, we have a number of exciting commercial plans scheduled for 2014. These include the Olympics sponsorship I mentioned, which is underway now, a Share Your Breakfast program in March, and Kellogg master brand category building programs to come later in the year. Some of these, particularly the ones later in the year, will be part of the reinvestment program related to Project K. We expect that these category-related activities will improve the relevancy of the cereal category progressively over time.

Now let's turn to slide 17 and our U.S. snacks segment. Both shipments and consumption increased in the cracker business in the fourth quarter, and share remained essentially flat. We had strong merchandising during the holiday season. And Town House Pita and Cheez-It Zingz, both of which were midyear innovations, continue to do well. Consumption of Town House crackers increased significantly due to both the innovation and share gains posted by the original variety. Cheez-It Zingz also contributed incremental growth as base Cheez-Its also grew. Partially offsetting this growth was some weakness in the Special K cracker business, as we had strong comparisons in the second half of 2012.

We have some good innovation coming in this category in 2014. We have just launched Cheez-It Grooves, which is off to a good start as is the cracker business as a whole.

The Keebler brand in total posted slight internal net sales growth due to good results from Fudge Shoppe in the fourth quarter. And we have some exciting new products coming later in the first quarter on Chips Deluxe. However, the cookie business as a whole declined in the fourth quarter. This was partially driven by reductions in inventory, although we saw weakness in some of our brands, including Mother's and Murray Sugar Free.

In the wholesome snacks business, Nutri-Grain again gained share in the quarter, driven by Nutri-Grain Crunch, and we also saw good performance from Rice Krispies Treats. However, this growth was more than offset by weakness in other parts of the portfolio and lower inventories at retail. So we saw growth in the wholesome snack business where we've innovated. But frankly, we've been disappointed with the performance of this business. So we're changing direction and are planning innovation and advertising that returns to the core in both Special K and Nutri-Grain brands. And with Kashi, much like we're doing in cereal, we're returning the brand to its roots. So we're taking the right steps to drive improvement over time.

Finally for snacks, our Pringles business posted strong double-digit internal net sales growth as a result of good consumption and the shipment of the new tortilla innovation I mentioned earlier. Pringles had a very strong year in 2013 despite some difficult comparisons. And we remain optimistic given the early results from the launch of new products and a strong commercial calendar. While we don't expect continued double-digit growth, we are excited by the potential growth of this great business.

So in summary, the snacks business had a difficult year in 2013. And 2014 will be a rebuilding year as we continue to focus on what's working and also on investment in innovation and better in-store execution. We recognize that we've got a lot to do in this business, and the team has been working hard on their plan.

Now let's turn to slide 18 and the strong performance of the U.S. specialty segment. Internal net sales growth was 5.1% in the fourth quarter and was 4.1% for the full year. In the 12-week consumption data, Kellogg gained share in the convenience channel in the cereal, cracker, and health and wellness categories. Innovation, distribution, and pricing drove good internal sales growth in the fourth quarter and strong double-digit growth for the full year in the channel. Our cereal-in-a-cup products have continued to perform well in this channel, as have breakfast shakes and our new launches in the cereal bar segment. Pringles also did well in the quarter and posted double-digit internal sales growth and share gains for the full year.

In foodservice, we renovated a significant number of SKUs in the K-through-12 schools business, where we posted double-digit sales growth as a result. In fact, the overall foodservice business outperformed the soft category due in part to good results from the Eggo brand.

Now let's turn to slide 19, which shows detail regarding the North America other segment. This segment, which includes the Canadian and U.S. frozen foods business, posted an internal sales decrease of 2.9% in the quarter against a double-digit growth comparison.

In the fourth quarter, internal net sales in the frozen foods business increased at a low single-digit rate, as we were lapping the most difficult comparisons of the year. You'll remember that we launched Special K Flatbread Sandwiches in the second half of last year, which contributed to the very strong double-digit sales growth we posted in both the fourth quarter and full-year 2012.

Our core Eggo business did well in the fourth quarter of 2013, as both the kid and family segments posted good grocer growth and we drove new brand building activities. Special K Flatbread Sandwiches benefited from the launch of a new Deluxe Egg and Cheese version in the second half, which also contributed. A new Bacon variety is going into the market now, and we expect that this and last year's innovation will both contribute to results in 2014.

We also saw double-digit growth in the burger segment of our MorningStar Farms portfolio and momentum in the poultry segment, driven by new product introductions in the middle of the year. It's worth noting we will take some SKUs out of the Kashi frozen foods portfolio in 2014, which will have an adverse impact on sales growth.

And our Canadian business ended the full year with a decline in internal sales of less than 1%. This was partially due to comps later in the year. But we also saw weakness in the cereal category throughout most of the year, much like in the U.S.

Now, let's turn to slide 20 and our international businesses. All of our international regions posted internal sales growth for the fourth quarter and for the full year. The European business posted good results in the fourth quarter, with internal sales growth of 1.2% and double-digit operating profit growth. Internal sales growth for the full year was 1.7%.

Pringles continued to post good results in the fourth quarter, as it has all year. Broader competitive conditions in both the UK and on the continent remain challenging. The cereal category in the UK continued to be difficult, although new Crunchy Nut Granola contributed to sales, and Crunchy Nut Rice Krispies and Corn Flakes all gained share. Special K will remain a focus for us in 2014 in the UK. And we have both new commercial plans and the introduction of Special K Granola coming during the year.

The Pringles business in the UK gained 1.7 points of share, as promotional pressure, good in-store execution, and strong commercial plans all contributed. We posted mid-single-digit growth in our European emerging markets, which include the Middle East and Russia, and we are pleased with results in these developing growth regions. However, southern Europe remains challenging.

So we had encouraging results in Europe in 2013. We saw good rates of growth in various businesses, and Pringles was a significant contributor. And we achieved the top and bottom line growth we expected. We have some good innovation and commercial plans coming, and we expect to post top and bottom line growth again this year. However, the environment in the region remains very difficult, and we believe we have pragmatic expectations for the business in 2014.

Slide 21 shows this year's performance in the Latin American region. Internal net sales growth was 3% in the fourth quarter against a 9% comparison in the fourth quarter of last year. The cereal category in Mexico has slowed somewhat, particularly in the adult oriented segment of the portfolio. Despite this, Kellogg gained 0.7 of a point of share in the most recent quarter of consumption data. The snack category saw declines in consumption in the latest data, but Kellogg again gained two points of share as a result of a mid-single-digit rate of sales growth. Also in the region, we saw good results in Brazil and in the Pringles business, which posted high single-digit internal sales growth.

Economic conditions continue to be difficult in Mexico, and the recently imposed tax on food and beverages could have a significant effect on sales in several key categories. Consumers were faced with a double-digit price increase on January 1. We expect that we will see more of an adverse impact in the first half of the year as consumers adjust to the new prices. And while we believe the team is planning appropriately, this and the continuing uncertainty in Venezuela will limit sales growth in 2014.

And finally on slide 22 is detail on the Asia-Pacific business. This segment posted internal sales growth of 4% in the fourth quarter and full-year growth of 3%. The Japanese, South Korean, Indian, Southeast Asian, and Pringles businesses all posted strong rates of growth in the quarter. In fact, the Asian business saw double-digit growth in the fourth quarter. Granola has continued to do well in Japan. Pringles gained share in many countries. And both Special K Cracker Chips and Biscuit Moments, both examples of innovation that have traveled from other regions, have done well in Australia.

The cereal category in Australia saw declines in consumption in the fourth quarter. We believe that category building activity will also help to drive this business, and we are currently formulating plans that we believe will begin to address this issue. However, we remain cautious on cereal in Australia as we go into 2014.

And now I'll open it up for questions before coming back with a brief summary.

Q&A

Operator

[Operator Instructions] Your first question comes from the line of Thilo Wrede. Your line is open.

<Q - Thilo Wrede>: John, you talked about you have plans to invest in desire, decide, delight. Where do you think is the biggest gap right now? Where is the biggest opportunity to really move the business? And what kind of steps are the most promising to tackle that?

<A - John A. Bryant>: Thilo, there are a couple ways of thinking about that question. I think the answer depends a little bit by business. So if we look at the cereal business, particularly in some of the large developed markets, I think it's primarily a desire opportunity, a category relevance opportunity. And so you'll see us investing back more in our developed cereal business in category building activities, category relevance activities in markets like the U.S., UK, Australia, and Canada. We'll also selectively invest back in delight. There is some food investment opportunities there as well.

If I go to the snacks business in the U.S., I think the opportunity in snacks is more in the decide phase. It's more about in-store execution. And so what you're seeing us do there is invest back into our U.S. sales organization, invest back into the DSD system specifically, and reduce the number of stores per route so our people can spend more time in-store and execute more effectively.

<Q - Thilo Wrede>: So on cereal, you're still not of the view that cereal in the U.S. is a structurally broken category?

<A - John A. Bryant>: No, absolutely not. In fact, if I step back and talk about the cereal category for a minute, I'll use the U.S. as an example. The breakfast occasion in the U.S. is actually still growing. If you look at a range of food items consumed at breakfast in the U.S. in home, it's actually up about 3% through the back part of last year. And in that context, cereal is the number one item consumed at breakfast and has a very high household penetration.

When we look at what's happening within cereal, we are losing people to other categories such as eggs, toast, peanut butter, yogurt, et cetera. We're not losing people to any one category in particular. And when we ask people why they are leaving, there's no one negative item. In fact, there's no real negative item. In fact, when we talk to consumers about why they're eating less cereal, we call it an unconscious migration because the answer we get is generally I didn't realize I was eating less cereal in a week.

So as we think about what we need to do on cereal, we need to tell our story more effectively about the benefits of eating cereal for breakfast. One way to think about that is to move our model from a focus on winning in the cereal category, brand versus brand within cereal, to winning with cereal at the breakfast occasion, and looking at the benefits and communicating the benefits of cereal to the consumers relative to some of the other alternatives at the broader breakfast occasion. Now the challenge for us to do that is to do that in a way that we own the outcome. We own the growth in the category. And we think we can do that by activating the strongest brand we have, which is the Kellogg brand. And to put that into context for you, Kellogg is the number one food CPG brand as ranked by Interbrand. So we have strong insights in messaging around the benefits of cereal using the Kellogg master brand, and you'll see more of that category building activity as we go through the middle of this year in some of these major cereal markets. And we believe we can absolutely win with cereal at the breakfast occasion.

<Q - Thilo Wrede>: All right, thank you.

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

Operator

Your next question comes from David Driscoll from Citi Research. Your line is open.

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

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

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

<Q - David C. Driscoll>: I wanted to ask. I've got two questions. The first one is on your inflation guidance. Can you guys just talk about – I think you said gross inflation of 3% to 4%, and I believe that would build on top of the 5% in 2013. Can you just discuss the key factors that are impacting gross inflation for Kellogg? And then I have a follow-up question I'd like to ask on snack bars.

<A - Ronald L. Dissinger>: Sure, David. On the gross inflation, so we're seeing inflation across a number of components of our cost of goods structure. First, we are seeing deflation in some of the key grains that you can see on the exchanges, but probably 80% of our material cost base we're still seeing inflation. Things like packaging and energy are inflating significantly. That's having an impact on our cost structure. In addition to that, we've got increases in some of our factory investment in wages as well. So when you wrap it all up, we're still seeing around 3% to 4% cost inflation. But remember, I said overall we are expecting to see net deflation because of our strong productivity improvement programs as well as some of the savings we get off Project K.

<Q - David C. Driscoll>: And then on the snack bars, John, the Nielsen data on snack bars looks pretty bad. Some of the time I see down mid-teens on snack bars. Number one, it's a grain-based product. Is it related to the issues in cereal? Is it related to a lack of focus on granola? Is it just you're zigging when you should have zagged or something like that? Why such extraordinarily negative results in a category that still looks like a good category?

<A - John A. Bryant>: I think we still believe the wholesome snacks business is absolutely a good category to be in. To be frank, we're disappointed by the performance of our wholesome snacks business. If we peel the onion back, Nutri-Grain and Rice Krispies Treats are actually still doing reasonably well in the category. We have some weakness specifically around Special K and FiberPlus. As I said in the prepared remarks, we need to focus back on the core within these wholesome snacks. And as we look at 2014, we expect this business to continue to be a challenge. But I think a big part for us to win in this business, strong innovation, brand building, and in-store execution. In particular in the area of in-store execution, I think we have an opportunity to reinvest back within our DSD organization and improve the execution in-store over time. So we have a good core business. We probably have some innovation in that business that hasn't stuck in the marketplace that's a bit of a drag on us. And we need to focus back on the core, improve some of the core food, and improve in-store execution as well.

<Q - David C. Driscoll>: John, just comment though on the interaction between the snack bar problems and the cereal problems. A lot of people ask me about carbohydrates. What's your opinion here on the issues, whether they are related?

<A - John A. Bryant>: I believe the wholesome snacks business, which we position largely as breakfast on the go, is still a category that can continue to grow as it meets the needs of consumers' more portable breakfast solutions. So I think of that one as a good category opportunity. I think with cereal, we just have a lot of different alternatives at the breakfast occasion. If you look at our share of voice, it's probably been declining over time at a category level relative to some of that competition. And we have an opportunity to sharpen our message and to increase our investment a little bit and drive the relevance of the cereal category back. So I see them as two distinct discussions.

<Q - David C. Driscoll>: Thank you.

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

Operator

Your next question comes from Matthew Grainger from Morgan Stanley. Your line is open.

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

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

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

<Q - Matthew C. Grainger>: Hi. As we look at the measured channel data for the cereal category, I understand you're investing across the breakfast opportunity trying to increase relevance. One of the things that I still find a little concerning is just the weakness. In a way, it seems to be concentrated in some of the core franchises and some of the more enduring brands within your portfolio like Special K, like Mini-Wheats. So on those brands in particular, are there specific issues of merchandising or innovation timing? Maybe you held back ahead of the Olympics activity. Or are you seeing anything, any broader pressure on those brands? And just on Special K in particular, also, if you could, address the protein line extension and whether that's proven to be incremental or not to the overall brand.

<A - John A. Bryant>: Thank you, Matthew. So I think if you look at brands like Mini-Wheats, we're actually seeing that brand strengthen over time. And if you look at brands like Raisin Bran, we're actually seeing good growth when we get behind a Healthy Dividends type messaging. So when we have clear insights, good messaging, we can absolutely drive these businesses. And I think if you're looking within some of the more recent consumption data, say some of the published data in January, I think you are seeing some timing of activity between our Olympics activity, which is more February, and our share of breakfast activity, which is March as opposed to January.

What I will say in January on Special K specifically is we did not have as strong a resolution event as we would have hoped, and there is some short-term softness in Special K as a result in January. There is a broader macro trend against some of these weight measurements type propositions, not just Special K and cereal but some other similar propositions in other categories, and there is some general softness in that. Special K remains a very strong brand. I think we need to re-amp the messaging and find another angle with consumers. We have some work to do on Special K in general. And I think that is part of the weakness we're seeing in the category, not just the U.S. but some of our other developed markets.

<Q - Matthew C. Grainger>: Okay, that's helpful. Thank you, John.

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

Operator

Your next question comes from Robert Moskow from Credit Suisse. Your line is open.

<Q - Robert B. Moskow>: This is a question about cereal again. Did you consider, John, making a deeper investment this year to try to rebound, to help the category rebound? When I look at how much you're actually spending incrementally, it really isn't that much. It sounds like it's more a shift in resources to more umbrella advertising for the Kellogg brand, a master brand strategy. Is that going to be enough? Did you consider making a bigger investment?

And then secondly on master brand advertising, I've seen the attitude towards that wax and wane in consumer packaged foods. Campbell tried it and then shifted right back again. What makes you think that master brand can really work this time?

<A - John A. Bryant>: Rob, we have not really activated Kellogg for a very long period of time. It's a very strong brand, so we're very confident that that brand has the capability of engaging consumers back into the category in a way that we can uniquely own. At the same time, being pragmatic, we haven't had these programs in market yet. So to your question about whether we would double or triple-down on the investment, I think we want to see it work before we drive a large amount of investment into it.

And it's important to remember, to your point, that while we are adding more brand building, we spend $1.5 billion a year on brand building. We have a lot of brand building fuel in the engine. And if we find these programs really drive the business, we'll probably reorient the money we already have as opposed to have to add all-new money into the category.

<Q - Robert B. Moskow>: Okay, I'll leave it there. Thank you.

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

Operator

Your next question comes from Ken Goldman from JPMorgan. Your line is open.

<Q - Kenneth B. Goldman>: Hi, thank you for question. I'm interested in the thinking behind excluding upfront costs. Kellogg used to openly pride itself on keeping these costs in. They were a normal part of doing business. But now this thinking has been reversed, and I'm not sure why other than to frankly optically drive EPS higher. My question is this. If these are ongoing costs and they happen every year and they've been similar in EPS impact most years, why should we exclude them? What's different about these upfront costs than the investments every food company does each quarter?

<A - Ronald L. Dissinger>: Ken, as you saw within the information that we shared on our guidance, we clearly stated the amount of upfront cost change in 2013 and added that back before we grew the 1% to 3% in terms of our guidance. We think it's simpler. Rather than trying to dissect our investments in upfront costs between base upfront costs and Project K, we think it's simpler and cleaner to just bundle everything together over the life of Project K and exclude them from our underlying results. So there's really nothing more than that. We do still have a small element of base upfront costs that we're including in our total project investment so that we can drive additional productivity investments and savings in the 3% to 4% base productivity that we strive to achieve each year.

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

Operator

Your next question comes from John Baumgartner from Wells Fargo. Your line is open.

<Q - John J. Baumgartner>: Thanks, good morning. John, when you speak to the investment in your DSD system going forward and I guess some of the technology there, are there certain competitive deficiencies that you've noticed in terms of technology or execution? Is it part of the normal replacement cycle, just any thoughts there in terms of your observations on DSD either in isolation or versus your competitors? Thanks.

<A - John A. Bryant>: John, as we look at our DSD business, we think we have the ability to be more effective by providing them with new tools. So we have new iPad type based programs, applications to help them be more effective in-store. In addition to that, we are reducing the coverage rate, so going from each route being about 18 stores down to 12 stores. It's a pretty meaningful move there.

In terms of our competitive position, we have as, quite frankly, the Mondel■z split from Kraft has occurred, that large sales organization is focused on a much smaller part of business, and that has been a competitive headwind for us. We're looking to ensure that we have the right resources in-store to drive our business forward.

<Q - John J. Baumgartner>: Thanks, John.

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

Operator

Your next question comes from Andrew Lazar from Barclays. Your line is open.

<Q - Andrew Lazar>: Good morning.

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

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

<Q - Andrew Lazar>: Just to follow up on the last comment, John, you reduced the cover or improved the coverage rate. I guess my question is inherently it makes sense. But how do you do that in I guess a cost effective way? Because obviously just the overall scale of your DSD business versus that of Mondel■z, I would assume makes the DSD system a pretty fixed cost intensive system that much tougher to start with, let alone the scale differential. So I'm trying to get a sense of how you do that, or does that just hit margins for a period of time here or reset the margin base?

And then secondly, I'm just curious, and this is probably better asked to others. Do you get a feeling that other players or player in the U.S. cereal category will also try and activate or help restimulate the category as a whole as opposed to again just the specific brand-versus-brand type of stuff, just from what you may see in the industry?

<A - John A. Bryant>: Andrew, first on the snacks investment, the investment is actually not as large as it might sound. We spend a lot of money getting the product to the store, and then we just need to add a little bit more resources activating it actually in the store itself. So it's not as significant an investment as it might sound in terms of reducing the store coverage, as I said earlier. It is, however, important for us to win in-store to ensure that we have the resources in place to build the displays and to get the activation going.

On cereal, we're focused on driving our business, which will drive the category. I believe the dynamics we're seeing in the cereal category holds true for us as it does for other manufacturers. As we look over time, what drives this category is health and wellness, brand building, great food. And we're focused on driving the business in a sustainable way that will grow the category. I can't talk to how other manufacturers will react or what their plans will be. But I believe if you look back over time, this is a very consistent message in terms of what has driven the category historically.

<Q - Andrew Lazar>: Thanks, John.

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

Operator

Your next question comes from Eric Katzman from Deutsche Bank. Your line is open.

<Q - Eric R. Katzman>: Good morning, thank you.

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

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

<Q - Eric R. Katzman>: I'll – just let me get on a soapbox for one second. I disagree with Ken. I think everybody else has been – most companies, Hershey, others have been excluding tons of charges. And so I think it's perfectly reasonable for you to – ultimately, it's what the cash cost is, not what the earnings is. So I don't have a problem with that.

But looking at your 2014, and I recognize that things are challenging and it's a transition year. But it sounds like the $0.08 of upfront and the $0.08 of the 53rd week plus you're going to be doing more buybacks of 1.5 points, so is net income actually down here for the year ex-currency, assuming that still is neutral?

<A - Ronald L. Dissinger>: Let me walk you through our guidance, Eric. First of all, we said approximately a point in terms of our sales growth. So that's driving call it around $60 million worth of profit accretion. And then we also said we have a little bit of net deflation. It's a little less than a point, and that includes Project K savings that's driving our gross margin expansion. That's probably $60 million or so, also a profit increase. From there, we're investing back in brand building at a rate faster than sales, and advertising also at a rate faster than sales. And then John has been talking about the investing in capability, the sales execution, the category teams that we put in place, and some investment in R&D as well. And we've got a little more than a point, as I said, on incentive compensation headwind. We are growing operating profit, and net income is relatively flat as a result of the share repurchase program.

So when you move to earnings per share going from flat to up 2% on operating profit to up 1% to up 3%, we're getting about 1.5 points to two points accretion related to the share repurchase program. And then we do have a little bit of headwind from tax expense. We had a lower tax rate in 2013 versus what we're expecting in 2014. So we're basically getting about a point of accretion, the low operating profit really attributable to our share repurchase program.

<Q - Eric R. Katzman>: Okay. And then on a more – I guess just an operations standpoint, can you remind me of what is on the DSD truck in terms of your brand now? And is there any consideration of what's going to shift? Obviously, Pop Tarts is doing well on its own, and that hasn't been on the truck. But is there shifts in what you're going to put through warehouse versus what's on the truck as part of this efficiency move?

<A - John A. Bryant>: So, Eric, we have three big businesses that go through the DSD system. There's crackers, cookies, wholesome snacks. We have a fourth segment which is part of our snacks business, which is Pringles, which goes warehouse. To answer your question, we have no plans to change that dramatically. We have a tremendous DSD system. It's an incredible execution machine and it has great ability to drive the cookie, cracker, and wholesome snacks business. We just need to invest a little bit back behind that system and ensure it's set up for success.

<Q - Eric R. Katzman>: Okay, I'll pass it on. Thank you.

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

Operator

The next question comes from the line of Jason English from Goldman Sachs. Your line is open.

<Q - Varun S. Gokarn>: Good morning, it's Varun Gokarn in for Jason. My question is on cereal. You mentioned focused advertising that communicates the benefits of cereal as an overall category. But much of the recent market share weakness that your brand is seeing has to do with promotional intensity from your primary competitor which, at least in the Nielsen data that we're looking at, you're not currently matching. So when you talk about reinvestment, how do you balance the need for tactical pricing adjustments versus advertising on the overall category versus innovation? Thanks.

<A - John A. Bryant>: If you sit back and look at the cereal category, it's always an intensively competitive category. And I don't believe it's any more competitive today or any less than it has been historically, so I think the category is fundamentally rational. When you look at what drives this category, again, it's health and wellness, brand building, innovation, great food. It's not constantly driving down prices. Empirically, you go back to 1996 and 2010 when prices came down, the category did not grow. So we are focused on driving our business the right way. We are and will remain competitive in the category. And what you see from time to time is the actual ebbs and flows of competitive activity. So for example, we have a little bit less activity out there in January relative to January last year, but we have a strong Olympics program in February. So I'm not sure what data specifically you're looking at, but be careful not to overreact to short-term movements in data for one month to the next in the category.

<Q - Varun S. Gokarn>: Okay, great. Thanks, I'll pass it on.

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

Operator

The next question comes from Alexia Howard from Sanford Bernstein. Your line is open.

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

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

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

<Q - Alexia Jane Howard>: Hi, so there has been some commentary about millennials being less loyal to big established brands than older consumers. I'm thinking specifically in snack bars. We're seeing the rise of some niche brands in there, which is a reversal of previous trends over the last several years. Does that make it harder for Kellogg to gain share over time? And would you consider acquiring some of those niche brands to bolster growth over time and shift the portfolio into faster growing products? Thank you.

<A - John A. Bryant>: So, Alexia, I think we would look at that from all angles. Firstly, if there is something that is interesting to acquire, as you've seen in the past, we have done that. I think also, as I said before, in the desire-decide-delight continuum, we have an opportunity to invest some more money back on the delight side; in other words, invest more money back into the food. I think what you're seeing sometimes from millennials is not so much a lack of brand loyalty as they're looking for different food values, and some of the pre-existing businesses don't always meet their needs. And so within our portfolio, we need to have choice. We have some great brands in the portfolio that do lean towards those millennials. I think in most brands, we need to ensure the food really is meeting their requirements.

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

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

<A - Simon D. Burton>: Michelle, we have time for maybe one more question.

Operator

Okay. Your final question will come from Chris Growe from Stifel. Your line is open. Mr. Growe, your line is open.

<Q - Christopher R. Growe>: Can you hear me okay?

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

<Q - Christopher R. Growe>: Okay, thank you for the time and for the call. I had a question for you, John, in relation to your revenue growth in 2014. I guess as a global comment, do you expect cereal sales to grow? Maybe I'm just trying to get at the balance between cereal and snacks growth in 2014 and maybe how those investments could benefit the cereal category throughout the year.

<A - John A. Bryant>: We will have elements of cereal growth throughout the year. So as I said, for example, in Asia-Pacific we're seeing good growth outside of a market like Australia. As we think about the big developed cereal markets, which is where we have our challenges right now, I think for very similar, consistent reasons, we need to talk more about the nutritional benefits of cereal to our consumers in those markets.

While I'm excited about the plans we have for 2014, as we set the guidance we've set, we're going to be pragmatic, though I expect those categories and quite frankly ourselves in those categories to be down year on year slightly, low single digits. Because those big developed markets are such a big percentage of the cereal business, that means there's going to be a drag on our cereal sales in the year.

Obviously, we're driving to have a better performance in U.S. snacks in 2014. And we are having tremendous success with Pringles, which will continue to help drive our snacks business as well as some of the wholesome snacks offerings we have globally. So I do expect a better performance out of the snacks business than the cereal business in 2014. Long term, I'm very confident in the potential growth of the cereal category and our cereal business, but I think it's best to be pragmatic as we look in 2014 around that business specifically.

<Q - Christopher R. Growe>: And just to follow on that, as you talk about these investments in the category and in the category the important aspects of the category to the consumer, is that happening now, or is that more about in the future as you get these savings coming through? are you bringing that message to the consumer now is my question.

<A - John A. Bryant>: It's really more Q2 – Q3 of 2014, and that's not due to savings. That's just when the programs are ready and the best time to put them into the year given other calendar events. For example, the Olympics are sitting right in February. So we need separation between activation so we don't submerge and confuse the message to consumers.

<Q - Christopher R. Growe>: Okay, thanks very much.

John A. Bryant

Great, thank you, Chris.

And now if I could take a moment to make some concluding remarks, first, thank you, everyone, for joining us today. We face a difficult environment in 2013 in developed regions, and we expect this will continue in 2014. However, as we have highlighted today, we have plans to address this. In fact, over the last couple of years, we've made significant strides with our broader strategy, which hasn't changed. And the plans we've talked about today fit in well with this strategy. We improved our supply chain organization. We completed the successful acquisition of Pringles, which has exceeded our expectations and has provided us with a global snacks platform. We announced and started to implement Project K, a four-year efficiency and effectiveness program and the largest in the company's history. And we're developing and investing in ideas that will drive growth in the future.

We recognize the challenges that we have, and we're taking meaningful actions that will begin to address them. This will be a journey and it will require a lot of work. I'm sure we're making the right decisions now to drive growth in the future. And as we continue this journey, I'd again like to say thank you to all the Kellogg employees around the world. They will make all the difference, and it's their hard work that will drive our success. Thank you.

Simon D. Burton

Okay. Thanks, everybody, for joining us today. We'll be available for follow-up as you need us. Thanks.

Operator

Thank you, everyone. This concludes today's conference call. You may now disconnect.