

Company Name: Kellogg
Company Ticker: K US
Date: 2013-08-01
Event Description: Q2 2013 Earnings Call

Market Cap: 24,059.78
Current PX: 65.42
YTD Change(\$): +9.57
YTD Change(%): +17.135

Bloomberg Estimates - EPS
Current Quarter: 0.983
Current Year: 3.825
Bloomberg Estimates - Sales
Current Quarter: 3801.333
Current Year: 15050.000

Q2 2013 Earnings Call

Company Participants

- Simon D. Burton
- John A. Bryant
- Ronald L. Dissinger
- Paul T. Norman

Other Participants

- David C. Driscoll
- Bryan D. Spillane
- Robert B. Moskow
- Eric R. Katzman
- Andrew Lazar
- Christopher R. Growe
- Jason English
- Ken B. Goldman
- Lucia von Reusner

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Second 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 period. [Operator Instructions] We please ask that you limit yourself to one question during the Q&A session. Please note, this event is being recorded. Thank you.

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

Simon D. Burton

Great. Thank you, Mike. Good morning, and thank you, everyone, for joining us today for a review of our second quarter 2013 results. I'm joined here today by John Bryant, President and CEO; Ron Dissinger, Chief Financial Officer; and Paul Norman, President of Kellogg International, who has been primarily focused on stabilizing and turning around our European business over the last year. The press release and slides that support our remarks this morning are posted on our website at www.kelloggcompany.com.

As you're aware, certain statements made today such as projections for Kellogg Company's future performance, including earnings per share, net sales, margin, operating profit, interest expense, tax rate, cash flow, brand building, up-front costs, investments and inflation are forward-looking statements. Actual results could be materially different from those projected. 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.

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As a reminder, a replay of today's conference call will be available by phone through Monday, August 5. The call will also be available via webcast, which will be archived for 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've seen, today we announced the results for the second quarter, which is the final quarter that we will be affected by comparisons to periods before we owned Pringles. Results met our expectations for both operating profit and earnings in the quarter. Underlying reported operating profit increased by 11% and underlying internal operating profit increased by 3.4%.

However, sales growth was slower than we expected. As you've seen in recent public consumption data, some of the larger categories in which we compete, particularly in the U.S. saw lower rates of growth in the quarter. We continue to expect good rates of long-term growth from our categories. But we recognize the short-term weakness that we've seen and have taken a pragmatic approach with guidance. We just launched increased levels in innovation that will add to results in the second half, and we're increasing rates of advertising, particularly in the third quarter.

So, we expect improvement but realize that it could be at a slower process through the balance of the year than we originally expected. We are on track to achieve our guidance for currency neutral earnings per share as a result of continued good performance from Pringles, and the work we've been going on our cost base. This will allow us to cover the impact of the sales outlook, while continuing to invest in the future growth of the business. This is important as we continue to focus on our margins and plan for further investment in the future.

Let's turn to slide 4 and a quick update on the Pringles acquisition. As you know, we've now owned Pringles for more than a year, so our third quarter 2013 results will be lapping [indiscernible] (03:45) full quarter of ownership last year. We've made great progress with the integration. The transition service agreement that we had with Procter & Gamble have now all ended and the business is operating on Kellogg systems. This was a major initiative as this acquisition was a carve-out, which required us to quickly integrate the business into our structure.

The entire organization, including the Kellogg business units, the new employees that joined us from Pringles and the transition team, have all done a great job. Thanks, too, to P&G for all their help throughout the transition.

Reported global sales increased at a low single-digit rate in Q2, reflecting a difficult comparison due to pre-closed adjustments in the second quarter of last year. However, we saw good underlying rates of consumption growth. For example, consumption in the U.S. increased by approximately 7% in the quarter. And, as you know, the business has continued to run smoothly all year.

Our sales and marketing execution has been good and the sales growth we've seen has exceeded our expectations. We saw more accretion than we originally anticipated in the first half and we're tracking for the higher end of our synergy range for the full year. This is great brand with untapped potential. We are increasing innovation and investing in capacity and we have visibility into improving margins over time.

So, I'd just like to thank everyone involved in the acquisition and the transition for all their hard work.

And now, I'll turn it over to Ron for a discussion of our financial results.

Ronald L. Dissinger

Thanks, John, and good morning everyone. Slide 5 is a recap of our performance for the quarter and year-to-date. Reported sales growth was 6.9% and internal sales declined by half a point. We have owned Pringles from June 1, 2012, so Pringles adds the benefit of two months of sales and profits to our reported results.

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We saw some weakness in several segments in the U.S., and trade inventory declined in several regions around the world. But we had solid results in Latin America, Asia Pacific, and in Frozen Foods and Specialty in the U.S.

Underlying reported operating profit increased by 10.9%, which included a benefit from lower Pringles' integration costs. Underlying internal operating profit, which excludes the impact of the acquisition of Pringles, increased by 3.4% as we expected and included the impact of cost inflation, net of productivity in our supply chain, as well as effective management of costs and some timing in SG&A.

And finally, comparable earnings per share, which excludes integration costs, was \$1, in line with our expectations. Comparable growth was 5.3% and this included a \$0.02 adverse impact from currencies.

Slide 6 shows the components of the quarter's 6.9% reported sales growth. Internal volume declined 1.6%, with nearly one-half of the decline being driven by trade inventory reductions in the U.S., France and Mexico. It's worth noting that we saw a good volume growth in our Asia Pacific region, and we did see price/mix improvement in the quarter across most of the regions. Of course, Pringles is a primary driver of the 7.9 points of growth related to acquisitions in the second quarter.

While we expect that our innovation will contribute to results in the second half of the year, we do expect that sales growth will continue to be a bit slower for the balance of the year than we originally anticipated. I'll provide more detail regarding our outlook later. Finally, currency translation reduced sales growth by half a point in the quarter.

Slide 7 shows the shape of the net inflation we'll see this year and it's a slide that we showed you last quarter. You'll remember that we've recognized net cost inflation in the first half of the year, and as you can see in the chart, we continue to expect net deflation in the second half of the year, which should provide a benefit to our gross margins. We have better visibility into our cost structure for the balance of the year and now expect a small amount of net inflation in the third quarter and then net deflation in the fourth quarter.

The slower sales growth we've seen so far this year has led to reduced operating leverage. We saw the impact of this in the second quarter and expect it to have an impact on margins in the second half of the year, particularly in the third quarter.

In the second quarter, our underlying reported gross margin declined by 140 basis points. Of this, approximately 50 basis points was due to the impact of the Pringles acquisition and approximately 90 basis points was due to the impact of net inflation, operating leverage and some country and product mix.

Slide 8 highlights some of the brand building activity we have planned for the second half of the year. Obviously, this is just a small sample, but it highlights the breadth of activity we expect in the business.

As you know, we launched a significant amount of innovation around mid-year, and we will support these products over the balance of 2013 with strong support planned for the third quarter. As we've mentioned a few times over the past year, we have been doing a lot of work increasing the efficiency of our investment in brand building. This work continued in the second quarter, and we have seen encouraging results.

This work included savings in working media, through mix improvements, digital purchasing, negotiations and moves to pan-regional purchasing. We have also realized savings in non-working media by leveraging copy across multiple markets where practical.

And in addition, we've done a lot of work with consumer promotions around the world. As a result, we expect that advertising will be up in the second half and flat to up for the full year despite the savings that I've mentioned.

Now let's turn to slide 9, which shows quarterly internal operating profit performance for each of the regions. Overall, total company underlying internal operating profit growth of 3.4% was broadly in line with our expectations. And underlying operating margins were solid at 15.5%, up more than 50 basis points from last year. North America's internal operating profit increased by 3.2%, a sequential improvement from the first quarter. We saw good cost discipline and we benefited from Pringles synergies. The Morning Foods, Specialty and North America Other segment, which includes Frozen Foods and Canada, all posted operating profit growth. Operating profit in the Snacks business

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was flat due to sales performance.

We have a stronger innovation pipeline and increased advertising planned for the second half of the year in North America, although, we do expect the environment to remain challenging. Internal operating profit grew by 1.8% in Europe and included a mid single-digit increase in advertising. The restaging of Special K across Europe that we've spoken about before began in the UK and Northern Europe at the end of the second quarter. And we've seen early signs of improvement.

Internal operating profit in Latin America decreased by 8.3% in the quarter, due to significant commodity inflation and the impact from reductions in retailer inventories. Much of this is behind us, so we expect improved performance in Latin America across the second half of the year. And in Asia Pacific, we saw an increase in internal operating profit of 11.3%. Growth was driven by solid sales across key businesses and included increased levels of advertising.

Slide 10 provides detail of our year-to-date cash flow performance. Cash flow from operations before capital spending was \$705 million in the first half of the year. This was an increase of \$25 million from the first half of last year. And remember, we benefited last year from the structure of the Pringles transaction with the addition of approximately \$100 million of cash flow in the second quarter of 2012. Capital spending was \$238 million, an increase of \$83 million over the first half of last year and in line with our plan.

We still expect to spend slightly more than 4% of sales for the full year. And we have now repurchased more than \$500 million of shares so far this year. We still expect to repurchase shares in line with proceeds from options for the full year. Our share repurchases in the first quarter were well below options proceeds. And while we are currently tracking ahead of proceeds for the year-to-date period, we expect that this will balance out as we progress through the second half.

Now let's look at slide 11, which shows our guidance for 2013. Due to the slower sales growth we saw in the second quarter, expectations for the remainder of the year and increased currency headwinds, we now expect that reported sales growth will be approximately 5%, 2 points lower than our original guidance. The decline in sales growth is split evenly – 1 point from currency and 1 point from internal growth expectations.

While our underlying reported earnings per share has come down by 2 points, our currency neutral earnings per share is consistent with original guidance. We have been able to manage the 1-point of internal sales shortfall through improved performance from Pringles and disciplined cost management.

We haven't changed our estimate for full-year cost inflation at approximately 5% and cost savings of around 4%. But inflation is a little lower and savings are slightly higher. And as I mentioned, we still expect to see net deflation in the second half as a result of lower cost pressures and slightly higher cost savings.

We now expect the gross margin for the full year will be down 75 basis points to 100 basis points, a change from our original guidance of down 50 basis points. Pringles is still contributing approximately 50 basis points to the decline due to the lower margin structure.

Slide 12 shows more detail regarding our full-year earnings per share guidance. Previously, we gave guidance for underlying earnings per share growth of between 5% and 7%. This included a \$0.02 negative impact from currency. We always expected currency neutral earnings per share growth, excluding integration costs to be between 6% and 9% or \$3.84 to \$3.93 per share and that has not changed. However, over the course of the last quarter, currencies have moved against us more significantly. This means that instead of a full-year negative impact of \$0.02, we now expect the impact to be \$0.09. Our guidance for reported earnings per share has gone from 5% to 7% growth to 3% to 5% growth. This change is completely due to the \$0.07 extra headwind in currencies. Obviously, currency translation will remain volatile, so we'll update you regarding the effect as the year progresses.

Now, let's go to slide 13 and some additional detail on our guidance. As we mentioned last quarter, we expected that estimates for the full-year tax rate might improve and that has been the case. We now expect that the full-year tax rate will be between 29% and 30%. We continue to expect that interest expense will be between \$230 million and \$240 million. We still expect annual cash flow to be between \$1.1 billion and \$1.2 billion, and total capital spending to be

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slightly more than 4% of sales.

In the second half, we have increased innovation, more advertising and Pringles will be included in the base. As for the phasing of earnings over the remainder of the year, we expect reported earnings per share, including the impact of currency, but excluding integration costs, to be roughly equal in the third and fourth quarters. Our current expectations are that integration costs and the impact to currencies will be approximately balanced between the third and fourth quarters.

As has been the case all year, our guidance for comparable operating profit and earnings per share excludes the impact of adjustments from mark-to-market. And finally on Pringles, we continue to expect that integration costs will be between \$0.12 and \$0.14 per share. But synergies will be toward the high end of our \$50 million to \$75 million range for the year.

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

John A. Bryant

Thanks, Ron. Slide 14 shows the internal net sales growth posted by Kellogg North America. As we mentioned, performance was mixed in the quarter.

Let's look at the segments in more detail starting with slide 15 in the U.S. Morning Foods business. Growth in the cereal category in second quarter was disappointing. Although, we did expect it to be challenging given the timing of innovation, scheduled for launch at midyear and the need for additional activity.

Special K saw a consumption growth of approximately 2% in the quarter, as a result of growth posted by Special K Protein, which we re-launched in the second half of last year, and Special K Chocolate Strawberry, which launched this year.

Frosted Flakes continued to perform well as did Raisin Bran. We saw a high single-digit consumption growth as a result of our recent healthy dividends campaign. Healthy dividends is targeted at adult health-conscious consumers and focuses on bringing boomers into the cereal category. For example, the campaign highlights the benefits that come from a balanced diet, including cereal and a healthy lifestyle.

As I mentioned last quarter, we've seen some weakness in the adult cereal segment. In addition to the healthy dividends campaign, we also have innovation that will help to address this, including Raisin Bran containing Omega-3, Kashi Chia Heart-to-Heart and multigrain Special K. Special K is a great brand that travels well around the world.

So, in addition to all the activity I've mentioned, we've also just launched Special K Nourish Hot Cereals in the U.S. And as you'll hear from Paul, we're also launching hot cereals in Europe. In the U.S., we have launched three varieties, which are a healthy blend of oats and grains, including quinoa. They also include inclusions such as cranberries, which you add after preparation. We've only just introduced these cereals, but acceptance has been good and we have activity planned for the fall.

We've also launched Kellogg's breakfast beverages and they're off to an encouraging start. [ph] BCD (20:59) is good and brand building has started. Obviously, it's early, but we're optimistic that these will be successful and will generate a meaningful amount of incremental sales growth.

Finally, Pop-Tarts had an excellent quarter. Consumption increased at a mid single-digit rate. We introduced two kinds of peanut butter Pop-Tarts in May, and again, although it's early, both are exceeding our expectations.

Now let's turn to slide 16, which shows the internal net sales performance of the U.S. Snacks segment. The segment posted an internal sales decline on the most difficult comparison of the year. Internal sales in the cracker business were down slightly, partially because we were lapping very strong growth with Special K Cracker Chips last year. However, we've seen improvement in distribution and quality merchandising in the business in recent weeks, and the innovation we launched around midyear is off to a good start. Cheez-It Zingz and TownHouse Pita are both getting good rates of

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trial, and we're selling all the crackers in our new cup packaging that we can make.

The cookie business also declined in the quarter. Again, the innovations we've just launched including Keebler Simply Made cookies, Jumbo Fudge Shoppe and cookies in a cup are all off to a good start. And the decline we saw in the wholesome snacks business was at least partially due to the strong 7% sales growth posted last year. We did see some good growth this quarter from Special K Pastry Crisps and new Nutri-Grain Crunch Bars also contributed.

Our Pringles business saw good consumption growth of approximately 7% in the quarter, which outpaced the category's growth and we gained share as a result. The core grew and our Pringles Stix innovation also added to the results. We've got good activity planned for the second half and more innovation planned for introduction toward the end of the year.

We always knew the second quarter would be a difficult one for the Snacks business. We've got innovations that just launched and more coming. This, in combination with additional support and Pringles now being included in internal sales growth, should help results in the second half. Of course, it will continue to be a difficult environment, and we continue to expect that improvement will take some time.

Slide 17 shows a net sales performance of the U.S. Specialty segment. We posted internal net sales growth of 1.9% in the second quarter. We posted good results in the convenience channel, driven by cereal in a cup and our 5 SKUs of Special K Cracker Chips in single-serve packs, which are doing very well. We've just launched Special K Nourish Bars in this channel and have more innovation planned for later in the year.

In addition, our food service business has good plans for the second half of the year and we're optimistic that the Specialty Channels business as a whole will improve over the balance of the year. Finally, Pringles, which has done very well in these channels since the acquisition, continued to post growth in the quarter and our expectations are for continued good performance in the second half.

Slide 18 shows detail regarding the North America Other segment, which includes the Canadian and U.S. Frozen Food businesses. The segment posted 3.9% internal sales growth in the quarter. In Canada, we've seen some good results from innovation, including share gains in the Frozen category, as a result of the launch of Special K Flatbread Sandwiches and Eggo Minis Waffles, growth in crackers due to the introduction of Special K Cracker Chips and good early performance from breakfast beverages.

We saw high single-digit internal sales growth in the Frozen Foods business in the quarter. We saw good volume growth in the Frozen Breakfast business and also posted gains in price/mix. Growth in the Frozen Breakfast business was driven by the continued success of the Special K Flatbread Sandwiches and we've got a new version being introduced later this year.

Now, let's move to the International business. As you know, we've had a difficult start to 2012 in Europe. We've been doing a lot of work over the last year to stabilize the business and we saw growth at the end of last year and early this year.

So now, I'll turn it over to Paul Norman to provide more color regarding our plans for the European business.

Paul T. Norman

Thanks, John, and good morning, everyone. Back in November at Day at K, we discussed some of the issues affecting performance in Europe over the past few years and we shared our strategy to change all that, highlighting three key where to play choices: one, sustainably grow cereal in and beyond the bowl; two, explosively grow snacks, and three, accelerate growth in select emerging markets. To win, we said we would need to operate differently by designing the scale, by developing and executing ideas at a pan-European level.

Finally, to enable this we needed to reorganize the way we worked. The acquisition of Pringles provided the catalyst for us to do so. Several months on, and Pringles is now integrated. The region is organized around two category hubs, namely cereal and snacks, and we are bringing pan-European ideas to market in cereal, in and beyond the bowl, and in

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snacks, as well as increasing levels of investment in key emerging markets. Our overall rate of innovation will increase significantly in 2013 and we have good visibility to 2014 and beyond. I would like to run quickly through a few slides on key initiatives coming in the back half of 2013.

Let's start with cereal on slide 20. In the second half, we will be looking to drive momentum behind key adult brands. On Crunchy Nut Corn Flakes, our leading taste brand in the UK, we will accelerate momentum via new advertising from the proven, 'the trouble is they taste too good' campaign, as well as with innovation in the form of the recently launched Glorious Oat Granola, and soon to be launched Chocolate Curls variety.

In France and Italy, the Extra brand will benefit from an all-new advertising campaign backed by significant year-on-year increases in investment.

Finally, in the UK, Spain and the Nordic region, we will be launching the 5 Day Challenge on All-Bran, offering consumers faster, more effective relief from digestive discomfort.

Moving on to slide 21, we will also continue to reinvigorate our largest brand, Special K. As you know, we launched renovated base-food including whole grain and fiber in recent quarters. And this rollout continues in more countries, as we speak. We are expanding our presence within the cereal category to hot cereal.

With the launch of Special K Multi-Grain Porridge coming to selected countries in September. A differentiated food offering in three varieties and two different packaging formats, we feel confident we will attract new users to the Special K brand over the coming months. As 2014 comes, we will be expanding further into additional formats in various parts of the region with the Special K brand; more to come on this, soon.

Moving to slide 22. Our aim is also to compete more broadly in breakfast beyond the bowl. As a result, we are just launching on the continent a full range of new Nutri-Grain handheld breakfast solutions. We recognize that sometimes consumers don't have time for a bowl of cereal and milk. That's why we develop foods that provide the benefits of cereal in a portable and convenient format that better meets their needs. These are delicious, toastable and dunkable whole grain foods designed to better fit the local breakfast occasion. The range will include Breakfast Biscuits, but also unique new-to-market propositions too, including toastable pastries.

Now let's talk Snacks on slide 23. First up is Pringles, where things continue to go well. Following another quarter of mid single-digit consumption growth, driven by some great in-store focus from our local sales teams, selected innovations like the [ph] Xtra subline (29:36) and continued geographic expansion in emerging markets, we feel good about the future.

We're adding capacity in 2014 to further fuel the brand, in terms of growth in existing geographies and in new ones and to enable a strong pipeline of innovation that you will hear more about in the coming months.

Moving slide 24 on Special K snacks and an update on a couple of key pan-European initiatives. Firstly, Biscuit Moments, which is we launched in the UK last year and now can be found across the region in 2013. This is a great example of an idea designed and delivered consistently across the region. And it's an idea that has worked in other regions too. For example, this idea was launched in the U.S. under the Special K Pastry Crisps brand and has been doing very well. Another example is Special K Cracker Crisps, which are shown on slide 25 and which will rollout across the region later this year. These are similar to the Special K Cracker Chips, you will know in the U.S. This idea has obviously been successful and has now traveled to Europe, but has also now been launched in Canada, Mexico and soon in Australia too.

So, when you put it all together on slide 26, you will see a good cross section of activity in and beyond the bowl of breakfast and an exciting set of initiatives across snacks to accelerate growth. And all of this is being done with the benefits of scale both in development and delivery.

To close, I've pulled back my summary slide from Day at K last year in November. We continue to transform our company in Europe into a Cereal and a Snacking company, leveraging ideas with scale across the region by operating differently. Change takes time and effort, and I would like to recognize the entire team in Europe for what they're doing to make it happen and bring our strategy to life.

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

John A. Bryant

Thanks, Paul. Now let's turn to slide 28 and our other International businesses. Internal net sales increased by 4.1% in Asia Pacific in the second quarter, driven by strong volume growth. The Australian business contributed to this growth as the breakfast drinks we launched last year continued to do well. Nutri-Grain, our core cereal brand in Australia, gained category share in the quarter, and we've got more innovation planned for introduction in Australia including Special K Cracker Chips, which is similar to the ones you know in the U.S.

In Asia, we saw good growth in India, Southeast Asia and South Africa. South Africa posted double-digit net sales growth as a Corn Flakes brand including Corn Flakes Porridge did very well. We also saw double-digit growth in India due to strong growth from Chocos, Muesli and the Special K brand. And Pringles also posted mid single-digit sales growth in the quarter driven by both volume growth and price realization.

The Latin American business posted 5% internal sales growth, although, this included some unusual items, including a reduction of trade inventories that I've mentioned before. Without these items, both sales and operating profit growth would have been much higher. The economic environment in Mexico remains difficult as cereal consumption growth remains good. We've had some recent gains in distribution, and we've got some innovation that's working well. And we've got more plans for introduction before the end of the year. We also saw growth in Brazil, the Andean region, Venezuela and Chile. And Pringles also did well in the quarter exceeding our expectations.

Now let's turn to slide 29 and the summary. We made our goals for operating profit and earnings in the second quarter. We have better plans for the second half, including more innovation and increased levels of advertising. However, we recognize that the difficult environment we saw in the first half will continue through the balance of the year. We have completed the majority of the Pringles integration and the business is performing very well. And we have reaffirmed our full-year targets for earnings, excluding the impacts of currency translation.

So finally, I'd like to say thank you to all the Kellogg employees around the world for all their hard work and dedication. Together, we are building the plans and laying the foundation necessary for future growth.

I'll now open it up for questions.

Q&A

Operator

Thank you, sir. We will now begin the question-and-answer session. [Operator Instructions] The first question we have comes from David Driscoll of Citi. Please go ahead.

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

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

<Q - David C. Driscoll>: Would you please comment on the cereal merchandising outlook? It seems like General Mills captured a lot of merchandising activity during your second quarter period. Can you just give us some comments on how you see the merchandising outlook in North America for the rest of the year?

<A - John A. Bryant>: Well, David, it's very hard to predict how the merchandising activity will change, as we go through the back half of the year. What I'll say on cereal is, we're focused on driving our business the way that we've seen the business respond historically, which is through brand-building, innovation, both food and packaging as well as nutrition. We believe that's the right way to drive the cereal business. Obviously, cereal is always an intensely competitive category. We'll be competitive in that category, but I wouldn't say that there's any trends around

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merchandising that concern us.

<Q - David C. Driscoll>: Related to the cereal category on new products, how have the new products performed? And would you call this out as a reason for the soft sales in any way? Or more importantly, are the new products more of a second-half event? Maybe if you could help me out a little on that one?

<A - John A. Bryant>: David the new products are really a second-half event. They only started shipping towards the end of the second quarter and the brand building won't be turned on until we get well into the third quarter and we have the right level of distribution across the U.S. stores.

<Q - David C. Driscoll>: Okay. Final question for me is just a detail on advertising. What was the advertising change during the second quarter?

<A - Ronald L. Dissinger>: So, David – this is Ron. Our advertising was down just slightly in the second quarter, and that was a function of the innovation – timing of innovation launches that John mentioned. So, we do expect advertising growth in the third quarter.

<Q - David C. Driscoll>: So, then the nice operating margin performance relative to the gross margin was not related to like a giant decline in advertising? It was other factors, namely Pringles savings and/or other savings; is that correct?

<A - Ronald L. Dissinger>: And/or other savings, David. Particularly, we've been very focused and cost-disciplined around overhead. We've executed some initiatives earlier in the year knowing that we were facing high inflation in the front part of the year.

<Q - David C. Driscoll>: Really appreciate the comments. I'll pass it along. Thank you.

<A - John A. Bryant>: You bet.

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

Operator

And next, we have Bryan Spillane, Bank of America.

<Q - Bryan D. Spillane>: Hi. Good morning.

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

<Q - Bryan D. Spillane>: Just one clarification and a question. I think, Ron, you had mentioned in your prepared remarks that in phasing the back half of the year, the third quarter earnings would be the same as the fourth quarter. I just want to make sure, I was clear. Is that the absolute or is it the year-on-year growth rate that you're referring to?

<A - Ronald L. Dissinger>: That is the absolute earnings per share, Bryan.

<Q - Bryan D. Spillane>: Okay. Great. Thanks. And then just a question on Pringles. It's been an important sort of revenue growth contributor since the acquisition – and profit growth contributor, since the acquisition and still – and it's important component as we look into the second half, especially now that it becomes internal – part of the internal calculation.

Can you talk a little bit about first, sort of where you stand today on capacity, whether your capacity constrained at all? And then second, now that you're completely free from the Procter's shared service arrangement, how effective you've been at filling in some of the white space, so the markets where you've had this sort of find your own distribution now that you've kind of pulled away from Procter. So, just those two things as we look at Pringles going forward, please.

<A - John A. Bryant>: Thanks for the question, Bryan. I'm going to answer at a very high level. Then Paul might end up with some questions on – or some comments on Europe, specifically around Pringles.

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First, as you said, the Pringles acquisition has gone incredibly well for us. The integration is largely complete. We now have Pringles operating on our systems and that's enabling us to generate the synergies that we're seeing come through on the cost side. So, remember a lot of the cost synergies from Pringles was unhooking the P&G shared activity, hooking it on to the Kellogg systems and support processes and be able to run the business without adding a lot of additional cost. We're absolutely seeing that come through. Also, when we acquired the business we were concerned about the top-line growth of the business, given it had been through a difficult transition. So, we were relatively conservative in setting out top-line growth expectations.

The good news is, this business has responded incredibly well to merchandising with our sales force and bringing to life those programs in store. So, that's working very well for us. As you pointed out, we have been capacity constrained in this business. We do have new capacity coming on. We've also been able to run the plants a little bit harder and get more capacity out of them, which has also worked well in terms of supplying the market.

So, as we look at Pringles around the world from a consumption perspective in the second quarter, we saw a 7% growth in U.S., good growth in Asia Pacific and Latin America and also some very good growth in Europe.

In terms of the white spaces, there's some good Pringles opportunities in Europe as well. So, why don't – I'll let Paul just talk a little bit about the Pringles' experience in Europe.

<A - Paul T. Norman>: Hi, Bryan. If you think about outside of the Kellogg go-to market salespeople and you think further, a feel into emerging markets, remember, Pringles for us was pretty transformational. In several markets, it will have almost doubled the size of our business. So, we find ourselves today with a great opportunity. We have Kellogg distributors and we have inherited Pringles distributors. And the process we're going through now, as you can imagine, is to consolidate, given our newfound scale, to drive more capability to go further to grow, and obviously, this cost-to-serve benefits to come. So, I don't think the business has been left exposed anywhere. In fact, we've ended up with more distributors than we probably had before and the opportunity is now, I would say in emerging markets in Europe, but also the same case in Latin America and parts of Southeast Asia, the opportunities to consolidate, build capability and hopefully improve cost-to-serve and invest to grow further.

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

<A - John A. Bryant>: Thanks, Bryan.

Operator

Next, we have Robert Moskow of Credit Suisse.

<Q - Robert B. Moskow>: Hi. Thank you. I was curious about the gross margin guidance coming down to, I guess, a decline of 75 basis points to 100 basis points. And the grain cost futures markets would indicate that you – and you said yourself, that your costs are lower than you thought, and your productivity seems to be coming in lower than you thought. So, is this an issue where it's just a volume and de-leveraging is causing gross margin to be lighter than you thought? And then I had a question on Kashi consolidation.

<A - John A. Bryant>: Yes, Rob, it's really a factor of our operating leverage. So, we have very good visibility to our cost structure as we look at the back half of the year, seeing net deflation in the fourth quarter. As I mentioned, a little bit of inflation in the third quarter, and that's because of the operating leverage impact as a result of the sales coming down in a couple of the key U.S. businesses. So, it's nothing more than that. Pringles is still about 50 basis points of dilutive impact on the margin as well. So, the underlying margin is down about 25 basis points to 50 basis points.

<Q - Robert B. Moskow>: Okay. And then regarding Kashi, I heard that you've consolidated headquarters into Battle Creek. Can you talk a little bit about the cost benefit of that? Kashi had a very strong culture in La Jolla and sales have been weak lately. When do you think performance will improve and what are you doing internally to make sure that you retain what made it strong to begin with?

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<A - **John A. Bryant**>: We think Kashi is a great opportunity for us to drive additional growth. I think the opportunity with Kashi is to play its role within our portfolio. One of the benefits of having it viewed within the broader Kellogg portfolio is we can more clearly have some Kellogg brands play in some places and Kashi play where it needs to play.

And the opportunity for Kashi is really in the area of pioneering nutrition, putting the value back in the food, whether it'd be GMO, organic or new-edge grains, et cetera. And that's the opportunity that Kashi can play. And by having it viewed within that broader portfolio, we can actually more clearly define, articulate, the job that we need Kashi to go out there and achieve for us.

Also Kashi now is a very large business, and we can more effectively leverage the scale and benefits of the Kellogg Company by putting it into the broader context of Kellogg. So, we feel very good about the longer term growth opportunity for Kashi. And if anything, we think this gives us – gives it the better opportunity to achieve its long-term growth potential.

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

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

Operator

The next question we have comes from Eric Katzman of Deutsche Bank.

<Q - **Eric R. Katzman**>: Hi. Good morning.

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

<A - **Ronald L. Dissinger**>: Hi.

<Q - **Eric R. Katzman**>: I guess one thing I haven't heard from you yet on Pringles is the revenue synergies that you expect a little longer term. I think you started to talk about it, qualitatively but not quantitatively. And obviously, you bought Pringles for – not for its cost savings, but for the revenue potential. So, perhaps we'll start with that.

<A - **John A. Bryant**>: Eric, I think the significant revenue synergies coming out of the Pringles acquisition – we've not quantified those for external purposes, but think of it in a number of ways. The first wave is the benefit of putting Pringles into the Kellogg sales system and driving that initial growth. And that's what we're seeing come through.

The second wave is a little bit dependent upon broader capacity coming online for Pringles, which is innovation on the Pringles business itself. And there's a third wave out there, which we're also going after aggressively, which is leveraging the Pringles infrastructure to drive Kellogg's snacks more aggressively around the world. I think Europe's a great example of where we're doing a lot of that today.

<Q - **Eric R. Katzman**>: Well, I'd just say, I think it would be helpful at some point sooner versus later, if you could give some quantification on that. And then, this is, I think a question that's been asked in the past. But given the poor core results out of the business versus your advertising spend relative to sales, you've talked for a couple years about "optimizing your advertising spend." But the reality is, despite a lot of new products and effort, the core business volume has been pretty weak for an extended period, whether it's Europe or U.S. or what have you. And I just – I kind of wonder like – I mean, what would sales at your company be like, if, God forbid, your advertising spend wasn't nearly as strong as it is? I mean, why isn't such high spending giving a better lift to the portfolio? I just – it just – it still makes me scratch my head.

<A - **John A. Bryant**>: All right, Eric, we're very comfortable with the level of advertising we spend as a company. And that advertising is becoming even more effective and efficient each year as we drive more into digital, and we activate the brands even more effectively through those programs.

If you look at where some of our weakness has been on the volume side, it's really been back in cereal. So, as we think about cereal – and this is true in the U.S. and some of the other large developed markets we have around the world. The

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good news for cereal is that the breakfast occasion is, in general, growing, particularly here in the U.S. And within breakfast, cereal has the single largest share.

And there's reasons to believe that there's long-term growth potential in the cereal category, whether it be aging population, health and wellness or desire for value. However, there has been some short-term pressure over the last couple of years on the cereal category from alternatives at the breakfast occasion. So, how are we addressing that as a company, because this will help us get back to volume growth long term. One is to win with cereal at breakfast. If we take adults, which is the biggest source of opportunity, we're trying – we're driving increased adult consumption around cereal really with four levers: innovation, advertising, food and packaging. On innovation, as you can see here in the middle of this year, we have Special K Multi-Grain, Kashi Chia, Raisin Bran Omega-3 coming out.

On advertising, to your question, about advertising effectiveness, the healthy dividends program was in place in the second quarter. It drove strong growth in Raisin Bran, which was heroed in that particular piece of advertising.

On food, as we mentioned before, on Kashi, our focus is on pioneering health. And we're seeing the benefits of getting the food right; we have, say, Bear Naked growing double-digits in the second quarter.

And then on packaging, whether it be receivable bags, easy open liners or more portable solutions like cups, all helps us drive that cereal consumption. And it's more than just winning with cereal at breakfast. It's also winning in breakfast beyond cereal. So, we have a number of warm breakfast alternatives such as Eggo, Pop-Tarts, the Special K Breakfast Sandwiches. And now we have Special K hot cereal launching both in the U.S. and in the UK.

And within that as well we're looking at portability, whether it be wholesome snacks, handheld breakfast that Paul mentioned in Europe or breakfast beverages here in the U.S. So, we're confident we can do both in this – in the breakfast occasion. We can grow cereal at breakfast as we did across the 2000s and we can leverage our strong cereal brands into other formats to meet consumer needs at that breakfast occasion. And we believe if we do this well, we can get ourselves back to volume growth as a company.

<Q - Eric R. Katzman>: I'll pass it on. Thanks.

<A - John A. Bryant>: Thanks, Eric.

Operator

The next question we have comes from Andrew Lazar of Barclays. Please go ahead.

<Q - Andrew Lazar>: John, I think that the general expectation to your earlier – just the answer you just gave, by many investors is that the cereal category will ultimately bounce back to a rate of growth, whether it's the low single-digit rate that it's had historically, even though thus far that recovery has been slower than you would have liked. But if this slower cereal category growth rate continues for a bit of time or longer than planned, I guess, do Kellogg and the investment community have to wade through perhaps a longer period of profit pressure as you launch in transition to a lot of these new outside-the-bowl initiatives and formats, as necessary as they may be, but require spending and may have potentially negative mixed issues given the excellent profitability of your core cereal franchise.

So, I guess, in other words, can Kellogg's long-term EPS growth targets of 7% to 9% be hit and sustained during a transition like I've described and as you've talked about in your – just in the previous answer?

<A - John A. Bryant>: Andrew, I think it's definitely our intent to, over the long-term, get back on our sustainable growth model. We are making the investments we need to make in order to get back on that model, and we recognize the need to drive our growth more aggressively in the cereal and breakfast occasion. And we're making the investments we need to make.

What I think you're seeing within that investment model is, we are using cereal equities to help drive our growth in some of the non-cereal spaces. So, for example, leveraging the Kellogg master brand to launch the Kellogg to-go beverages in the U.S. That enables us to have a more efficient investment model, so we don't need to add a significant

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amount of additional brand building in order to drive that growth as it halos back on the cereal business as well.

At the same time, within the advertising line, we continue to move money between digital, consumer databases and so on, which make that spending even more efficient, which also enables us to free-up investment. Also, we'll continue to look within our company on the cost side, to be more effective and efficient to identify opportunities to provide fuel for growth in our organization going forward.

<Q - Andrew Lazar>: And then, I know that you've switched over to using a third-party broker for just some of the in-store work around your Morning Foods business, I think maybe back in April or so. Just trying to get a sense if that transition's gone relatively smoothly, I don't know if you've got any metrics to point to around distribution or merchandising effectiveness. But has it basically delivered on what you had hoped you'd get from it?

<A - John A. Bryant>: Andrew, I think any transition like that always has its bumps early in the process, but I feel like it's working very well today.

<Q - Andrew Lazar>: Okay. Thank you.

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

Operator

The next question we have comes from Chris Growe of Stifel.

<Q - Christopher R. Growe>: Hi. Good morning.

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

<A - Ronald L. Dissinger>: Morning.

<Q - Christopher R. Growe>: Hi. Just wanted to ask you first on the revenue growth for the business and looking out. I think what I heard from you so far, and I think we heard this – this has been a consistent theme – is a very heavy level of innovation, marketing that's picking up in the second half of the year. I had assumed some of that started in Q2. I think a little bit – it sounds like it started late in the quarter. I guess, what I'm getting too, John is, is it as simple as you'd increase your marketing even more, your advertising, or do you think these new products are what's going to help fix what are, in some cases, a category issue, like in cereal, or just a competitive or slower dynamic, in say, cookies and crackers in the U.S.?

<A - John A. Bryant>: I believe that the innovation we're putting in the marketplace here in the second half as well as the commercial plans we have in the second half, will lead to a better sales growth rate in the second half than what we had in the first half.

I also believe that it's going to take more innovation and pressure over time to get the categories fully back into the growth rates we'd like to see. So, this is not a short-term, easy fix. This is a longer-term journey that we're on, but we're absolutely doing the right things. We've seen the ability to grow these categories over time back in the 2000s. And it's a case of engaging and exciting the consumer and bringing them back in.

<Q - Christopher R. Growe>: Okay. And then just a follow-up to that. You've had a fairly heavy level of productivity savings this year. And it sounds like it's a little higher than maybe what you thought initially. Is there anything unique that's helping drive that? And I guess, a lot of us remember back to periods where the supply chain maybe was cut a little too far. So, I'm just trying to understand what's driving that and how sustainable this level of savings is?

<A - Ronald L. Dissinger>: No, the tick-up in savings, productivity savings, is only slight, Chris. It's not significant. So, we're quite comfortable with the programs that are in place and the things that the supply chain is doing to generate their savings.

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<A - **John A. Bryant**>: And, Chris, on the supply chain. I feel very good about the state of our supply chain. The investments that we've made over the last few years have enabled us to run those plants even more effectively. And quite frankly, the work that we did in those plants is enabling us to run even more efficiently this year and that's a little bit of a source of some of the productivity benefits.

<Q - **Christopher R. Growe**>: Okay. Thanks a lot.

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

Operator

Next, we have Jason English, Goldman Sachs.

<Q - **Jason English**>: Hey. Good morning, guys. Thanks for the question.

<A - **John A. Bryant**>: Good morning, Jason.

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

<Q - **Jason English**>: More innovation coming to try to rejuvenate growth. We've been hearing a lot about innovation for a number of years now. If we look at the cereal category, which is clearly a point of weakness, TDP growth suggests it's been pretty explosive expansion of the varieties in the category; meanwhile, velocity's fallen off a cliff. Why shouldn't we be bracing for maybe some SKU rationalization in that category rather than banking on innovation to turn it around?

<A - **John A. Bryant**>: Well, Jason, I think the – in a category like cereal, which is a high repertoire category, you always have a level of innovation and a level of ongoing rationalization on the shelf. So, the shelf is not growing and it's not declining. It is an element of bringing new news to the category and continuing to bring consumers in.

In some parts of the business such as, say, Special K, where you need a high level of choices to keep people excited and interested in eating Special K each day, there is a wider level of varieties out there than what you might have in some other brands.

Also, Jason, when we talk about innovation, we're not just talking about another line extension. We are talking about beverages. We're talking about hot cereals. We're talking about breakfast sandwiches. So, I think if you compared our innovation pipeline this year to, say, last year or the year before, there's a greater proportion of incrementality within the innovation pipeline. Plus, when you look at the International innovation, we are ramping up from a relatively low base. And within that and some of the things that Paul talked about in Europe, that innovation is significantly more incremental than some of the historical cereal-based line extensions.

<Q - **Jason English**>: Thank you for that. I going to come back with one more question. It's really picking up where kind of Growe led into it, with your sustainable growth model, it worked for a number of years. It hasn't really proven to drive very sustainable growth recently. An important pillar of that is grow brand building, continue to increase the investment. Yet, over the last five years, advertising up at a 1% CAGR, well below sales, down so far this year. So, I guess back to Chris' question, why shouldn't we think that we need just a lot more reinvestment to really get this thing going, to get you back on the sustainable growth wheel?

<A - **John A. Bryant**>: Well, within that advertising line over the last five years, there has been a pretty significant shift under the surface between traditional 30-second advertising and digital and engaging consumers more effectively with different – a different media mix. Having said that, I mean, we'll constantly look for fuel for growth in the organization. And say, how do we continue to drive effectiveness and efficiency to enable us to invest more in the business over time.

<Q - **Jason English**>: Thanks. I'll pass it on.

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

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Operator

The next question we have comes from Ken Goldman, JPMorgan.

<Q - Ken B. Goldman>: Thank you. You aren't the first company to experience some sluggishness in your legacy categories and brands at the same time that you're integrating a new one, in this case Pringles. So, as you look back on some of the challenges you've faced in those legacy cookies, crackers, cereals, lately, would you have done anything differently, John, over the last year in terms of your time focused on legacy products and your whole management team's focus versus toward the integration? Or in your view, maybe would those challenges facing those categories have taken place whether Pringles was taken on or not?

<A - John A. Bryant>: Ken, it's a very difficult question to answer. Certainly, Pringles being the second largest acquisition in our history and being a carve-out and bolt-on was a more intense integration, particularly in some parts of the world, such as Europe. I don't think that some of the issues we've seen in cereal more recently were impacted by the Pringles acquisition. But certainly, it has been something that the organization has been focused on with the integration.

<Q - Ken B. Goldman>: Okay. And then quickly, Latin America, almost all of your growth over the last few years has come from price/mix. Your volumes have been down. Can you talk a little bit about the breakdown between price and mix in that line? And to what extent you're comfortable with volumes not really growing in a region where a lot of companies are seeing their tonnage up over the last few years?

<A - John A. Bryant>: Over time, as we go forward in Latin America, we are looking for more volume growth. I think when you look in the second quarter, it's a little distorted by lapping the trade inventory build that happened in Q2 last year that we spoke about on the second quarter call last year.

The – in particular, in Mexico, where our shipments were down quite significantly and our consumption was actually [ph] up (59:00). I think if you're looking at a [ph] full (59:04) basis, the volume performance would be much better. And certainly, our strategy going forward in Latin America is to be in volume growth.

<A - Simon D. Burton>: Mike, I think we have time for one more question.

Operator

Yes, sir. The next question, or last question, that we have comes from Lucia von Reusner of Green Century Capital Management.

<Q - Lucia von Reusner>: Hi, thank you. I was curious, as a company publicly committed to sustainability, how will Kellogg ensure that the Kellogg brand is not associated with the illegal deforestation that its partner, Wilmar, has been accused of? How will you ensure that the Kellogg brand remains sustainable and all that?

<A - John A. Bryant>: Well, the Kellogg Company has a very strong track record on sustainability and we have a sustainability report that I would turn your attention to. In terms of our palm oil, we actually buy green certificates to cover all of our palm oil purchases and we feel very good about our practices in that area. We work with a number of partners and suppliers around the world, and I'll leave it to you to talk to Wilmar directly, if you have any questions for them. But, we feel good about Kellogg Company's position on this topic. Thank you very much.

Simon D. Burton

Okay, everyone. Thanks very much for dialing in and we'll be available throughout the rest of the day and tomorrow for questions. Thanks.

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And we thank you, sir, and to the rest of the management team for your time today. This conference call is now concluded. At this time, you may disconnect your lines. Thank you, and have a great day, everyone.

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