Company Name: Kellogg
Company Ticker: K US
Date: 2014-05-01
Event Description: Q1 2014 Earnings Call

Market Cap: 23,649.21
Current PX: 65.84
YTD Change($): +4.77
YTD Change(%): +7.811

Bloomberg Estimates - EPS
Current Quarter: 1.074
Current Year: 3.998
Bloomberg Estimates - Sales
Current Quarter: 3743.167
Current Year: 15104.588

Q1 2014 Earnings Call

Company Participants

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

Other Participants

- Andrew Lazar
- Kenneth B. Goldman
- Bryan D. Spillane
- Robert B. Moskow
- Alex M. Sloane
- David H. Hayes
- Eric R. Katzman
- Alexis N. Borden
- David S. Palmer
- Matthew C. Grainger
- Alexia J. Howard

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company First Quarter 2014 Earnings Call. All lines been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period. [Operator Instructions] Please note this event is being recorded. Thank you.

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

Simon D. Burton

Thanks, Emily, and good morning, and thanks to everybody else for joining us today for a review of our first quarter 2014 results. I am joined 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. And 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 side 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 Thursday, May 8. The call will also be available via webcast which will be archived for at least 90 days.

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

John A. Bryant

Thanks, Simon, and thank you, everyone, for joining us today. We are pleased to announce first quarter results that were broadly in line with our expectations. Operating profit was in line with guidance and earnings per share were ahead of guidance. Our sales growth was lower than expected, primarily due to ongoing weakness in our large, developed cereal businesses. However, we continue to see strong results from Pringles and we are building momentum in our U.S. Snacks business.

Project K, our four-year efficiency and effectiveness program continues to go well. You will have seen some of the announcements we made during the quarter, and we are on track to hit our targets for the project in 2014. The execution by the team has been very good and we're pleased with the progress we've made so far. And we're reaffirming our guidance for the full year, while recognizing the impact of the difficult operating environment in some of our categories. As you will remember, we are always expecting improved results in the second half of the year as we haven't begun the brand building investments tied to Project K yet.

In 2014, this will include investment in category-building activities in developed markets around the world and also in additional in-store capabilities in our U.S. Snacks business. This investment will begin in the second quarter and will build over time as will the benefits. Ron will give you some more color on our guidance in a few minutes.

And now if you'll turn to Slide 4, we'll spend a couple of minutes discussing our progress on Project K. The project remains on track and we continue to execute well. Last quarter, we updated you on some of the announcements we've made so far. As you know, we've announced plans to close or reduce capacity at various facilities in developed markets. In addition, we've also announced increased supply chain capacity investment in a number of emerging markets. Since then, we've announced progress with implementation of global business services. We've announced plans to implement a three-tiered model which will include local, regional, and global services. As part of this, in the third quarter, we plan to open the first regional center which will support North America. GBS is an important part of Project K and is a major undertaking for the organization.

And Project K itself will drive significant changes. It will allow us to build key capabilities, create the supply chain we need to service our global business as it evolves, and generate the savings necessary to improve results and drive future growth. Some of these decisions are very difficult ones to make, but they are necessary to drive long-term growth.

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

Ronald L. Dissinger

Thanks, John, and good morning. Slide 5 shows the first quarter's financial results. Internal sales declined by 2.4% in the quarter, although we saw improvement in March and this continued into April. The decline in sales was primarily driven by developed cereal markets and the elasticity impact of pricing related to the food tax in Mexico. On the positive side, we saw strong growth in Pringles in each region across the globe, improving trends in our U.S. Snacks business, and solid growth across Asia.

Underlying internal operating profit decreased by 5.5%, which was broadly in line with our expectations. The year-over-year decline was primarily driven by our sales performance and the timing of costs and savings within cost of goods sold across the year. It's worth noting that the first quarter's underlying operating margin was approximately equal to the level we expect for the full year.

Comparable earnings per share, which exclude integration costs, mark-to-market adjustments, and Project K costs were $1.01 per share in the first quarter, which was ahead of our expectations due to the timing of a below the line benefit of $0.03 per share. Without this, earnings per share would have been $0.98 at the high end of our guidance. Reported earnings per share for the quarter were $1.12 including $0.01 of Pringles integration costs, $0.10 of upfront costs related to Project K, and a $0.22 benefit from mark-to-market adjustments.

Slide 6 shows the composition of the first quarter sales growth. As I mentioned, total internal sales declined by 2.4%. We saw total price and mix improvements of 1.1 points in the quarter with North America, Europe, and Latin American all posting good growth. Volume decreased by 3.5% in the first quarter as declines in developed cereal and in Mexico were key contributors. Unit volume declined at a slower rate as a reduction in the weight of products impacted by volume by around one point. We expect improving trends in volume and continued positive price mix as we progress through the year driven by strong commercial programs and investment in our categories.

Finally, the impact of currency translation decreased reported sales growth by 0.7% in the quarter, primarily as a result of movement in the Canadian and Australian dollars.

Now let's look at Slide 7, which shows our underlying reported growth profit for the quarter. Our underlying gross margin increased by 10 basis points in the quarter with improvement in price mix, more than covering a slight inflationary position in cost of goods. This was due to the timing of both costs and savings across the year. Our cost inflation is a little more front-end weighted and the productivity we expect to get this year from Project K is more back-end loaded. Our initiatives are on track and we have good visibility to our cost structure over the balance of the year. We are currently covered on commodities and packaging at around 80%, which is in line with previous levels of coverage at this time of the year.

Slide 8 shows the quarterly internal operating profit performance for each of the regions. North America's internal operating profit decreased by 6%. Lower sales in cereal were a key contributor, but the timing of costs and savings I mentioned earlier were a key factor in this region. We also saw some effect from weather in the quarter which impacted production and distribution. We expect improvement in the second half of the year in North America as sales and productivity improve and as we recognize some of the savings from Project K.

Internal operating profit in Europe was flat in the first quarter as the impact of the decline in sales and slightly higher brand building was offset by cost of goods performance and some pricing impact. Internal operating profit grew 9% in Latin America. Pricing and productivity helped drive an increase in gross margin, and the timing of investment and brand building also helped the business more than offset the lower sales posted in the quarter. Like many in the industry, we saw volume impact from the tax increase in Mexico. And Asia-Pacific posted a decrease in internal operating profit of 27% in the quarter. This was largely due to cereal sales declines in Australia and investments in India related to brand building and the new plant we are preparing to start up in 2014.

Slide 9 shows cash flow for the quarter. Cash flow from operations was $268 million, and this was in line with our plan. The accounts payable initiative, supplier-financing, is also progressing according to plan. So, our full-year expectations for cash flow have not changed. Capital spending in the quarter was $97 million comparable to prior year. And we continue to expect that we will invest between 4% and 5% of sales for the full year. So, free cash flow was $171 million, on track to meet our expectations for between $1 billion and $1.1 billion for the full year. And finally, share repurchases this quarter were $321 million, consistent with our plan to return cash to our share owners, and we still expect to reduce our average share count by between 1.5 and two points over the course of the year.

Now, let's turn to Slide 10, which shows our guidance for 2014. And as you can see, we are reaffirming the initial guidance we provided last quarter. We still expect that internal net sales will increase by approximately 1% for the full year. This excludes integration costs, currency translation, and this year's 53rd week. While we saw softer sales performance in our developed cereal markets in the first quarter, we have stronger commercial plans and category-driving investment over the remainder of the year, with key programs starting in the second quarter. We expect our global business' internal sales to return to growth beginning in the second quarter. We continue to expect moderate material-related inflation and that total cost of goods inflation will be between 3% and 4%.

Productivity in savings from Project K will ramp up as we move through the year and should more than offset this inflation. And as a result, we continue to expect moderate net deflation for the year and still expect full-year gross margin to increase by 40 to 50 basis points. We anticipate that underlying internal operating profit will be in a range from flat to up 2%, and brand building should increase at a rate greater than sales growth. Of course, this includes the 53rd week which will add between 1.5 and 2 points to reported operating profit growth.

Currency neutral comparable earnings are expected to increase by between 1% and 3% or to $3.89 to $3.97 per share. The 53rd week will add approximately $0.08 per share resulting in currency-neutral earnings per share including the 53rd week of $3.97 to $4.05, which we believe is in line with the latest consensus estimates on Bloomberg. The tax rate is still expected to be between 29% and 30%, and interest expense is anticipated to be between $215 million and $225 million.

Slide 11 is an earnings per share walk and is the same one we showed you last quarter. Based on the latest spot rates, we continue to estimate that currency translation will not have an impact on the results. This excludes any potential impact from the devaluation of the Venezuelan bolivar. And just to put it into perspective, Venezuela has traditionally been about 1% of total company sales and approximately 2% of total company operating profit on a full-year basis. Our estimate for integration costs remains at $0.07 to $0.09 per share, and Project K upfront costs are still expected to be between $0.60 and $0.65 per share.

Now, let's turn to Slide 12 and some final comments on guidance for the year. Cash flow is expected to be between $1 billion and $1.1 billion, and as I mentioned previously, capital spending will be between 4% and 5% of sales. This is 1% higher than our normal long-term guidance due to the investments related to Project K.

I'd also like to provide some color regarding the second quarter. We expect that we will return to top line growth, but we expect underlying internal operating profit to be down slightly as a result of a significant increase in our investment in brand building. We expect comparable currency-neutral earnings to be approximately in line with last year's result of $1.02 per share.

And now, I'll turn it back over to John for more detail on the operating sector.

John A. Bryant

Thanks, Ron. Now let's look at Slide 13 and some more detail regarding morning foods. Sales declined by 5.5% in the quarter, which was a disappointing start to the year. Obviously, we've faced some challenges in the cereal category in the U.S., and we've also faced specific issues with Special K, Mini-Wheats and Kashi. However, where we focused activity, we've seen better results. The good growth I mentioned last quarter in Raisin Bran and Raisin Bran Crunch continued this quarter. Both brands posted high single-digit consumption growth as our health-related messaging continued to appeal to consumers.

So, for 2014, we expect category consumption to continue to decline, but at a moderating rate. And while we expect our consumption to remain down over the remainder of the year, we do expect it to be more in line with category trends. We are very committed to the cereal category and we'll talk more about we're planning to do.

First, we've got more activity planned for the second quarter of this year including the beginning of our category-building programs. In fact, we're planning a high single-digit increase in investment in brand building in Q2, followed by continued growth in Q3. We will focus our investment on the desire, decide, delight framework that we highlighted last quarter and at the CAGNY conference. The category relevancy work we have planned will highlight the nutritional benefits of cereal and milk and will also remind consumers that cereal is a healthy way to satisfy cravings for a late night snack.

Secondly, we've also got significant brand-specific activity planned including a mix of support and innovation, particularly for the three brands I mentioned. We've got a new program for Special K, called Simple 5, that highlights that consumers can lose up to five pounds in two weeks which includes Special K products from across our portfolio. We've got more Non-GMO verified Kashi products scheduled for introduction, and we're strengthening our brand-building program on Mini-Wheats which will highlight the brand's nutritious and delicious positioning. This program will incorporate TV ads, print, digital, and social media, and of course will be tied into the broader category-relevance work.

And also as part of desire, decide, delight, we will be investing to improve our in-store execution. All of this is just a small part of each of these initiatives, but hopefully, you can see that we've got a lot of activity planned. We've identified the problems, we're taking actions, and most importantly, we believe that this activity will drive better category results and better performance of our brands. And finally for morning foods, our Pop-Tarts brand posted growth again in the quarter and gained almost a point of share. We know improved performance in the cereal business will take some time, and we're committed to these categories and are confident that we will drive future growth.

Now, let's turn to Slide 14 and our U.S. Snacks segment. Internal net sales growth was 0.3%. As I mentioned, we've had good merchandising in the Snacks business in the first quarter. We are pleased with the overall results, especially the performance we saw later in the quarter. The Cracker business posted consumption growth of 2.7% in Q1, and we gained over a point of share. Innovation drove that Cheez-It brand as the white cheddar variety, and Cheez-It Zingz and Grooves all contributed.

In addition, original Cheez-It posted mid single-digit gains in consumption in the quarter. The Town House brand also continued to do well, as both the core original variety and new Town House Pita posted growth in consumption. And we also posted sales growth in the cookie business as we saw improved execution and in-store activity.

The Keebler brand in total posted low single-digit growth in consumption, due primarily to growth in the Fudge Shoppe and Sandies brands. Consumption for the Chips Deluxe brand declined due to lower incremental activity, but we saw very good initial results from the recent launch of two varieties co-branded with M&M'S, and we didn't begin activity until late in the quarter.

In the Wholesome Snacks business, Rice Krispies Treats again gained share, and Nutri-Grain gained share and posted increased consumption as a result of Nutri-Grain Crunch. However, these good results were more than offset by a weakness in Special K and FiberPlus.

We have recently launched innovation plan to address this including two new Special K protein bars. With FiberPlus, we are repositioning the brand around meaningful consumer benefits in addition to fiber including protein, calcium, and Omega-3. So, we weren't pleased with the results in the Wholesome Snacks business in the quarter, but we expect performance to improve over time. The Pringles business posted high single-digit growth in consumption and internal net sales growth. The three versions of tortilla Pringles that we launched late last year have done very well. The initial strong rates of trial appear to have led to good rates of repeat, and we are pleased with the success of this innovation and we've only launched this idea in the U.S. so far. Pringles is a brand with a lot of potential, both in the U.S. and around the world, and we have a strong calendar of events planned for execution this year.

So, the Snacks business had a better first quarter. We started to see improved results and the in-store activities that we've begun have been successful. The entire team is working hard across the portfolio, we've got good plans, and we're happy with the initial reaction to the actions we've taken so far. As a result, we remain on track to deliver full year top and bottom-line growth.

Now, let's look at Slide 15 and the U.S. Specialty segment. Internal net sales declined by 1.7%, which was impacted by food service trends resulting from adverse weather in the quarter. As you've heard from other companies, this affected much of the industry including sales to restaurants, businesses, and schools due to closings. However, it does seem that industry trends improved towards the end of the quarter.

We gained share in the convenience channel, in the health and wellness, and cracker categories with Special K and Cheez-It driving the performance in crackers. And Pringles also did well again this quarter and was the fastest-growing brand in the salty snacks segment of the convenience channel over the 52-week period through the end of March. New Pringles Tortillas is getting good placement and the early sales rates are encouraging.

Slide 16 shows detail regarding the North America other segment. This segment, which includes the U.S. frozen foods and Canadian businesses, posted an internal sales decline of 2.1% in the first quarter, although this was lapping a high single-digit comp from last year. Internal net sale sales in the frozen foods business decreased in the quarter. We were lapping strong double-digit growth in the first quarter of last year, primarily as a result of the introduction of Special K Flatbread sandwiches late in 2012.

The overall waffle category posted a slight decline in consumption in Q1, although our kids segment did well as both Wafflers and New Eggo Bites contributed. In addition, we expect distribution gains over the balance of the year and full-year growth. And like last quarter, we posted double-digit growth in the burger segment of our MorningStar Farms business.

We posted low single-digit internal sales growth in Canada in the quarter. The Snacks business was driven by Kashi and Nutri-Grain innovation, and Pop-Tarts also did well. Pringles achieved double-digit sales growth as a result of good activity, distribution gains, and strong in-store execution. We gained a small amount of cereal share in the quarter, driven by good performance in the kid and all family segments.

Now, let's turn to Slide 17 and our European business. Internal net sales in the European business declined by 1.7% in the quarter, lapping 3% growth last year. We continued to see lower rates of cereal consumption in developed markets in the quarter and we were lapping the impact of the launch of new products last year, including Special K Cracker Crisps and other snacks in various parts of the region.

We saw good cereal volume growth in emerging markets, particularly in the Middle East and Turkey. We saw better performance later in the quarter in some developed markets such as France, although the cereal business in most developed markets continued to be difficult. However, just like everywhere in the Kellogg Company, we're absolutely committed to the cereal business in Europe and we have plans for a significant increase in investment over the course of the next few quarters. This will involve category-building initiatives that highlight the health benefits of good, simple, tasty, and wholesome food.

The Pringles business in Europe also posted double-digit sales growth in the quarter. And we've got strong activity planned for Pringles across the region as we are launching a broad-based soccer-themed event in Q2 and other programs later in the year. And also on snacks, you will remember that we launched handheld breakfast products in various parts of the region last year, which continued to do well, posting double-digit growth in the first quarter.

So, the environment remains difficult in Europe, and as a result, we expect the full-year sales growth will be approximately flat this year. However, we do have a lot of activity planned, and we're making the right decisions now for growth in the future.

Slide 18 shows the first quarter sales growth for the Latin American region. Internal net sales declined by 5.3% lapping high single-digit growth in the first quarter of last year. The food and drink tax that went into effect in Mexico at the start of the year had an impact on sales growth as we mentioned. However, results were in line with our expectations, and the team has maintained a strong focus on innovation and in-store excellence. For example, we gained more than two points of share in the Mexican Wholesome Snacks business in the latest 12-week data as a result of good consumption growth in various brands, including Special K and Nutri-Grain, driven by the success of [ph] Fruitella (27:13).

So, we expect that the impact from the tax will continue this year, but that the elasticity that we saw in Q1 will decline progressively as consumers adjust to the new prices. Our Latin America businesses has moved to a regional category model for both cereal and snacks and this has facilitated increased investment in both brand building and innovation. We have plans to increase significantly our investment in brand building in the region over the next couple of quarters. The team has already begun some Kellogg parent brand category-building activity and we're seeing a good early response.

Across the rest of the region, we gained share in many of our wholesome snack and savory snacks businesses and we saw good sales growth in Brazil in both cereal and snacks. The Pringles business continued to do very well, posting high single-digit sales growth in the quarter, and we expect continued strong results from the brand as a result of new commercial plans and additional brand building, including soccer-related activity planned for the summer.

So, we do expect good sales growth from the region over the remainder of the year, although results will continue to be impacted by the situation in Mexico and the uncertainty that remains in Venezuela.

Now, let's turn to Slide 19 and detail on the Asia-Pacific business. This segment posted an internal sales decline of 1.4%. This was driven primarily by the Australian business, as the Asian business posted high single-digit growth in the quarter. Specifically, we saw good growth in Japan, South Korea, and Southeast Asia. The Japanese business was driven by the continued growth of granola, and importantly, the Southeast Asian business benefited from the category building activity we started recently in the region. And the Pringles business in the region posted high single-digit growth as expansion into India and new listings expanded our footprint.

In Australia, the cereal category saw mid single-digit declines in consumption in the period, although performance improved later in the quarter. We have category-building activity that will drive this business going into the market in Q2, and we have a significant increase in investment planned for both Q2 and Q3. Separately, the Chinese joint venture also posted strong results.

So, overall performance was good in the Asian business. Although results in Australia were lower than expected, we have plans in place to improve the relevancy of the category and specifically the performance of Kellogg's brands.

Let's turn to Slide 20 and the summary. We are pleased that results for the first quarter were largely as we expected. Sales weakness in developed categories and regions continued, but we saw good growth elsewhere and we saw signs of improvement in our U.S. Snacks business. As you know, late last year, we announced Project K – a four-year efficiency and effectiveness program, the largest in the company's history. And I'm pleased to say that the project is going very well, we've made good progress on GBS, and supply chain with strong execution. And we've also made great progress developing the ideas that will drive sales growth in the future. We're excited about the potential we have, and you'll hear much more about these initiatives in the months to come. We are on track for the year and have reaffirmed guidance.

As I said last quarter, this is a journey, and some of the decisions we have made have been difficult. However, Project K, and the significant amount of investment we will make in the business over the next four years, are the right things to do. They will improve our supply chain network, build key capabilities, cut costs, and fuel the investment that will drive sales growth.

None of this would be possible without our Kellogg employees, and I'd like to end by thanking them for all their hard work and commitment. And now, we'll have time for questions.

Q&A

Operator

Thank you. [Operator Instructions] Our first question will come from Andrew Lazar of Barclays. Please go ahead.

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

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

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

<Q - Andrew Lazar>: John, I know it's probably a bit early to have a real sense of the success of the category-building work that you're just starting to do. But I guess since you started talking about the master brand plan, I've tried go back and look maybe into some other food companies that have attempted something maybe sort of similar in the past, and I guess it is tough to find ones that have been particularly successful, but I'm sure I don't have a complete list by any means. So, I guess my question is, maybe – what is it that's different about this time for you guys? Maybe – because I'm sure your folks know obviously all the pitfalls that have plagued maybe others that have tried a similar sort of process.

<A - John A. Bryant>: Andrew, I think the thing to keep in mind on what we're doing here with the Kellogg parent brand is that we are providing additional investment to the portfolio. So, the money coming in to support the parent brand is actually additional money that we've been spending on cereal. So, all of the brand-specific programs are still in place. If we were moving a tremendous amount of money from brand-specific activities to category-level activities, I think that would be a risky move. This is more as we invest back into the business, we're investing back in a way that we believe will have the greatest impact.

When we look at what's happening in cereal today, there's really two elements as you look at our business: one is around category relevance, with category down around 4% and 5%; and then there's some Kellogg-specific issues that we have. As we look at that category relevance work, what is happening within the occasion, the breakfast occasion is actually growing, household penetration is high for cereal, but the issue is that consumers are seeking protein. And they're not taking into account that milk and cereal is a great source of protein because of the milk. And often some of the cereal, some of the grains, also have a good amount of protein in them as well.

So, we really, with this parent brand, rather than moving money from the sub brands up to the parent brand, we're activating it with new investment money. We're talking about the benefits of protein that comes with cereal and milk, which is very much on track with the consumer today. And it's also very much aligned with what the Milk Board is talking about as well. So, I think there's an opportunity here for additional synergies as we look across all the activities that are happening in the marketplace.

<Q - Andrew Lazar>: Gotcha. Okay. Thanks for the extra color.

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

Operator

Our next question is from Ken Goldman of JPMorgan. Please go ahead.

<Q - Kenneth B. Goldman>: Hi. Thanks for the question. John, at least in measured channels, one of the bigger tailwinds to your cereal business had been positive changes in distribution points. But that trend lately – again [indiscernible] (34:35), has turned into a headwind with [ph] TBP (34:38), I guess, starting to trend down a little bit. So, a couple things, first, is that representative of what's actually happening out there, or is there something in that data we should be aware of? And second, if it is representative, I'm just curious if you could help us understand what's underlying some of those trends. Thanks

<A - John A. Bryant>: And just on that, Ken, you're really focusing on cereal in your question?

<Q - Kenneth B. Goldman>: Yes. Thanks, John.

<A - John A. Bryant>: Okay. Well, as we look at this cereal, the entire cereal aisle is not changing all that much in terms of size. I think within our business, we've got a couple businesses that have struggled a little bit of late and we have lost a little bit of distribution in. So, the one business I guess I'd point to that has been impacted by that has been Kashi. Kashi remains an incredibly strong brand. It's actually one of the largest brands in the natural organic space. And what we're doing there is we're bringing out new food that's more in line with the progressive nutrition that people are looking for from brands like Kashi. And so, you're seeing GMO-free type SKUs coming into the market now as well as longer-term some new innovation to ensure that we are in an area of pioneering health. So, as you look at our complete points of distribution across the cereal aisle, it's come down a little bit, not dramatically, and we have an expectation that we can continue to grow our distribution over time.

<Q - Kenneth B. Goldman>: Thanks very much.

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

Operator

Our next question is from Bryan Spillane with Bank of America. Please go ahead.

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

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

<Q - Bryan D. Spillane>: And, John, congratulations. I just had a question about Mexico. Can you talk a little bit about the – not just the elasticity in the first quarter, but have you seen consumers switch from products that were taxed to products that weren't taxed? And I guess what I'm after is I know in soft drinks, it appeared as though there was some trade across out of some of the sugared or taxed beverages into things like water or other types of flavored beverages. So, have you've seen that type of switching in consumer behavior in Mexico?

And then second, just wanted to make clear or make sure I understood, in terms of pricing in Mexico, was your pricing – did you take price increases above the – in addition to the rate increase that – or the tax increase that the consumer saw on the shelf?

<A - John A. Bryant>: Thanks, Bryan. As you look at our business in Mexico, most of our portfolio actually fell underneath the impact of that tax, so we didn't see a lot of switching within our portfolio. And that's true also at a broad category level. We did see an impact from the tax obviously and that impact was exactly in line with what we expected. To your question, we also did take a price increase at the same time, so the impact on the [indiscernible] (37:26) was slightly higher than just the tax in isolation. As we look at Latin America as a reporting segment, we do expect to it to return to growth in the second quarter. We do expect and are seeing the elasticity moderate over time as consumers get used to that pricing impact.

The other thing that was impacting our Latin America business a little bit in the first quarter is actually Venezuela. Venezuela sales were actually down in Q1. That's in part because we were unable to fully ship in P3, but we were able to ship in P4. And so, we had some catch-up shipments occur in P4. So, there's a little bit of a Q1-Q2 shift occurring there as well. We actually feel good about the Mexican business, we feel like it is tracking right where we expected it to, given the tax impact and the price increase. And in fact, in the marketplace, as I said in the prepared remarks, we even gained some share in the Wholesome Snacks area.

<Q - Bryan D. Spillane>: Will there be more brand building that goes into Mexico in the balance of the year now that the price is on the shelf?

<A - John A. Bryant>: Yes. Absolutely, Bryan. We, in the prepared remarks, commented that there'd be additional brand building across Q2 and Q3 in Latin America and that will certainly also be the case in Mexico.

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

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

Operator

Our next question is from Robert Moskow of Credit Suisse. Please go ahead.

<Q - Robert B. Moskow>: Hi. Thank you. John, I do remember you talking about kind of the tactical strategy for the master brand approach and talking about the benefits of milk and cereal together and the protein it provides at CAGNY. But I guess one of the concerns I had was that consumers appear to be drinking less milk as well as eating less cereal, and I want to know in the testing that you've done, are you hearing any kind of consumer feedback about consumer demand for milk declining on health concerns?

And then secondly, I think you also said that you might try to go up against Greek yogurt and do you kind of comparisons there in the advertising. Is that still part of the plan?

<A - John A. Bryant>: As we look at the category-building program, there's actually three or four different executions within that program. One of those executions is reminding consumers of the benefit of protein that comes with cereal and milk. And we believe that absolutely resonates with consumers, it's actually a surprise to consumers that when you look at the protein that's in say a bowl of Mini-Wheats and milk that there's as much protein there as in many yogurts. So, that is a positive surprise to people, so an opportunity to reappraise and reconsider cereal and milk. That's not the only activation though. As you point out, there is a little bit of a trend against milk out there. And so, we also activate programs with the soymilk suppliers and so on and other alternative ways with which people consume cereal.

And rather than think about cereal going up against yogurt, it's also worth remembering that cereal is actually a complement to yogurt in that a lot of people add cereal to their yogurt as well. But that's not the only execution of our parent brand or category-driving activity. We also have a cereal snacking program, recognizing that the incidence of snacking on cereal has increased significantly over the last decade from 20% of all cereal consumed outside the breakfast occasion to nearly 30% of all cereal outside the breakfast occasion. And historically, we've seen good success with those programs on brands like Special K and evening snacking. So, we have those sorts of programs coming back into the market.

And then there are other programs that remind people of the simplicity of the food; that this is food directly from the farm to the table, that a cornflake is literally a corn grit that's been rolled and toasted. So, it's not – as you think about the category relevance work, it's not all just a milk and grain story. It's actually several different executions around the world that we'll be able to work with through Q2-Q3, get responses from, adapt, adopt, and quickly take up what's working and move it around the system.

<Q - Robert B. Moskow>: That's great. Thank you for the color.

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

Operator

Our next question is from Alex Sloane of Société Générale. Please go ahead.

<Q - Alex M. Sloane>: Yes. Good morning. I was hoping to get some more color on the like-for-like sales decline in Asia. I appreciate Australia was the key factor there. Just wondering, is the weakness in Australia entirely a cereal issue, or has Pringles also been held back? And with the actions you're taking in Australia, do think you can post positive internal net sales growth in Asia-Pacific for the full year? And I guess while we're on Asia, it's around about 18 months since the announcement of your JV with Wilmar in China. So, I was just wondering if you'd give a very brief overview on how that JV is progressing relative to your expectations? Thanks.

<A - John A. Bryant>: Thank you. So, within Asia-Pacific, we actually saw very good growth in Asia. As I said before in the prepared remarks, Japan, Southeast Asia, a number of these markets grew quite strongly in the first quarter. Unfortunately, it was held back by Australia in the first quarter. We're lapping – last year in Australia where we launched the breakfast beverage business that had some big volume comparisons coming from that launch.

As we look at the Australian cereal category, it has similar dynamics to what we've seen, say in the U.S., and we have very significant investment going into brand building behind the Australian cereal business in the second and third quarters, as well as large consumer promotion events in each of the next three quarters. So, we do expect an improvement in the Australian cereal business. And while we don't normally give guidance at a segment level, we do expect Asia-Pacific to have positive growth across the year.

On Pringles specifically, actually Pringles in Australia grew quite nicely. And Pringles in the region also grew despite some foreign exchange headwind as we take Pringles, say, from U.S. into Japan and obviously, the cost of goods goes up as the exchange rate has moved.

If there's one thing I would say about Asia-Pacific is we have seen a slowdown in India. That's probably the one area that's a little bit slower than we would have expected to see; still growing, but not at the extremely high rates that we've seen over the last two three years. But we feel good about the stage of the Asia-Pacific business and the long-term potential.

On China, that's a relatively small joint venture; early days. Having said that, we virtually doubled the business in the first quarter, but it's not consolidated in our results. So, there's no benefit from the China joint venture sales within the internal sales number that we report for Asia-Pacific.

<Q - Alex M. Sloane>: Thanks. That's very clear.

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

Operator

Our next question is from David Hayes of Nomura. Please go ahead.

<Q - David H. Hayes>: Morning, gentlemen. My one question is just around the advertising expenditure and the phasing of that. I wonder if you can give us a little bit more color, at least directionally maybe, in terms of the expenditure levels to [ph] replenish (44:48) the sales in the first quarter versus year-on-year and sequentially. And then, I think you mentioned obviously there's buildup through the year. I just wonder whether you can give us some feeling as to whether that's going to be very heavy in the second and third quarter and falling away in the fourth, or building up through the year.

And then, related to that investment, again obviously, you're talking about being ready for this category push in the second quarter. A lot of that's around, as we understand it, direct store and merchandising in store. Can you talk about any activities and the investment that you've made in the first quarter to put more salespeople in place et cetera, which are ready to go as we go into the second quarter? Thanks very much.

<A - John A. Bryant>: I'll ask Ron to answer the advertising phasing question, and I'll come back and talk about the feet on the street investment.

<A - Ronald L. Dissinger>: So, in terms of the advertising, our total brand-building phasing pressure across the year. First, we had good pressure in the first quarter, but our brand building was down slightly year-over-year. Our pressure is much stronger, particularly in the second quarter and the third quarter. So, we're looking to be up probably mid-to-high single-digits in terms of our brand-building pressure. And then as we said for the full year, we expect our brand building and advertising to grow at a rate faster than sales growth. But good pressure out there in the second quarter and the third quarter.

<A - John A. Bryant>: If we look at the investment back in the sales organization, it's really happening in two places in the U.S. The first one is in our DSD system. We've invested back in the DSD organization by increasing the number of reps, and we've improved the technology available to those reps as well. So, we're seeing a very good performance from our DSD sales organization; already started to see that come through in the first quarter. We're building momentum in three of the four big businesses within snacks. We gained over a share point in Crackers, we saw growth in Cheez-It Club from base innovation, Town House, the core Cracker brands.

We also saw a very good growth in cookies towards the end of the quarter with the M&M'S cookies coming through. Now, all this is coming through in terms of improved execution in store. Wholesome Snacks is the one business that is not firing on all cylinders. Within that we have a couple brands that are doing well, and a few that need some work, but we're seeing improved merchandising there over time as well. And of course, Pringles continues to deliver double-digit growth in the first quarter on top of double-digit growth last year. So, we're seeing a good response to investment in the sales organization on DSD.

The other part of the sales organization that we are looking to continue to optimize is on the morning foods or cereal side of the business, the warehouse side, where we have more of a broker model and we are selectively adding back Kellogg direct employees' feet on the

street there in the right locations where we have the greatest impact. That's more later in Q1 into Q2 as we go through the year.

<Q - David H. Hayes>: That's great. Thank you.

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

Operator

Our next question is from Eric Katzman of Deutsche Bank. Please go ahead.

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

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

<Q - Eric R. Katzman>: Two questions. I guess first one, Ron. You mentioned on Slide 11 about Venezuela, and I think you said it had no – there's no FX impact or you haven't assumed any. Can you just – have you not adjusted your [ph] CCAD (48:03) rate, or were you just talking ex-currency, and if we include currency, how much of a drag is Venezuela expected to be on the range?

<A - Ronald L. Dissinger>: So, at this point in time, Eric, we have not taken a devaluation for the Venezuela business. Let me just elaborate on that a little bit. First, as I said in the prepared remarks, sales are approximately 1% of our total company sales and operating profit is approximately 2% of our company operating profit. The valuation of our net assets and the translation of sales and profits are really a facts and circumstances situation. Within Venezuela, Kellogg's is deemed a priority industry and we manufacture virtually all of our product domestically within Venezuela. We are also able to secure funds for anything we buy out of the country to produce in the country, we're able to secure funds at the official rate of 6.3 bolivar to the U.S. dollar. So, at this point in time, we have chosen to continue to value our business at that rate.

Now, the [ph] CCAD 1 (49:18) rate I believe is just under 11 bolivar to the U.S. dollar. If our facts and circumstances were to change and we were to value at that rate, we would have a one-time charge impact for the devaluation of the net assets, and then we would have an impact

from the future translation of profits to our business. The estimated impact for that – and this will be disclosed within our Q as well, is around $0.09 to $0.11 of earnings per share.

<Q - Eric R. Katzman>: Okay. All right. Because I guess you have production locally, and you're deemed by the government to be special or that's why you're different from other companies that have had to recognize the 11 rate?

<A - John A. Bryant>: That is absolutely correct, Eric.

<Q - Eric R. Katzman>: Okay. And then, John, if I could follow up, the Nielsen data going into the quarter showed your cookies and crackers business as struggling a bit, but you kind of pointed to it actually being quite strong. I think if my memory is correct, crackers are really the bulk of the business and the most profitable part. Can you talk a little bit about the difference between the Nielsen data and your shipments, and also kind of how you see the Project K enabling that business when obviously your competitor in [ph] Mondelize (50:54) has a lot riding on their North American business both being stronger in terms of sales and profits and they are taking production down to Mexico et cetera.

<A - John A. Bryant>: I feel very good about the momentum that we are building in our Snacks business in the U.S., and we had a tough year last year, but as I look within the U.S., it probably is not as evident when all you see is the quarterly results. When you look at the phasing within the quarter, we came out of Q1 strong, and we're seeing very good momentum behind crackers and cookies, Pringles obviously as well. And in that business, it's not really the ability to have a big disconnect between consumption and shipments over time because it's a DSD business; it's not going through a warehouse where you could get inventory hung up for a period of time.

So, a couple reasons why our shipments were stronger than our consumption: one is we had some good activity going in customer that is outside the measured data; and also, we had very good display levels at the end of the quarter on four and seen that pool out in [ph] P4 (52:12) consumption as well. So, I believe we are building momentum in the Snacks business, and feel like we are absolutely on the right track.

In terms of our competitor, I can't really talk to what their strategy or their intent is, but our intent here is to play our game which is innovation driven, in-store execution driven, invest back in the sales organization. We've gained share in crackers for just about every year for the last 10, 12 years except for the last one or two years, and to see ourselves back in cracker share growth there, to see the Keebler business growing single-digits, to see Pringles driving double-digit growth on top of double-digit growth, there's a lot of reasons here to see the business start to turn. Wholesome snacks, there's still work to be done, but we're absolutely addressing it and taking the right actions.

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

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

Operator

Our next question is from David Driscoll of Citi Research. Please go ahead.

<Q - Alexis N. Borden>: Good morning. This is Alexis Borden in for David this morning. Just a question about your inflation expectations. I know you reiterate your guidance of 3% to 4% and you said that inflation was modest in the first quarter. So, maybe you can clarify or elaborate a little bit of the pacing on a go-forward basis?

<A - Ronald L. Dissinger>: Yeah, so, we did see a little bit of net inflation within the first quarter. We still expect, as I said, around 3% to 4% of cost inflation and that will be more than offset by the productivity improvements that we expect over the course of the year. Remember, we've always talked about inflationary costs and materials and primarily that being driven by our packaging costs. We did see some timing of cost and savings, as I said, within our factories. In particular, timing of production, our production was a little bit lower in the first quarter, not an issue for the full-year necessarily, but a little lower in the first quarter and some of that was related to the weather impact that John talked about. We all actually saw some impact to our ability to produce in some of our manufacturing facilities.

So, our inflation is a little bit more front-end weighted, not a significant exaggeration in terms of front-end versus how it spreads across the year. The other important thing is our savings. We have good savings in the first quarter, but those savings do ramp up as we progress through the balance of the year, and the Project K savings are a particular contributor to that. Those savings, as you can imagine particularly for our supply chain initiatives, will increase as we go through particularly the back part of the year. So, we will see – or have seen, net inflation in the first quarter and we'll see some net deflation over the balance of the year.

<Q - Alexis N. Borden>: Okay. Thank you.

Operator

Our next question is from David Palmer of RBC Capital Markets. Please go ahead.

<Q - David S. Palmer>: Good morning. First a follow-up question after your conversation with Eric there with regard to shipments versus consumption. Do you think your shipments overall were in line with consumption across your businesses? And second, my primary question is, you've been talking about your investments in brand building in the quarter and I think we're all assuming that the bulk of that is going to be U.S. cereal, perhaps you can confirm on that, and with regard specifically to advertising behind that. Given that, I thought it was interesting you said you expected cereal to be down, but down in line with the category. Given your importance in the category, are you expecting that the category growth or decline rate will improve through the rest of this year? Thanks very much.

<A - John A. Bryant>: So, there's a few questions in there. Firstly, in terms of any difference between shipments and consumption, I would say that our shipments were broadly in line with our consumption. And if we look at our trade inventory levels, there is nothing there that stuck out to us as a concern year-on-year. Secondly, in terms of brand building investment, the brand building investment we have coming in Q2 and Q3 is a bit more cereal oriented, particularly in some of the developed markets such as parts of Europe, Australia, the U.S. Obviously, we'll continue to invest more in brands like Pringles as well, which has continued to drive tremendous growth for us. I'm trying to remember the third piece now that you asked me.

<Q - David S. Palmer>: Just the part about brand building and the fact that you said that you expect the declines to continue. Given this investment, it seemed rather conservative.

<A - John A. Bryant>: Well, I believe that the category growth is a function of what the manufacturers do. So, to your point, if we improve our performance, then the category performance should improve as well. And in some respects, that is inside of expectation. In the first quarter, the category is down 4% to 5%. The category is likely to be down more sort of low single-digits across the back half of the year, with us more in line with the category – not necessarily in line with the category, but closer to the category. And if we can improve our performance, I believe the category will improve.

<Q - David S. Palmer>: Thank you.

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

Operator

Our next question is from Matthew Grainger of Morgan Stanley. Please go ahead.

<Q - Matthew C. Grainger>: Hi. Good morning, everyone.

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

<Q - Matthew C. Grainger>: I just wanted to focus more on the Non-GMO Kashi offerings and just any early thoughts you have on the performance there? Can you give us a sense at all of the cost-benefit trade-offs, whether there's a material difference in margin, how retailers are responding to it, and if you have any observations about performance at the consumer level relative to the legacy SKUs?

<A - John A. Bryant>: Well, first, as I said earlier, Kashi is a tremendous brand; it's one of the largest brands in the natural organic space. We do need to invest more back into the food to ensure we're on track with progressive nutrition. And as we do that, it means putting money back into the food itself. So, it does impact the gross margin structure, but essentially there's a shift within Kashi from brand building into the food because you have to have the food right.

In terms of are we seeing an impact, it's too early to say there's a big impact on GMO-free. We do have organic SKUs within Kashi, and they have been doing well. So, I think there's reason to believe in that. But ultimately, we need to get more new innovation to the marketplace over time. So, we're confident in the long-term growth of Kashi. What I will say is this business, because it has lost some distribution over the last 12, 18 months, it is going to be a headwind as we go through 2014 as we're just lapping those distribution losses. But long term, this is a very strong business. We just need to get it back on track and invest more in the food, because that's what consumers are looking for from this brand.

<Q - Matthew C. Grainger>: Okay.

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

Operator

And our last question will come from Alexia Howard of Sanford Bernstein. Please go ahead.

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

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

<Q - Alexia J. Howard>: Thanks ever so much for the detail on Kashi and what's going on in there. You mentioned that there were also some problems with Special K and Mini-Wheats as well and it would be great to get some detail on that. You mentioned distribution losses at Kashi. Was that specifically in regular grocery stores? Was it in the natural grocery outlets? And more broadly, because the cereal category as a whole has been in trouble for I guess about 18 months now, how are the retailers thinking about shelf space allocation for the entire segment at the moment? Thank you very much.

<A - John A. Bryant>: Okay. Perhaps I could take that in reverse order that you asked the questions. So, again, the retail support for the category remains strong. This is one of the largest most profitable categories within the retail environment. And the discussions we're having with retailers are very productive and positive about how we grow our combined business. And in some respects, you come back to the category relevance work, we're getting very good retail support from that work, because it's helping retailers both with the cereal category and with the milk category, which is another important category for them at the time as well.

So, we continue to get good retail support for shelf assortment. There's probably a little bit less merchandising support over the last couple of years, but continue to get good primary shop support.

In terms of where the distribution losses have occurred for Kashi, quite frankly, there have been some retailers that are more mainstream in orientation. They probably took a little bit more Kashi than they could sustain in that sort of outlet, and we're still seeing very good distribution in the primary stores where the natural organic shopper goes to shop.

And then coming back to your first question about some of the other brands where we have some challenges, we have Special K and Mini-Wheats where we have specific activity coming to market against both of those. So, on Mini-Wheats its on-air here in the second quarter. It's also being heavily featured in the category work that's going on. And on Special K we have a new Simple 5 program that's coming in the second quarter, which actually is a portfolio program across Cereal Snacks and Frozen, and really highlights the all-day weight management partner that Special K is. And so, we have a number of specific programs addressing those very specific brand opportunities, which we think are part of the solution to drive back to growth.

<Q - Alexia J. Howard>: And on Special K, was there a reason that the beginning of the year typical campaign on dieting and so on didn't work as well this year, or is it a different issue? Thank you.

<A - John A. Bryant>: I think we have a couple of opportunities with Special K. Certainly, the resolution event earlier this year was not as effective as we would have liked, and I think we have an opportunity to continue to improve those programs over time. I think they've become – we used to call them the two-week challenge, it's become a challenge, it's become something difficult do, it's not resonating with consumers as well. And so, we need to continue to move the brand to a more positive footing of great food that helps you live your life to the fullest and manage your weight as opposed to more of a negative orientation.

And quite frankly, that's a challenge not just in the U.S.; it's a global challenge on Special K. If you look around the world where the weakness is in some of our cereal businesses, it is a Special K discussion. And so, as we look at our Special K programs globally, we are working on different programs around the world. We've changed the food in a number of markets, and as we see again what works, we'll continue to adapt and adopt rapidly around the Kellogg system and bring those ideas to bear.

<Q - Alexia J. Howard>: Great. Thank you very much for the question.

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

Simon D. Burton

Thanks, everyone, for joining us. We'll be available in the next couple of days for follow ups.

Operator

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