Company Name: Kellogg
Company Ticker: K US
Date: 2017-05-04
Event Description: Q1 2017 Earnings Call

Market Cap: 24,643.57
Current PX: 70.40
YTD Change($): -3.31
YTD Change(%): -4.491

Bloomberg Estimates - EPS
Current Quarter: 0.973
Current Year: 3.922
Bloomberg Estimates - Sales
Current Quarter: 3166.077
Current Year: 12645.200

Q1 2017 Earnings Call

Company Participants

- John P. Renwick, CFA
- John A. Bryant
- Fareed A. Khan
- Paul T. Norman

Other Participants

- Robert Moskow
- David Cristopher Driscoll
- Rob Dickerson
- Michael Lavery
- John Joseph Baumgartner
- Bryan D. Spillane
- Eric Larson
- David Palmer

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company First Quarter 2017 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] Please limit yourself to one question during the Q&A session. Thank you. Please note this event is being recorded.

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

John P. Renwick, CFA

Thank you, Gary. Good morning, everyone, and thank you for joining us today for a review of our first quarter 2017 results. I am joined this morning by: John Bryant, Chairman and CEO, who will give you an overview of our business results and priorities; Fareed Khan, Chief Financial Officer, who will walk you through our financial results and outlook; and Paul Norman, President of North America, who will give you an update on our North America business.

Slide number 2 shows our usual forward-looking statements disclaimer. As you are aware, certain statements made today, such as projections for Kellogg Company's future performance including earnings per share, net sales, profit margins, operating profit, interest expense, tax rate, cash flow, brand-building, up-front costs, investments and inflation, are forward-looking statements. Actual results could be materially different from those projected. For further information concerning factors that could cause these results to differ, please refer to the second slide of this presentation, as well to our public SEC filings.

As a reminder, when describing our results and outlook during today's prepared remarks, we will be referring to them on a currency-neutral comparable basis, unless otherwise noted. The appendices to our presentation provide you with

the detail on our GAAP and non-GAAP performance.

Finally, a replay of today's conference call will be available by phone through Tuesday, May 9. The call will also be available via webcast, which will be archived for at least 90 days.

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

John A. Bryant

Thanks, John, and good morning, everyone. In a quarter that was unusually challenging across our industry, we're disappointed with the start to our year on top-line growth. There were essentially three drivers of this slow start, as we had mentioned previously. First, we experienced an expected reduction in trade inventory due to early shipments in Q4 in various categories in the U.S. and from the timing of shipments related to distributor transitions in a handful of international markets. We should be largely past these impacts.

Secondly, we did encounter some customer-specific interruptions in Q1, mostly related to price-pack changes we are making on Pringles to cover input costs, product reformulations and currency. These negotiations have been resolved, though their impact could linger a bit into Q2 as we ramp back up normal orders and promotional activity in these accounts.

Thirdly, and most importantly, like virtually every packaged food company, we experienced a suddenly lower consumption trend across all categories in the U.S. This was the continuation of long-term trends, exacerbated by some transitory issues, such as holiday timing and delays in tax refunds. In our business, we saw the worst of it in January, moderating but still soft in February, and then in March and April showing signs of returning to the run rates we saw in Q4 and full year 2016 adjusted for Easter timing. Shipments, too, seemed to normalize in March and April.

Even despite this disappointing top-line, we still managed to grow currency-neutral profit and earnings. Project K and Zero-Based Budgeting continue to deliver savings as planned and we generated positive price/mix. We expect margin expansion to continue. This is what gives us confidence that we remain on track to deliver on our profit, earnings and cash flow guidance.

Meanwhile, we are confident that our top-line performance will improve in coming quarters. We'll be past some of the discrete factors that affected shipments in Q1. We are already seeing signs of improvement in consumption trends, and we have stronger commercial plans. That said, the longer-term trends we have seen over the past couple of years are still with us. We are addressing these trends, making sure we are getting our consumers what they want, when they want and where they want to purchase it. This is the essence of our 2020 Growth Plan, and we're making good progress against it.

Slide 4 highlights some 2020 Growth Plan elements that directly address the longer-term trends that have been weighing down consumption for packaged foods companies and we made progress in all these areas during Q1. We renovated food and packaging to be more on-trend. This is what will get us out in front of today's trends. Q1 saw Kashi Company return to growth in cereal share and consumption, while launching new and renovated snacks. We also launched a portfolio of new and renovated Special K bars. We renovated Eggo to eliminate artificial colors and flavors.

We're building capabilities required for reaching today's multi-channel shopper. We need to find the consumer wherever he or she is shopping. In Q1, we had another quarter of growth in our Specialty Channels business. We continue to build capability and momentum in e-commerce and in high-frequency stores all around the world. And our recently-announced transition out of DSD, which served one particular channel, is specifically intended to free up resources that can be reinvested for the benefit of more brands across all channels. That transition got off to a good start in Q1.

We're expanding in emerging markets. This is where we'll see better growth for a long time. In Q1, we generated organic growth in these markets. And we also saw continued expansion in our joint ventures, and we made good progress in integrating Parati in Brazil, a transformational acquisition for us in Latin America, and a business that is

already posting strong growth. Over time, these actions will result in better presence and scale for us in markets that will outgrow developed markets.

And we continue to increase our operating profit margin. This not only supports our earnings power in a growth-charged environment, but it helps to offset headwinds and creates fuel for future growth. Project K and Zero-Based Budgeting continue to generate expected savings. Gross margin continues to improve sequentially and operating profit margin continues to improve as well. Returning to profitable top-line growth is a must for us. And while Q1 feels like a step back from a net sales standpoint, we did continue to make progress.

At this point, I'll turn it over to Fareed who will walk you through the financials.

Fareed A. Khan

Thanks, John, and good morning, everyone. Slide 5 offers a brief summary of our financial results for Q1. While we had a disappointing quarter from a net sales perspective, our savings and efficiency programs were strong enough to grow operating profit on a currency-neutral comparable basis. Below operating profit, we were able to reduce interest expense and other financial costs while substantially increasing our earnings from joint ventures, which are growing strongly.

Our favorable effective tax rate was expected in Q1, driven by a previously-disclosed tax benefit related to intra-company brand assets between subsidiaries. I would note that after Q1, our effective tax rate moves back up to higher levels for the remaining quarters and finishes the year higher than 2016, as previously guided. We finished Q1 with earnings per share growth that keeps us on track for our full-year expectations.

Let's go into a little bit more detail, starting with net sales. Slide 6 breaks our reported net sales performance into its components, so you can get a currency-neutral comparable basis. As you can see from the slide, our price/mix continued to firm, contributing 130 basis points after being negative for much of 2016. It was volume that pulled down our net sales in the quarter.

As we mentioned back in February, we were expecting a slow start to the year, based on the three factors that John mentioned: a reduction in trade inventories; second, some customer interactions associated with the implementation of price-pack changes on Pringles, particularly in Europe that have since been resolved; and third, broad-based consumption softness in the U.S., particularly in January and February. Q1 was not the norm and we expect to see sequential improvement in Q2, with further improvement coming in the second half.

Slide 7 summarizes the key initiatives we have in place to drive our margins higher. The first four items on this slide are all well-accounted for under Project K, the largest restructuring program our company has ever undertaken. As you know, this program includes: Network Restructuring, which has included the closure of capacity, as well as investments in new capabilities; the move to a Global Business Services model; and Organizational Design work, which is also on track in generating savings. These efforts are global in scope and on track to deliver our projected benefits.

The most recent element of Project K addressing our Go-to-Market Model represents our recently-announced decision to exit from DSD. It's a little different than the other elements of Project K, in that it's specifically intended to both improve top-line growth for our U.S. Snacks business over time, while also improving margins. This initiative remains on track, as Paul will discuss shortly.

Finally, our Zero-Based Budgeting is delivering. It's in its second year in North America, where it's been embedded into the way we work and has been fully implemented in our international regions, and cost savings are being captured as expected. These initiatives strongly supported our profit and earnings in Q1 and will benefit margins and top-line growth in the future.

Slide 8 shows how we improved our profit margins in Q1. Gross profit margin posted another quarter of year-over-year improvement. This was driven by productivity and cost savings under Project K and Zero-Based Budgeting, and by

favorable net input costs. These factors more than offset the impact of continuing to invest in our food and packaging, as well as the negative operating leverage of an unusually large decline in volume we saw for the quarter. On the operating profit margin, we continued to see strong expansion in Q1, not only because of the increase in gross margin, but also because of the efficiencies and savings initiatives. Importantly, this operating margin expansion was broad-based, with all four of our regions recording increases. So our margin expansion remains very much on track.

Also on track is our cash flow, as indicated on slide 9. In addition to higher net income, we continued to trim our core working capital as a percentage of sales, primarily through our efforts on payables. This year-over-year improvement in cash flow is strong, even when you exclude the year-ago impact of last year's bond tender. Our Q1 performance keeps us on track for our full-year cash flow target of $1.1 billion to $1.2 billion.

With that, let's turn to slide 10 and our latest guidance for the full year 2017. We are confirming our guidance for operating profit, earnings per share and cash flow, even as we soften our outlook for net sales.

The Q1 sales decline puts us behind the rate of our previous net sales guidance. And we are taking a prudent approach towards year-to-go consumption trends. So we think net sales growth for the full year is now more like a 3% decline. This doesn't alter our operating profit guidance, which we are affirming today. As we stated at CAGNY, we can deliver on a 7% to 9% operating profit growth, even if net sales decline 3% for the year. And we've identified additional opportunities that give us confidence in this outlook. Our earnings per share outlook is also affirmed, and this is both on a currency-neutral comparable basis, which is how we measure it, as well as on a comparable basis. And finally, we are also affirming our guidance on cash flow, as I mentioned.

While we don't offer specific guidance by quarter, I would like to take a moment to comment on the general shape of our earnings in 2017. We still believe operating profit growth will be weighted to the second half. Some of these quarterly phasing factors are described on slide 11. While we mentioned there are elements of Q1 that could linger into Q2, and specifically we are prudently assuming that it's going to take time for January and February's consumption trends to moderate, and we'll just be resuming normal shipments and promotional activities following negotiations with certain customers in Europe during Q1, but the largest driver of our second half weighting is the DSD transition. Simply put, there'll be some overlap between the reinvestment in our warehouse and brand-building and the cost of operating DSD during the Q2 and Q3 transition period. This is because we can't eliminate DSD costs until we have the bulk of our customers transitioned into the warehouse model. And, by and large, those savings will come in Q4.

In summary, Q1 was a slow start on the top-line, as we had indicated, but it didn't take us off course for earnings or cash flow. Much of our plan is weighted to the second half, with sales improving as we go along and savings related to the DSD exit coming late in the year. And our margin expansion programs continue to bear fruit, so we remain on track to achieve operating profit, EPS and cash flow guidance even with a softened top-line outlook.

To be clear, and to reiterate John's comment, bottom-line growth is not enough. We need to get back to top-line growth and that remains a key priority for us, even as we deliver our margin expansion.

So with that, I'd like to turn over the call to Paul Norman, our President of Kellogg North America.

Paul T. Norman

Thanks, Fareed. Good morning, everyone. The first quarter was certainly a challenging one for Kellogg North America. We again delivered strong operating profit margin expansion. However, our top-line was not where we wanted it to be. John has already walked you through the unexpectedly soft consumption that was felt across our categories and across the entire industry. And, as he said, it appears that at least some of this was due to transitory factors that will not persist.

We also had a notable decrease in trade inventories. We knew that trade inventory would come out in Q1 and it did. During the quarter, we made good progress on productivity initiatives, investment in food and packaging and our DSD transition, which I'll come back to in a moment. And we had strong commercial plans across our businesses for Q2 and the second half, though I'm confident that our sales performance will improve.

Let's briefly walk through each business, starting with ones whose results came in largely as expected, and then moving to Morning Foods and Snacks, where the factors I mentioned were most acute. I'll start with Specialty Channels on slide 13. Our Specialty Channels business in Q1 delivered a seventh consecutive quarter of sales and profit growth, even against a tough year-ago comparison. The net sales growth was delivered through equal parts of volume and price/mix, and by a market expansion in core channels, as well as expansion in emerging growth channels, all of which was aided by innovation. Operating profit margin continued to improve, driven by price, mix, as well as continued Project K and Zero-Based Budgeting savings. So we continue to feel good about Specialty Channels.

Now we'll look at our North America Other segment on slide number 14. As we expected, this segment posted strong 8% profit growth in Q1 with margins improving substantially, up 200 basis points on the strength of Project K and ZBB savings. In Frozen, Eggo consumption returned to growth in March. With the removal of artificial ingredients and solid commercial plans, we expect better net sales performance in coming quarters.

MorningStar Farms is a similar story. Consumption turned to growth in March and our renovated line is now on shelf and being supported. So that should get gradually better, too. At Kashi, trade inventory corrected, following innovation launches in late Q4. However, we continue to show good progress in our overhauled Cereal business, which continued to grow consumption in the natural channel and grew consumption in xAOC measured channels, too, with particularly encouraging gains for our bear naked brand. And we're just starting to get back on air with media. We launched our new Nut Butter Bars in January. Our early signs are good and we're following it up with further renovations and innovations in the second half. So Kashi is another business in which we expect to see gradual improvement as the year goes on, both in consumption and in net sales.

In Canada, we're still seeing the volume impact of our efforts to increase price realization in order to cover the steep transactional FX impact of a weakened Canadian dollar. We expect the impact to stabilize as we lap our pricing actions in the next couple of months. So Canada is on track to meet expectations for the year.

Now, let's turn to slide 15 and U.S. Morning Foods. Morning Foods' Q1 sales were affected by the category-wide consumption slowdowns in January and February, by trade inventory reductions coming out of Q4 and by the timing of our commercial plans. Performance across our core six brands was mixed. Our kid brands grew consumption and share behind a strong performance of Frosted Flakes and Froot Loops. Cinnamon Frosted Flakes is the leading category innovation this year, and Froot Loops responded very well to its new Whatever Froots Your Loops campaign.

On the flipside, Special K and Mini-Wheats started the year in decline, largely due to the year-on-year timing of innovation and renovation. Last year, both had important activity in Q1. While this year, both are set to launch new and renovated offerings during Q2. We expect quarterly sequential improvement in sales for cereal and share, driven by continued momentum in our kid brands and by the renovation, innovation, and new communication for the Special K and Frosted Mini-Wheats brands, which are breaking here in the month of May. We also have a major in-store event coming in late Q2 behind the movie release of Despicable Me 3.

Pop-Tarts in Q1 continued to gain share in toaster pastries, driven by the successful launch of new Pop-Tarts Dunkin' Donuts flavors. We'll continue to drive this brand hard in the back half of the year with the launch of JOLLY RANCHER-flavored Pop-Tarts. So we expect gradual improvement in Morning Foods' sales performance in the coming quarters, while OP margin expansion will continue.

Now, let's talk about U.S. Snacks shown on slide number 16. Snacks had a tough quarter for the consumption and trade inventory reasons we've mentioned previously. Additionally, but not unexpectedly, we also experienced some initial order softness during the few weeks in February when we were informing our DSD employees of our exit. These factors combined to pull down net sales and operating profit in the quarter. The good news is that we continue to gain share in Crackers, led by our Big 3 brands. And we saw newly-supported Keebler gain share in Cookies. We also sustained share growth momentum in another focused brand for us, Rice Krispies Treats.

So our underlying in-market business performance remains healthy. And we feel good about what's coming in our commercial plans for the rest of the year. We've already launched Special K Snacks in Q1 and still transitioning that on shelf, but that will help us stabilize that brand. As we transition out of DSD, we are ramping up brand-building support

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across key cracker brands, wholesome snack brands, and Pringles. Q2 will see support behind our innovations as well as in-store promotions around Major League Soccer and the tie-in to the movie, Despicable Me 3. And going into the second half, our plan strengthens further with innovations behind Cheez-It, the renovation of Nutri-Grain and new single-serve pack-form adds across multiple categories, all of this supported by the incremental brand-building that is a key element of our transition to our new Go-to-Market Model.

This brings me to another important development in the quarter, our progress against the DSD transition. This is graphically depicted on slide number 16 (sic) [17] (21:50). Transition planning is well underway, driven by a multi-functional team and led by individuals that orchestrated our successful integration of Pringles. Joint business planning with customers has gone well. And our retention of employees is on track. And we've made numerous other elements of progress against a host of operational elements.

So we feel very good about our progress so far. Portfolio optimization began in Q1 and will continue through the transition as we optimize the assortment for warehouse delivery and work down inventories. This will have an increasing impact on volume as the year goes on, but it facilitates the transitions this year and should contribute to a net improvement in velocity and profitability as we get into 2018. Customer transitions have begun, with the first of our customer base being converted here in Q2. This will trigger the first of the list price adjustments, which will have an increasing impact as more customers get converted across Q2 and Q3.

Keep in mind that we already have a fully-functioning warehouse system that is both efficient and scalable and is ready for this transition. Remember, though, most of DSD network will have to remain open through the transition. The final exit, including the final head count and DC reductions, will happen as the last of the customers gets converted during Q4. That's when you will see the true benefit of the savings begin to come forward at their ultimate run rate.

So in summary for Kellogg North America, our top-line performance across the region was affected by softened consumption across most categories in the U.S., as well as some shipment timing and some short-term issues that should be behind us. Commercial plans get stronger in Q2, and we are making good progress on the DSD transition. And we continue to deliver strong improvement in our operating profit margin.

With that, I'll turn it back to John for a look at the international regions.

John A. Bryant

Thanks, Paul. Let's now turn to our international regions, starting with Europe on slide 18. We had a very difficult start to 2017 in Europe. The principal reason for our below-trend net sales performance in Q1 was Pringles. While our consumption held up reasonably well in the quarter, our shipments had an unusual downturn in Q1 because of some customer-specific interruptions as we sought to price behind our food and packaging upgrades, not to mention higher input costs and currency.

This took some time to negotiate with customers, particularly in the UK and France. Getting this done was important as it enables us to reinvest behind the brand. These negotiations have been resolved. So after some lingering impact and tough comparisons in Q2, we should see Pringles return to growth in the second half, particularly given its geographic expansion and stronger commercial plans.

I should point out that while net sales for our UK Cereal business declined year-on-year, we did post another quarter of sequential improvement. We also saw most of our biggest brands hold or gain share in the quarter, with Special K being the one we still have to stabilize.

Overall in Cereal, we expect to continue toward stabilization in the UK and deliver better performance in the rest of Europe. We have strong commercial plans in the developed markets, with an emphasis on Special K, featuring renovation, innovation, and media-supported repositioning. We also expect to sustain our momentum in emerging markets, like Russia and Arabia. Europe is likely to remain challenging over the foreseeable future and we still have a lot of work to do, but we should see sequential improvement as the year goes on.

Latin America is shown on slide 19. Sales in Latin America were off slightly, but solely because of distributor transitions in Central America and Peru. Excluding these transitions, our sales remained in growth. And this was led by good growth in Mexico, thanks to strong growth in high-frequency stores, a strategic priority for us, and solid consumption in our kid-oriented brands in cereal.

Across the region, we sustained strong momentum in Pringles, including double-digit growth in the Southern Cone and continued gains in Mexico, Colombia and Brazil. The integration of Parati, another key priority for us this year, is going well. And Parati, itself, continued to post strong year-on-year growth in the quarter.

If we were to combine Parati's year-on-year growth on a pro forma basis with our currency-neutral comparable results, it would've added to our sales and profit growth in Latin America in the quarter. This is an exciting region for us, and we expect improved growth going ahead. [ph] We also expect margin expansion in Latin America to deliver an extremely strong improvement in Q1, (27:17) putting it well on track to deliver margin expansion for the year.

We'll finish up our international discussion with Asia Pacific on slide 20. Asia Pacific posted improved sales growth in Q1 and very strong profit growth. In our biggest market, Australia, sales were off modestly year-on-year in the quarter, but this represented yet another quarter of good sequential improvement and we generated growth in consumption and share in Cereal.

In Asia, we generated high single-digit sales growth and this growth was broad-based. India is rebounding nicely from the impact of demonetization. And we are recording good growth in Southeast Asia, as well as Japan and Korea. Meanwhile, we continue to grow Pringles across the Asia Pacific region. In Q1, this was led by momentum and expansion of small cans in Korea, the successful launch of a popular new variety in Japan, helping us return to share growth in that market, and strong double-digit gains in emerging markets.

Outside of our consolidated net sales results, our joint ventures continue to perform extremely well in local currency. Both delivered strong double-digit growth again, with West Africa led by strong noodles volume and China more than doubling its e-commerce sales. Given their size and growth rates, if we were to add our share of the JVs' year-on-year sales growth, we'd be talking about double-digit currency-neutral comparable sales growth for Asia Pacific. Asia Pacific is another region that is very much on track to deliver on its projected sales and profit growth in 2017, and is important to the company's overall growth profile going forward.

So now I'm going to summarize with slide 21. It is an unusual time for large packaged food companies, more than ever underscoring the importance of our 2020 Growth Plan and our margin expansion target. Our Q1 got off to a slow start, as we had mentioned it would back in February, and as other companies have experienced. We are disappointed by this top-line performance, but we do believe much of the headwinds are behind us, and remain committed to doing what we have to do in order to sequentially improve this performance near-term, and ultimately returned to top-line growth.

We remain on our profit, earnings, and cash flow guidance for the year, a testament to the strength of our productivity initiatives. We are making good progress on our 2020 Growth Plan. In Q1, that was evident in our growth in emerging markets, in our expansion in emerging channels, our launch of on-trend food and packaging, and even our progress on exiting DSD.

And finally, we continue to improve our currency-neutral comparable operating profit margin with good visibility to our 2018 goals. As always, I want to thank our employees for their hard work and determination in making us a stronger Kellogg Company.

And with that, we'll open up for questions.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Rob Moskow with Credit Suisse. Please go ahead.

<Q - Robert Moskow>: Hi. Thank you. I was hoping I could ask a little bit about the inventory reductions that you've seen in the trade, and maybe you could help me understand what the customers are doing here. Are they consciously just trying to improve their working capital or have you seen, I guess, distribution losses in different categories and geographies for your own business that necessitate lower inventory?

And then particularly in Kashi, I guess I thought Kashi was kind of improving. And then to see the inventory kind of cut back, maybe you could help me understand why that occurred?

<A - John A. Bryant>: Thanks, Rob. Let me just talk about the company at a macro level, and then I'll let Paul jump in with anything he might want to add on North America. Clearly, inventory had an impact on our first quarter top-line growth. And if I just sort of give you a sense of the impact, we were down about 4% on organic sales in Q4. That breaks into four different buckets. 1% is the underlying consumption trend line that we had across 2016. About 1% is the softer consumption from January, February. About 1% is the trade inventory question that you've asked. And another point was the impact of Pringles pack-price architecture and some customer disputes that disrupted our business in the quarter.

If I go specifically to your trade inventory question, so, again, that's about a one point impact on the consolidated results for Q1. We mentioned back on the fourth quarter call that we ended the fourth quarter with higher inventories than we would normally have. So we expected some of this to come out in Q1. It's fair to say we also ended Q1 with lower inventories than what we would normally have. And a part of that could be, for example, in the Snacks business, where we are culling SKUs in preparation for the DSD transition.

What's not driving this is loss of distribution broadly in our categories. In fact, we have the same shelf presence and shelf footprint today as we had last year and the year prior. So we see a good stability in that area. I think this is a correction from higher inventories, and, quite frankly, we're at unusually lower inventories at the end of this quarter, which can give us some line of sight to additional sales as we go through the year. Paul, do you want to add anything?

<A - Paul T. Norman>: Hey, Rob, Paul. Yeah, Kashi. I will come to cash in a second. If you look across Crackers, Cookies, Pop-Tarts, Cereal, Frozen, and Kashi, consumption was higher than our shipments in every case. Okay? So it really was a significant impact; again, more granular on something like Kashi. There's a big disconnect in cereal, in particular, partly because of the selling in of innovation at the end of last year, which we knew drove some inventory in.

The good news is, is the consumption is exactly where, if not ahead of where we planned. So we're seeing that come through in the first quarter and will normalize now as we go forward into the second quarter.

I want to dig deeper and give you a little bit of color maybe on Snacks. Snacks was off, as you can see, by about 6%. Half of that, we think, is consumption-related broad-based trends in the marketplace.

As I said, we grew share in Crackers. We grew share in the Keebler Cookie brand. Rice Krispies continues to do well. But the other half is things like the inventory decline, so planned SKU culls and a little bit of disruption around the, as John said, the transition as it relates to ordering, particularly in those two weeks when we spoke to our sales force about their future. Though you can see this disconnect come through just about in every one of our businesses, it gives us the belief it's transitory and things will get better at Kashi.

<Q - Robert Moskow>: Thank you.

<A - Paul T. Norman>: Thanks.

Operator

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

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

<A - John A. Bryant>: Morning, David.

<Q - David Cristopher Driscoll>: One of your competitors is pretty open about expecting to see gains in shelf space and display activity because of your DSD exit in the second half. I'd just like to hear your thoughts on this. How do you minimize the disruption of this event? What do your retail partners tell you about what's going to happen to the shelf as you make that change? And then, just one related question to this whole thing, you mentioned about brand-building in snacks and starting to ramp on it. Could you just develop that a little bit more and when should we start to expect to see significantly higher levels of brand-building for the snack operations?

<A - Paul T. Norman>: Thanks, David. Here's how we see the status of the DSD transition. So far, everything is on track. And we're very happy with where we stand. If you step back, remember, what's driving this is a consumer and shopper-driven reason and a customer channel-driven reason. Part of the orientation away to a pull model is that we will shift significant resources to brand-building behind those, what I would call, invest-to-grow brands, particularly [ph] delivering snacks brands like (36:13) Cheez-It, Rice Krispies Treats, Pringles, for example.

Our warehouse model is more effective and efficient. We already ship through warehouses. We deliver better service at higher in-stocks and it offers us better joint value creation with our customers as we come through on one platform.

As far as the shelf is concerned, we're deliberately leaning in to optimize our assortment, so we can make the shelf work harder. And so we are looking proactively to make sure that we have our fastest moving, biggest brands, where the investment is going to go, on shelf. We're not looking to lose space. We're looking to optimize our shelf so it can work harder.

Within our customer discussions, so far, there is broad-based agreement that this is the future of delivery in these kinds of categories. And we're working through how we achieve it in the near-term. So we've had generally very good support for the move. Specifically, on brand-building, as I alluded to, you will see the brand-building ramp up here as we go through Q2, Q3, and Q4. It is really important as we go through this transition that we have strong plans in market to ensure shelf presence, display presence and we've got big things to sell behind. So as you look at our Snacks business year to go, we do have a double-digit increase in brand-building coming on crackers, wholesome snacks and Pringles.

We have renovation of the core Nutri-Grain business and brand. We have a big range of seasonal innovations across cookies and wholesome that will drive fun and excitement and display in store. We have Cheez-It innovation coming in the back half. And we have lots of new pack formats across crackers, cookies, and wholesome snacks to drive incremental consumption in new occasions. And a lot of those packs will exist in the mainstream retail environment as well. So we have are pretty packed program of things to come that will drive excitement in the category and we'll benefit from the brand-building as we put it in in the back half of the year.

<Q - David Cristopher Driscoll>: Just one quick follow-up – sorry, go ahead.

<A - John A. Bryant>: Just add one more comment to that. I think Paul made the point that while we're coming out of DSD and going into a warehouse system, we're not just going to any warehouse system. We're going into the Kellogg warehouse system, which is designed to help support large heavily-merchandised categories like cereal. So even when we come into this warehouse system, we'll continue to have feet on the street. We'll continue to drive merchandising with our customers. And as we do this, obviously, we're improving our customer margins on these products and it makes it even more profitable for the margins to support our business.

So we feel that we have some advantages in our warehouse system, given how it's set up, given our experience with cereal and our continued presence in store with feet on the street.

<Q - David Cristopher Driscoll>: Just one follow-up, when you guys use the phrase optimize the portfolio, I generally think that means there's some SKU elimination and you can quantify a sales drag. But I'm also hearing that you're trying to restage the shelf to put your biggest brands on. So I'm a little confused. Is there a quantification of SKU

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elimination and you could say, okay, it's like a two-point drag against the Snack business?

<A - Paul T. Norman>: I can't give you a quantification today, David. But what you're saying is what we're doing. We are eliminating tail where it doesn't make sense. And we're looking to prioritize and maximize assortment against the biggest things we have. And so when I talk about putting more brand-building in behind brands like Cheez-Its and Rice Krispies Treats, et cetera, we are making sure that we have the most efficient and effective assortment to drive our business harder going forward. But there is a degree of SKU rationalization, and [ph] we've leant in (40:04) proactively on that.

<Q - David Cristopher Driscoll>: Thank you so much. I'll pass it on.

Operator

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

<Q>: Hey. Good morning. It's actually [ph] Josh (40:16) on for Ken. On DSD, I guess sticking with this. I know you've talked about in the past, about the plan generally – or you talked earlier about it being on track. But you've also talked in the past about having to give back on certain terms like on price to customers in Keebler. I know it's early, and the customer's obviously only started the transition with, but trying to get a sense of the level of these give-backs, whether, again, it's pricing or other forms and just being sure that this is more or less where you expect it.

<A - Paul T. Norman>: Hey, [ph] Josh, (40:46) I can't go into detail on price or anything that you call the give-backs. But I can tell you that the discussions with retailers have gone well. And within the context of the plans we put together going in, so far so good.

<Q>: Got it. Thanks. And then maybe just a larger question on the retail environment, I guess you didn't really emphasize that part as much, right. Obviously, there's some inventory changes that acted as a drag in certain places. But Kraft Heinz last night said that the competitive environment and the pressures they were getting from customers really weren't different from what they usually are, I guess. Would you agree with that assessment? Because, obviously, there have been, obviously a lot of articles lately about big grocers trying to extract something extra from their vendors. We're trying to figure out how this is actually playing out in reality. Thanks.

<A - Paul T. Norman>: Yes, [ph] Josh, (41:43) I think it would be fair to say there is always pressure from our retail partners to keep prices low. If you look at the data we see, you see there's not a lot of massive deflation going on in our categories right now. We have seen a little bit of push from private labels in selected categories. Frozen would be one. We've see private label items come up, and we've also seen our Eggo items come up, which suggests that there are factors going on there. And the retail environment is changing to adapt to consumer needs, quite frankly. And so we're seeing growth on the fringes of retail in all kinds of places, just incumbent on us to be more agile with the right food in the right format at the right price, depending on those retail environments. But the pressure is the same as it's always been.

<Q>: Thanks very much.

Operator

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

<Q - Rob Dickerson>: Thank you. I just had a question on the margin here. It seems like if your top-line guidance is sales decline about 5% and operating profit growth would be up, let's call it, about 5% or so, that implied operating profit margin is, I don't know, up 150, 200 basis points? But what it seems like is that increase in that operating profit for the year that's expected, that obviously doesn't include the full upside on the operating profit margin coming from snacks. So I guess we think about 2018, it would seem like there should be a sizable step up in 2018 that we're not going to see in 2017, even though 2017 is stepping up. Am I thinking about that the right way?

<A - Fareed A. Khan>: Thanks, Rob. It's Fareed. A couple of points; first of all, we are on track for the 350 basis point operating profit growth that we've outlined a few years ago and you see that lift in the quarter and you will see that lift in the full year. There is a number of moving parts, and you touched on several of them, so it might be worth just kind of revisiting the phasing a little bit.

First of all, on the top-line, as John mentioned, about half, or 200 basis points, of our top-line decline in Q1 was really quarter-specific factors between the trade inventory and some of the customer discussions. Through Q2, we expect that to moderate and we'll be back to more of a normalized run rate, still negative, for the year. And we guided to down 3%, so that implies still a soft back half, but more normalized.

We had price/mix favorability in the quarter and we expect that to continue. That's through initiatives as well as regions. On cost of goods, we have seen some favorability in raw materials. We have Project K and ZBB initiatives that are already in flight. And those are going to deliver the objectives that we have set out. And so those are pretty large numbers for the year, and they will basically deliver pretty consistently throughout the four quarters.

And then we get to the DSD, which is really the primary driver of some of the phasing differences. And, as Paul mentioned, we've got brand building investments. We've got investments in the network, in inventory and getting ready for the transition to make sure that that's successful. And then, we have price changes with customers. And then, we operate the DSD network and the warehouse network somewhat in parallel until we get a critical cut mass of customers on the warehouse model and then we can start taking down and capturing the cost benefits.

And so that actually drives the most significant kind of first half, second half phasing. And obviously, with the size of the network and some of the more front-loaded investments, those are big swings. So we do see operating margin up 100 basis points and definitely on track for the 350.

<Q - Rob Dickerson>: Okay, great. Thanks. And then just a follow-up on U.S. Snacks, the organic sales were down 6% in the North America sub-segment and I realize there are some kind of one-off variables driving that performance, but as think about as we go through the rest of the year, it does sound like as you transition into more retailers, there's maybe a bit more incremental pricing pressure, maybe even a bit more incremental volume pressure. So is the thought that the overall North America performance should still improve as we go through the year, despite potential worsening in U.S. Snacks?

<A - Paul T. Norman>: Yes, we see the improvement coming sequentially across the year. A far as the Snacks business is concerned, obviously, I'm not sure we'll see incremental volume or price pressure, as John alluded to. As part of the transition, our retailers will actually get more margin here. And we have great plans to pull coming through in brand-building. So we will see some deflation of pricing because of the net sales impact, but overall underlying velocities, there's going to be a lot of volatility. But we're still going to execute our plan.

<Q - Rob Dickerson>: Okay, great. I'll pass it on.

Operator

The next question comes from Michael Lavery with Piper Jaffray. These go ahead.

<Q - Michael Lavery>: Morning. Thank you.

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

<Q - Michael Lavery>: Just wanted to touch on snacks. First of all, make sure I heard you right, that about half the decline there was just consumption-driven. Snacks, obviously, recently has been one of the few bright spots in packaged food for top-line momentum. Are you seeing that turn? And what's changed there that you would point to the consumption decline?

<A - Paul T. Norman>: I think some of that 50% or so, half of it being consumption decline, was related to the January, February impacts that I think the entire industry felt. We're not anticipating those declines to become the

norm. I think they were transitory in nature. And so we feel very confident that snacking categories are ripe for growth going forward.

<Q - Michael Lavery>: And can you touch on the Kashi Snacks launch? You had some of those new items early in the year. And maybe then you were poorly timed if the whole sort of industry impacted with it were out of favor, but how is that running against your expectations both in terms of distribution and the velocities?

<A - Paul T. Norman>: Specifically to Kashi Snacks, we launched two Nut Butter Bars at the beginning of the year here, and so far so good. The pickup has been better than we expected. We have more listings to come in the back half around nut butters. We're also fully renovating our chewy bars here at the end of the second quarter, moving into the third quarter, and the food is significantly preferred, so we have a real upgrade coming on our chewy bars. So that's the innovation and renovation. We've just gone back on air with new advertising which features the bars here in March, April, so. And that will continue through Q2 and Q3. So we are on track to deliver what we expected this year.

Now as we've said, on Kashi bars in particular, we expected growth on cereal this year from a consumption point of view. That is our outlook. On bars, we expected to dramatically decline the rate of decline, if you like. So we're not expecting growth, but we are expecting a much lower rate of decline, in the single digits. And so far, we're on track and we feel good with the uptake of these new bars.

In terms of points of distribution on bars, we are seeing going into the second half of the year, a stabilization as it pertains to points of distribution, which is positive because we hadn't seen that over the past couple of years. So with a bit of luck and a bit of hope and a bit of good execution, we're bottoming out here and we can start to look forward on snacks.

<Q - Michael Lavery>: No, that's helpful. And just a last follow-up, on the acceleration broadly that you expect across the portfolio, where do you see the biggest opportunities for that? And what should we be watching for when to see that come through?

<A - Paul T. Norman>: Specifically to Kashi, Michael, or to the...

<Q - Michael Lavery>: No, no. For your whole portfolio, when you talk about you expect the accelerating top-line over the course of the year, what would be the biggest drivers of that?

<A - Paul T. Norman>: [ph] Granted (50:53), we expect it to come across all of our businesses, as I mentioned, that we see consumption disconnected from shipments in just about every category. So we expect improving consumption on cereal through the back half of the year. We expect it on cookies and crackers from a velocity point of view, Pop-Tarts. Frozen, we're anticipating getting back into growth. Kashi Cereal, we're looking to see that consumption growth come through in our business. Specialty, we expect to maintain the momentum we've developed. And in our Canadian business, we're going to lap, as I said, the pricing interventions from a year ago soon, and we expect an improving performance there as well. So it really is broad-based.

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

Operator

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

<Q - John Joseph Baumgartner>: Thanks. Good morning. John, in terms of the E.U. softness around the customer negotiations, and I guess specifically the weakness in the UK, my understanding was that the net revenue management was going to be an increasing component for the business as the year rolled on into 2018. But, I guess given the consumer weakness you're seeing, maybe some of the UK inflation building from Brexit, how are you thinking about the risks to the net revenue management approach at this point?

<A - John A. Bryant>: John, I'd say that the revenue growth management work is even more important in a difficult environment like we have in Europe. So look what happened in Europe in the first quarter. Cereal actually was broadly

in line with what our expectation was. Pringles was the big deviation from what we both expected and the historical run rate. And what happened there is we had to take some pack-price architecture moves to offset both some cost inflation, but also [ph] beat (52:41) transactional foreign exchange issues that that business has, given how some of the [ph] cross rates (52:48) have moved within Europe.

Unfortunately, that did result in some customer disruption, some customer disputes. We are happy to say they are behind us, and we've come to common ground with our retail partners. And now here in Q2, there'll be some lingering impact of that, but that will be behind us, so we'll be able to move forward, getting that business back into good growth in the back half of the year, as we've seen over the last four or five years.

The Pringles business actually has a pattern of every about five years doing a food improvement, changing pack-price and including price realization. We were due for that this year on Pringles, both in Europe and the U.S. This is the first time we've done it under Kellogg ownership. Quite frankly, the disruption was a bit more than what we anticipated, but it was absolutely the right thing to do. I'm happy to say it's behind us and we are moving back on track where we need to be on that business as we go forward.

<Q - John Joseph Baumgartner>: Okay. And then just a follow-up, in terms of the ingredients renovations and reformulations, is there a way to frame where you are in terms of that program? Are you halfway through, 25% through? Can you just quantify, maybe, how much work still remains?

<A - John A. Bryant>: It's an ongoing process because the definitions of health and wellness and what consumers are looking for continues to change and evolve. So if you look at what we're doing to drive top-line growth, a big part of it is ensuring we have on-trend food and packaging. So this year, we have about a 50 basis point headwind on cost of goods as we make decisions to reinvest back in our food, whether that be elimination of artificials on waffles, which is doing very well here in the first quarter, or improving the performance of the food profile of Pringles, or investing back into our core cereal business. So these are changes that we'll keep doing. It won't be a case of getting it behind us. It's an ever, ongoing, evergreen evolutionary part of our business.

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

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

Operator

The next question comes from Bryan Spillane with Bank of America. Please go ahead.

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

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

<Q - Bryan D. Spillane>: I just had one question, John, and it's a follow-up to the answer you gave to an earlier question about you made a reference to the strength of your warehouse system and how that's, sort of, a good fit for the biscuit business. One of the things that has always, sort of, justified DSD is just turns, how much, how fast or how often a category turns and like soft drinks are an extreme. It turns like 80 times a year. Can you just give us a sense, in terms of the biscuit business, what the turns are or, more importantly, what they are relative to some of the big products in your warehouse brands now? Are they turned roughly the same amount and that's what gives you confidence that you can service it just as well?

<A - John A. Bryant>: Absolutely. So take cereal, for example. The velocity on items like cereal and Pop-Tarts are similar to or better than the turns on cookies and crackers. So we are used to distributing a high velocity, high merchandising set of categories through this warehouse system. The future in display is also very strong on cereal and Pop-Tarts, as it is on cookies and crackers. Remember that 40% of our Snacks business today goes through the warehouse system. And where we go through that warehouse system, we have better delivery performance, we have better share performance and we have a better growth profile.

So we have already proven those that these products can go through a warehouse system and, quite frankly, a warehouse system largely delivers cookies and crackers in major markets around the world. So what we're doing here in the U.S. is not new to the world. This is how these products go to market in markets like the UK, et cetera. So we are very confident in our ability to enable us and how to work. We do recognize that in the transition, there can be some disruption. This is a complicated thing that we're doing here. We have great plans around it. We believe we're well-positioned to execute it, but the destination is absolutely the right place. The path to get there is where we have to stay very focused and execute with excellence.

<Q - Bryan D. Spillane>: Thanks, John.

Operator

The next question comes from Eric Larson with Buckingham. Please go ahead.

<Q - Eric Larson>: Yes. Good morning, everyone. Thanks for squeezing me in. My question is for Fareed. By the way, welcome to the company. Cash flow, you've got a bunch of tailwinds with free cash. I know that you maintained your guidance for the year, but you've got some really meaningful working capital benefits that you're improving on. You've got your operating profit margins improving. Your CapEx for Project K should be coming down. Is some of that being offset? Well, obviously, some of it is being offset by lower revenue, but do you have other, maybe one-time cash uses right now for like the DSD conversion or can you give us a little bit of feel for why we're not actually trickling up a little bit on free cash?

<A - Fareed A. Khan>: Sure, Eric, and hello and thanks for the welcome. So we still have cash costs with some of the restructurings that we have in place through the various initiatives. And when we first launched them, we talked about $1.5 billion to $1.6 billion. And we're about $1.3 billion through those upfront costs. So there's still some left. The primary driver, as you noted, is going to be associated with the DSD conversion. We're still focused on working capital. We're still focused on a lot of the other initiatives. And so it's really there's some upfront cost investment. As you noted, we increased the dividend and will have board authorization for share buybacks as well. And that $1.1 billion to $1.2 billion cash flow target for the year still feels right.

<Q - Eric Larson>: Okay. Thank you.

Operator

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

<Q - David Palmer>: Thanks. Good morning, everybody. First a question on the DSD-supported businesses, how are you thinking about your year-over-year shipment performance as you go through the rest of the year and what's baked into your guidance?

<A - Paul T. Norman>: We don't give quarterly indications, but we have factored in, obviously, a degree of an inventory build and a transfer here through the second and third quarter, which will be offset by some other factors as the year goes on. So as John, I think, might pick it up, we'd originally factored in the impact to the company in the year from this. And there's no change to that.

<A - John A. Bryant>: Yes, so I think as we said before, we'll see a little bit of an inventory build probably Q2 and into Q3. So Q2 might be a little bit better than in Q3. And Q4, you'll see the price adjustments which will bring down our net sales. But, obviously, that will be with us as we go into 2018 as well. So that gives you a sense of a bit of the phasing as we go through the year.

<Q - David Palmer>: That's helpful, thank you. And then also, just looking at some of the scanner data for the first quarter, it looks similar to some of the past quarters, where Special K has been relatively weak and snack bars relatively weak, but it sounds like those are some areas; I don't know if it's Special K specifically, but your claim that you're

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going to get back to growth in Cereal is certainly speaking to improvement somewhere. And I guess you mentioned the new chewy bars that you're going to be launching. But any detail about how you're going to be improving those businesses would be helpful. Thanks.

<A - Paul T. Norman>: Yes. It's Paul, David. The Special K Cereal business has actually flattened out pretty much and held or grown share in the last two years. The impact in Q1 was really down to a timing of innovation activity, and we have all of that lined up to start and it's starting here in May, as we speak. So the Cereal business, you picked it up. If we're going to win and drive this category forward, our Core 6 needs to fire on all cylinders. And K needs to do better in the back half. We think we have the plans to do that. Our kid brands momentum will continue, specifically with wholesome snacks. There's more than Special K to wholesome snacks.

Rice Krispies Treats continues to grow, and we look to accelerate that. Nutri-Grain has significant renovation coming as well. And then the Special K transition is underway, with better food and we'll benefit from the new campaign across the entire brand. So we expect an improving trend in Special K bars as part of our wholesome snack business year to go.

<Q - David Palmer>: Thank you very much.

<A - John P. Renwick, CFA>: Okay. Operator, I'm afraid we're out of time.

Operator

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

John P. Renwick, CFA

Thanks, everyone, for your interest. And if you have any follow-up questions, please call me. I'll be around all day.

Operator

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

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