Company Name: Kellogg
Company Ticker: K US
Date: 2013-11-04
Event Description: Q3 2013 Earnings Call

Market Cap: 22,886.64
Current PX: 63.146
YTD Change($): +7.296
YTD Change(%): +13.064

Bloomberg Estimates - EPS
Current Quarter: 0.875
Current Year: 3.761
Bloomberg Estimates - Sales
Current Quarter: 3560.857
Current Year: 14851.063

Q3 2013 Earnings Call

Company Participants

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

Other Participants

- Alexia Jane Howard
- Andrew Lazar
- Eric R. Katzman
- Thilo Wrede
- David C. Driscoll
- Ken B. Goldman
- Christopher R. Growe
- Robert B. Moskow
- Jason M. English
- Todd Duvick
- Tim S. Ramey
- Kenneth B. Zaslow
- Bryan D. Spillane
- John Baumgartner

MANAGEMENT DISCUSSION SECTION

Operator

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

At this time, I'll 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, everyone, and thanks for joining us today for a review of our third quarter 2013 results. I'm joined here today by John Bryant, President and CEO; Ron Dissinger, Chief Financial Officer; and Alistair Hirst, Senior Vice President of Global Supply Chain.

The press release and slides that support our remarks this morning are posted on our website at www.kelloggcompany.com. As you are aware, certain statements made today, such as projections for Kellogg Company's future performance, including earnings per share, net sales margin, operating profit, interest expense, tax rate, cash flow, brand building, up-front costs, investments and inflation, are forward-looking statements. Actual results could be materially different from those projected.

For further information concerning factors that could cause these results to differ, please refer to the second slide of this presentation as well as to our public SEC filings. As a reminder, a replay of today's conference call will be available by phone through Thursday, November 7; the call will be also be available via webcast which will be archived for at least 90 days.

And now I'll turn it over to John.

John A. Bryant

Thanks, Simon, and thank you, everyone, for joining us. Today we reported results for the third quarter and we also announced Project K, a significant multi-year growth and efficiency program. I'll say more about this in a few minutes.

Internal sales growth was 0.5% in the quarter, which was below our original expectation. As you've all seen in the public data, center-of-the-store categories in the U.S. continued to see weak consumption data, and this certainly had an effect on our performance. Our operating profit exceeded our expectation, as we saw relatively less pressure in cost of goods and good performance in SG&A. And in addition to this, we also benefited below the line and posted comparable earnings of $0.95 per share, which was ahead of our estimate.

This is the first full quarter that Pringles is in the base, and integration is now largely complete. The business continued to perform well in Q3, and we saw double-digit sales growth in Europe, Latin America and Asia Pacific. While sales were slow in the U.S. as a result of comparisons to last year, consumption continued to be strong. So we've managed the situation well in the third quarter and delivered good operating profit and earning results, although our net sales performance was a little softer than we had expected.

Project K is the natural next step in the evolution of our company. To put this initiative into context, let's turn to slide four and a review of our strategy which we announced in early 2011. We remain focused on four key areas: cereal, snacks, frozen foods, and emerging markets. And these areas will receive even more attention as a result of Project K.

First of all, we have large core cereal businesses that have long-term growth potential, and we are committed to driving these categories and our global share leadership. These businesses are always competitive; we must stay focused on investing in growth and competing effectively. We've faced some challenges in the last couple of years, but we know that proven ideas, investment in our brands, and good in-store execution drive our categories and fuel our sustainable growth operating principle.

Secondly, we are committed to becoming a global player in snacks, and the acquisition of Pringles accelerated this transition. Pringles brought with it expertise that we can leverage and opportunities that we can unlock across the organization. With the integration largely behind us, we believe that we can more fully leverage these opportunities. Third, we have a large and growing frozen foods business in North America; and finally, we have the opportunity to further expand our footprint into developing and emerging markets.

Project K will enable us to invest in our brands and execute our strategy. Now let's go into the project in more detail, specifically how we will drive efficiency and effectiveness, the size of the opportunity, and our reinvestment priorities; starting with slide five. We've always had a focus on continuous improvement as a company. Project K is an opportunity to step back from our business and identify larger, structural, efficiency and effectiveness opportunities. And as a result of this review, we have found opportunities in four areas.

First, the project will drive a more global structure by creating and empowering global category teams and regional hubs. Second, it will build capabilities and drive functional efficiencies. Third, it will build the global supply chain of the future focusing on optimizing our infrastructure including the consolidation of certain sites and production lines as Alistair will discuss in a minute. And finally, it will implement a global business service model which will streamline our end-to-end transactional processes.

Now let's turn to slide six, which shows the financial highlights of the plan and gives you some idea of its scale. We expect that total cumulative pre-tax charges over the life of the program will be between $1.2 billion and $1.4 billion, with approximately two-thirds coming in supply chain. Of this total, $17 million was recognized in the third quarter of 2013, and we expect that we will recognize between $175 million and $200 million for the full year, or approximately $0.35 to $0.40 per share. Savings in 2013 are expected to be minimal.

Project K is designed to decrease long-term structural costs, and therefore, it will take some time to realize the benefits fully. As a result, we expect pre-tax charges in 2014 to be higher than we'll see in later years and savings to be lower. We'll give you more detail on the Q4 call when we give full-year 2014 guidance. We'll also give you more clarity on capital expenditure on the fourth quarter call, but our initial estimates are that CapEx will be between 4% and 5% of sales for the next couple of years.

We anticipate that pre-tax savings will reach an annual run rate of between $425 million and $475 million by 2018. These savings will also be divided approximately two-thirds to COGS and one-third to SG&A, and essentially all will be cash. As a result, we expect a very good rate of return of approximately 30% from the investment.

Finally, we expect that the applicable tax rate for the project will be similar to or slightly below our corporate tax rate.

As you can see, this is a significant initiative and is one that will drive our sustainable growth operating model over time.

Let's turn to slide seven, and our priorities for reinvestment. Our investment is in line with the strategy I reviewed earlier. First, we will reinvest in brand building in our core cereal businesses. For example, we've got some great ideas for supporting our strongest brand, Kellogg's, in the cereal category and developed markets and around the world. We will also increase investment in developing and emerging markets where we have even greater growth potential. This will include investment in brand building, capacity and increased R&D resources. And we'll also invest in global category teams, which will enable faster development and implementation of category growth initiatives. And finally, on our increased investment in brand building, we know that brand building and innovation drive our categories. This will include traditional advertising, but will also focus on increasing levels of digital engagement with consumers and other areas where we have validated the returns. And we'll also drive better in-store execution to bring our programs to life in store.

Now let me turn it over to Ron for some financial details on the quarter.

Ronald L. Dissinger

Thanks, John, and good morning, everyone. Slide eight shows our performance for the quarter and year-to-date periods. These results exclude charges for Project K. Internal sales increased by 0.5%. As John mentioned, our sales were lower than expected in some developed markets, particularly the U.S., as you've seen in the consumption data. However, we did see good internal sales growth in all the other regions of the world with Europe up 3.3%, Asia Pacific up 2.9%, and Latin America up 6.7%.

Underlying internal operating profit increased by 0.6%. These results included mid single-digit growth in advertising, cost inflation net of productivity consistent with our expectations, and cost containment, which drove savings in certain areas of SG&A that exceeded our expectations. Comparable earnings per share, which excludes integration costs and the impact of Project K, were $0.95 per share, ahead of our expectations due to the SG&A cost containment, a lower tax rate, and a lower currency headwind. Comparable growth was 2.2%.

Now, let's turn to slide nine, which shows the quarter's sales growth. Reported sales declined slightly, but internal sales growth was 0.5% with Asia Pacific, Latin America and Europe all contributing good growth as I mentioned earlier. Internal volumes declined slightly driven by the softer category sales we mentioned in the U.S. However, Asia Pacific, Europe and Latin America all posted volume growth, and all of the regions posted good improvement in price mix in the quarter.

The impact of currency translation reduced sales growth by 0.6% in the quarter. We expected our sales growth to improve as we progressed through the second half due to the innovation launched at the end of the second quarter and increased consumer marketing. Our innovation is doing well, but other parts of our portfolio, specifically within U.S. cereal and U.S. snacks, are softer than planned.

Slide 10 shows the shape of the net inflation over the second half of the year. As expected, we saw some cost inflation net of productivity improvements in the third quarter. This followed a period in the first half of the year when we saw significant inflation. The inflation was the largest driver of margin performance in the quarter, but we also saw reduced operating leverage resulting from the slower sales growth. Our underlying reported gross margin declined by 20 basis points, sequential improvement from Q2 due to the lower cost inflation I mentioned and the fact that Pringles is now completely included in last year's base. As we've said before, we have good visibility into our cost structure for the fourth quarter, and we still expect net deflation, but we are seeing some adverse impact from lower operating leverage due to softer sales in the U.S.

Slide 11 shows the quarterly underlying internal operating profit performance for each of the regions. As a reminder, the operating profit growth on the chart excludes charges for Project K. Underlying internal operating profit for the total company increased by 0.6%, which was ahead of expectations and included a mid single-digit increase in investment in advertising. North America's underlying internal operating profit decreased by 0.7%. This was driven by sales declines in morning foods and snacks, combined with increased investment in advertising, and was partially offset by cost containment measures. We expect fourth quarter sales to remain challenged in North America, but we're developing plans to invest behind our categories and improve in-store execution.

Underlying internal operating profit declined by 3.8% in Europe. This included a double-digit increase in advertising. We've invested behind innovation and we've restaged Special K across much of the region. That, and a strong program on Pringles, contributed to the significant increase in support in the third quarter. In addition, we investigated up-front costs in several efficiency initiatives in the region to drive future savings. Excluding these up-front costs, Europe's profit growth was more than 2%. Underlying internal operating profit in Latin America increased by almost 24% due to the strong sales growth and lower SG&A. And in Asia Pacific, we saw an increase in underlying internal operating profit of 2.3%, driven primarily by sales growth and lower SG&A.

Slide 12 shows our cash flow performance. Cash flow from operations before capital spending was $1.389 billion over the first three quarters of the year. This was an increase of $14 million over the same period last year. Capital spending in the year-to-date period was $363 million, an increase of more than $100 million over last year. This was in line with our expectations, and we still expect spending for the full year to be slightly more than 4% of sales. Our cash flow performance is tracking in line with our plan to deliver $1.1 billion to $1.2 billion for the full year, and we've decreased debt levels by approximately $900 million since the acquisition of Pringles.

Now let's look at slide 13, an update of our full-year guidance. As a result of the slower sales growth we saw in the U.S., we expect that reported sales growth will be approximately 4% to 5%. This is lower than our previous guidance of approximately 5%. And we expect that underlying earnings per share will be at the lower end of the $3.75 to $3.84 range we showed you last quarter.

Our estimate for full-year cost inflation remains approximately 5%, and the estimate for cost savings remains around 4%. And as I mentioned, we still expect to see net deflation in the fourth quarter. This deflation, combined with lower SG&A costs, contribute to the strong comparable earnings growth we expect in the fourth quarter.

Gross margin for the full year, excluding the impact of Project K, will be down approximately 100 basis points with the decline split equally between the impact of dilution from Pringles and performance of the base business.

Slide 14 shows a bit more detail regarding our full-year earnings guidance. As you can see, previous guidance including the impact of currency but excluding integration costs was $3.75 to $3.84 per share. We're still in that range, although as you can see, currencies have improved by $0.03, which has been offset by sales softness. So, we continue to be in the range but toward the lower end.

We also expect to recognize approximately $0.35 to $0.40 of charges this year related to Project K. This charge will not have a material cash impact in 2013. We estimate that approximately 85% of the 2013 charge will be in cost of goods sold and the remainder will be in SG&A. When we provide guidance for next year on the fourth quarter call, we will give you visibility into the costs associated with Project K for 2014.

Now let's turn to slide 15. We now expect that the full-year tax rate will be approximately 29%, and we estimate that interest expense will still be between $230 million and $240 million. As I mentioned, we also continue to expect annual cash flow to be between $1.1 billion and $1.2 billion including Project K.

Total capital spending including the additional capital we need due to the growth of Pringles will be slightly more than 4% of sales, consistent with previous guidance. We continue to expect that integration costs related to the acquisition of Pringles will be between $0.12 and $0.14 per share and synergies to be toward the high end of our $50 million to $75 million range for the year. And finally, note that our earnings per share guidance excludes the impact of adjustments for mark-to-market for commodities and pensions, integration costs, and Project K costs.

And now, I'll turn it over to Alistair for a discussion on our supply chain.

Alistair D. Hirst

Thank you, Ron, and good morning, everyone. I'd like to start off today with a couple of slides that I showed you last November at the Analyst Day in Chicago.

The first is slide 17 and our vision for supply chain. We have a highly capable team delivering high-quality food and delighting consumers and customers. The key for us is that we do all this with a low-cost supply chain. And we've made great progress over the last couple of years in these areas, as I mentioned in November. Importantly, the Project K program we announced today will help us achieve our goals in a number of ways, which I'll discuss in more detail in a minute.

Now if you'll turn to slide 18, you'll see another familiar slide. The right to play was our focus in 2012 as we looked to drive improvement in four fundamentals: food safety, people safety, customer service, and financial excellence. We've made significant progress in all these areas and built a dependable foundation for the organization, and Project K will enable us to do even more.

Next is the right to win, which involves a number of goals including the implementation of Kellogg Work Systems or KWS. KWS is very important to us, as it helps to drive zero waste using a standard operating model while improving employee involvement. And it's even more important to us now as we begin Project K. In fact, having KWS in place is one of the major differences between Project K and other cost reduction programs.

And finally on this slide, right to lead. We want to be dependable, but we also want to be agile and able to manage complexity. We want to enable sales growth while maintaining a focus on profitability, and we want to do all this while maintaining the safety of our food and our people, and while remaining responsive to our customer. Project K is an enabler of the work that needs to be done for us to achieve this vision.

Slide 19 is a reminder of some of the financial goals that are part of the company's operating model. As you know, we target between 3% and 4% productivity improvement each year. That's a significant commitment by the supply chain organization, and is one that we've got a great track record of achieving. And that commitment will continue even as we progress through the multi-year Project K initiative.

Our long-term target is for capital expenditure of between 3% and 4% of sales, and over the last couple of years, we have increased the amount of investment in growth. This is a trend that we intend to continue in the future. It is worth noting that over the next couple of years, Project K will likely increase the overall level of capital expenditure to between 4% and 5% of sales.

And finally, I've also put the impact of Project K on the slide. This is the total amount of savings we expect from the program, not just supply chain's contribution, although supply chain's contribution is meaningful. The important thing to note here is that the $425 million to $475 million in annual savings is incremental, because it is largely coming from structural cost opportunities. It will be achieved in addition to our normal run rate of productivity, which is driven by continuous improvement programs.

Now let's turn to slide 20, and a few specifics about Project K and the supply chain organization. As you can see, we have three main goals: aligning the network, organizing the supply chain for success, and implementing global business services. Let me talk briefly about each.

First, we must properly align the network to the realities of the marketplace and the requirements of our customers. This means making sure that we have the right infrastructure, including the right number of plants, the right kind and number of production lines, and that they're in the right locations, and obviously, we need to anticipate future needs while designing the network. So, all of this will lead to the consolidation of certain sites and production lines and the relocation of others. This is never an easy process, but it's one that is necessary for the long-term health of the business.

Secondly, we will organize a supply chain structure for success. This will allow us to do more with less through the use of more standardized processes and a more streamlined organization. A smaller, more agile team will lead to less complexity and will allow us to be more responsive to the needs of our customer and the changing competitive landscape. As you can imagine, this will involve the move to regional hubs, which will put resources closer to the plants.

And finally, we will implement global business services. This is a transformation of common processes or services that are currently being addressed by different functions in various regions. This will be a multi-year process, but we're already driving other significant transformations that will improve our procurement and engineering functions and also our core manufacturing network, as we highlighted at analyst meeting.

We are one year into the transformation, and procurement is already providing 1.5X the lift over traditional level of savings. Successful sourcing of low-cost engineering solutions is driving change in the operating model. As a result, we are getting more for each dollar we spend. These improvements have been significant contributors to our 3% to 4% savings goals. This process will lead to reduced complexity and increased efficiency, and will be the main driver of the right to lead initiative that I mentioned earlier.

So, finally on slide 21, a couple of words on Project K in general. Project K is a very different kind of efficiency and effective program. The prime source of savings will be from consolidating facilities and eliminating excess capacity. It will not be from reducing head count in our operating plants. It is designed to drive a more effective organization; it will reduce complexity while increasing our ability to execute, and we will maintain the levels of empowerment we've worked so hard to develop in supply chain.

In addition, this isn't a program limited to the supply chain organization. Rather, supply chain is just one part of the initiative. Project K is a commitment by the whole company and is a major step toward achieving our broader goals. So I hope that you can see the potential we have in supply chain to support the company while on that journey. This is not an easy process, but it is essential if we are going to recognize our potential and meet our strategic goals.

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

John A. Bryant

Thanks, Alistair. Now, let's turn to slide 22 and some detail regarding each of our businesses starting with U.S. morning foods and cereal. Both category and Kellogg's consumption were slightly lower than expected in the quarter. We were lapping strong share gain comparisons of 0.4% in 2012, partially as a result of our strong Olympics-related program, and our share also grew by 0.5% in the third quarter of 2011. So, part of this quarter's performance was due to comps; however, we did experience a slower-than-expected recovery in our Kashi brand and continued challenges in the adult segment of the portfolio. Our shipment performance was also lower than expected due to reduced trade inventories. In fact, we ended the quarter at the lowest level of trade inventories in the last four years.

As we've discussed over the course of the year, we have launched innovation aimed at providing the progressive nutrition that older consumers are seeking. Raisin Bran did well as a result of the new Raisin Bran with Omega-3, and strong support from a healthy dividends campaign. Rice Krispies is also included in the healthy dividends campaign and also posted sales growth. And Special K Protein, which we launched last year, also posted sales growth and share gains in the quarter as consumers continue to seek new sources of protein.

Obviously, we need to do more to provide innovative nutrition, and we have plans for 2014 that will help us continue to address this broad consumer trend, including the introduction of new organic Kashi cereals, which include grains such as quinoa and some which are gluten-free.

As you know, we launched our new Special K Nourish Hot Cereals at mid-year, and they're off to a good start, although it's still early. We've seen strong sales growth recently as the advertising support just began, and we have good brand building and merchandising support planned for the rest of the year. We also launched drinkable breakfast products at mid-year, and we have seen encouraging initial results. ACV on these products is good and we're on target to meet expectations. We're excited about this opportunity and some others as we focus more on on-the-go segment. We have additional activity planned for next year, as this is a segment that has strong potential due to the convenience and portability of the products.

We have other great programs planned for 2014 as well. You'll remember our successful Kellogg master brand advertising from the Summer Olympics last year, and we're pleased to sponsoring the Winter Olympics next February. This will include strong activation across the portfolio and be followed in March with additional programs. And finally, from Morning Foods, Pop-Tarts had another excellent quarter, as consumption increased by more than 7%. The peanut butter Pop-Tart innovation we launched a few months ago is continuing to do very well with good share and sales performance.

Now let's turn to slide 23, which shows the internal net sales performance of the U.S. snacks segment. Internal sales in the cracker business declined in the quarter, although we saw good performance from our big three cracker brands, which posted consumption growth of 6% in combination. Overall performance was the result of lower end-market support and the impact of Special K Cracker Chips.

Cracker Chips posted a sales decline due to difficult comparisons to the third quarter of last year resulting from the introduction of Popcorn Chips. The two cracker innovations that we launched early in Q3 are both doing well. TownHouse Pita has gained good share and is also having a positive impact on the growth of base TownHouse and Cheez-It Zingz saw good share performance and benefited from a broader Cheez-It Game Day sponsorship in September of this year.

The cookie business posted a decline in the quarter. As we saw in the cracker business, some of the innovations that we launched recently, including Keebler Simply Made cookies, are off to a good start, and the total Keebler brand posted sales growth in the quarter. The wholesome snacks business was approximately flat in the quarter as growth of the new Special K Pastry Crisps and Nutri-Grain Crunch Bars was partially offset by lower sales of core Special K and Kashi bars.

Our Pringles business posted good consumption growth of approximately 3% in the third quarter, and it's worth noting that this performance was lapping very difficult comparisons from the third quarter of last year. We're optimistic about the fourth quarter's results due to the continued success of Pringles Sticks and the launch of exciting innovation planned for introduction later in the quarter.

As a reminder, Pringles is also a warehouse-rooted product. Consumers of cereal saw a significant trade inventory reduction in the quarter. So, while we saw consumption growth in the quarter, shipments were down at a mid single-digit rate. So, the innovation we've launched in the snacks business in the second half has done well, but our results have been disappointing. And as we've said before, we expect that the environment will remain difficult in the near term, but the team is doing a lot of work and we expect that the business will improve over time.

Now let's look to slide 24, and the net sales performance of the U.S. specialty segment. As you can see, this business posted internal net sales growth of 6% in the third quarter. Growth was a result of distribution gains and a strong performance of Eggo and Nutri-Grain in the K-12 school business. In addition, the food service business gained share in the cereal, cracker and health and wellness categories during the quarter, and we've also launched breakfast drinks in some of these channels. And Pringles continued strong year-to-date performance with a double-digit net sales increase in specialty channels in the third quarter.

Slide 25 shows detail regarding the North America other segment, which includes the Canadian and U.S. frozen food businesses. The segment posted an internal sales increase of 0.3% in the quarter. Internal net sales declined in the frozen foods business as we were lapping very difficult double-digit comps in the third quarter of last year, as a result of strong growth in both the Eggo brand and the veggie food business.

Special K flatbread sandwiches, which we launched in the third quarter of last year, continued to perform well and drove growth in Q3 of this year, and we recently launched a new deluxe egg and cheese variety. We continue to see good performance from Eggo Thick & Fluffy and Wafflers, which provide the benefits of portability and convenience.

The burger segment of our veggie food business posted solid growth and innovation in other segments also contributed. And in Canada, we saw low single-digit sales growth in the quarter. Pringles gained category share as did the Canadian frozen food business as a result of the launch of Special K flatbreads and Eggo Minis. And in snacks, we gained share in the wholesome snacks segment as a result of innovation.

Now let's turn to slide 26, and our international businesses. Internal net sales increased by 2.9% in Asia Pacific. The Australian business posted low single-digit internal sales growth. The Indian, Southeast Asian and Pringles businesses all posted good rates of growth in the period. In fact, Pringles grew at a double-digit rate. We launched Pringles in a smaller can in Southeast Asia, and the early signs have been encouraging.

Kellogg Europe posted internal net sales growth of 3.3% in the third quarter. Western Europe grew as distribution of our new Nutri-Gain handheld breakfast products increased on the continent and Pringles posted great results as the successful summer commercial program resonated with consumers.

We also made progress with the relaunch of Special K in the region, and are seeing improving trends. Obviously, southern Europe remains challenging given the difficult economic conditions there. And in Latin America, we saw strong internal net sales growth of 6.7% in the quarter. Central America, Venezuela, Brazil, Argentina, Chile in the Pringles business all posted growth. In fact, the Pringles business grew at a double-digit rate.

The economic environment in Mexico continues to be difficult, although we have achieved good share positions in the cereal category in recent public data. Also around the region, we have launched innovation including new Zucaritas and Choco Krispies in Central America, and Special K and Nutri-Grain in Puerto Rico.

So, to summarize, we saw good operating profit and earnings performance in the third quarter. However, we did see weaker top line growth than we were expecting, as some of our categories remain challenging. We are working hard to improve this performance, and an important step is the announcement of Project K. This is a major initiative for us and we're excited by the opportunities we see for investment and increased growth.

Now, we'll open up for questions before coming back with a brief summary.

Q&A

Operator

[Operator Instructions] Our first question is from Alexia Howard of Sanford Bernstein. Please go ahead.

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

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

<Q - Alexia Jane Howard>: Hi. So, on Project K, I was curious about goals around advertising as a percent of sales and new product development as a percent of sales. Is there anything that you can tell us about where you're at right now, where you might be going on either of those metrics? Thank you.

<**A - John A. Bryant**>: Alexia, we haven't provided guidance on those specific metrics, and as we look at reinvestment back in the business, the reinvestment – as I mentioned in the prepared remarks, in 2014, are really focused on our core cereal business and making some investments in the emerging markets as well as some capabilities within the business. We haven't set reinvestment for 2015, 2016 and 2017. Obviously, as we go along, we'll determine the best place to make those reinvestments. For this stage, the primary focus of our reinvestment is to stabilize and rebuild momentum in our core businesses. We believe we do that through brand building, innovation, nutrition over time, and that's where we're focusing. So, we would expect to continue to improve our brand building as a percent of sales as we go forward.

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

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

Operator

The next question is from Andrew Lazar from Barclays. Please go ahead.

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

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

<**Q - Andrew Lazar**>: John, I remember, I think it was this past February at CAGNY, where – I think it was during the Q&A and was right after all the 3G announcements and things, where you had mentioned some discussions you'd had with the board around giving them a sense of what the implications were of some of the news at the time. And one of the things that you came away with was, if food companies left opportunities on the table, then it was more likely that others would take advantage of those opportunities for you. And I'm trying to get a sense, is some of this basically getting after more aggressively some of those opportunities? And do you view this as more offensive in – based on where you benchmark, this gets you sort of ahead of where peers might be, or somewhat more defensive around – it just gets you to catch up to where your benchmarking says others are?

<**A - John A. Bryant**>: Andrew, for us this is just the natural evolution, the next step in our strategy. If you look back over last few years, in 2011, we reinvested back in our supply chain, and that part of our business has been performing incredibly well ever since. And in fact, the investments that we made at that time are now enabling us to do some of the Project K initiatives. And we come forward from that, and we acquired Pringles, which enabled us to become truly a global player in snacks, and we re-implemented SAP at the same time. So, we come into 2013, 2014, we challenged ourselves to step back from the business and look for structural cost opportunities that we can retake and reinvest back in our business to drive the momentum and the brand building investment that we need to drive to get ourselves back on track. And that's really what we're doing here. It really has nothing to do with 3G highs; it just happens to be occurring at a similar point in time. It's all about investing in our strategies that we took you through before and setting ourselves up for the future.

<**Q - Andrew Lazar**>: Thanks for your thoughts.

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

Operator

The 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**>: A couple of questions. First, I guess, it seems like the free cash flow impact is pretty significant between the cash cost to the restructuring and the raised CapEx. Is that fair, and does that – what are the implications to that in terms of your share repo or dividend growth rate? Maybe you could just touch on that, and then I have some follow-up.

<**A - Ronald L. Dissinger**>: Sure, Eric. First, recall what I said was that the cash impact in 2013 is going to be relatively minimal. As you can appreciate, there are some cash investments up front associated with capital and the other investments we're making to generate savings as well, and then the cash savings will build or improve over time. As a foundation, we do generate strong cash within the business, but we do expect that our debt levels could increase up to $0.5 billion over the next two to three years. Now, we are working on an initiative in accounts payable, and this isn't embedded at this point in time, that might provide us some cash benefit. In terms of impact to our dividend and share repurchase programs, we do not expect any impact at this point in time. Instead, we expect the debt levels to go up slightly.

<**Q - Eric R. Katzman**>: Okay. And then, John, is there any sense – I realize you're putting this together, but I think it was mentioned that a lot of the savings here are supposed to be incremental, but obviously the competitive environment is more difficult. So, is it fair to say on the back of this that your long-term growth targets on the bottom line of high single-digit performance growth is unchanged?

<**A - John A. Bryant**>: Yes, Eric, at this stage, we're making no changes to our long-term growth guidance, high single-digit EPS.

<**Q - Eric R. Katzman**>: Okay. And last one, maybe to Alistair or John, maybe you want to take it, but obviously, K-LEAN was quite – in some respects, damaging to the company. Why is this one different, and why should investors have faith that Project K is going to be a much better outcome than the challenges that K-LEAN ultimately resulted in?

<**A - Alistair D. Hirst**>: First, let me say that it's not just a supply chain initiative as we just laid out. So, two-thirds of it, yes, will be delivered by supply chain, but it's an enterprise-wide initiative. It's also over four years, so that gives us the ability, particularly for the supply chain part, to appropriately plan, resource, phase and pace each part of the project. It's also across the global supply chain network, so allowing us to leverage our global resource base and not being biased to one particular region or particular business units. The project gets a structural fixed cost in our underutilized asset base over the four years. So, that's one of the big differences to the previous K-LEAN initiatives, which really was a wide-ranging head count reduction within the plants. So, this is very targeted to asset, to lines and to plants, so while that's very difficult, it's the right thing to do to be driving our long-term growth. So it is a very different point of entry from the previous initiatives that we've carried out as a company.

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

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

Operator

Our next question is from Thilo Wrede of Jefferies. Please go ahead. .

<**Q - Thilo Wrede**>: Good morning, everybody.

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

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

<**Q - Thilo Wrede**>: John, the center-of-the-store packaged food universe has been weak for quite a while now and seems to continue to be weak. What gives you the confidence that the investments that you make with Project K can change that, especially when you look at what you said in your prepared remarks: the innovation did well but the core business didn't do well. So, your innovation and the promotions and advertising that come with it just seem to cannibalize the existing business that you have. So why would Project K change that trajectory?

<A - John A. Bryant>: Well, I think if you look at our business right now, we're actually seeing some good growth in the international businesses, we're seeing some good growth here in the U.S. in specialty and in our frozen foods business over a period of time. The real challenge for us really is in morning foods and in snacks. And, in fact, within snacks, the categories are doing okay, we have an opportunity to be more competitive and so invest more behind that business. On cereal, we were growing cereal low single digits across most of 2000 [sic]. We did that when driving the adult portion of the portfolio, we had Kashi, Special K firing on all cylinders, and I think we can get back to that situation again. I wouldn't say the 2000s was a period of high growth within the packaged food business within center-of-the-store either, but we've demonstrated the ability to grow that business low single digit in a number of different environments, and I think we can get back to that in the future.

<Q - Thilo Wrede>: But just to pick up on your example of snacks, again, it seems like your innovation is cannibalizing the existing business that you have. How can you avoid that going forward?

<A - John A. Bryant>: If you looked at the innovation on Cheez-It and TownHouse and snacks in the third quarter, it's actually driving both of those businesses with Cheez-It up about 5%, 6% and TownHouse actually up 20% in the third quarter, so we are seeing some good growth there. I think, if anything, the issue that we have on snacks is Special K Cracker Chips was such a big innovation last year it's hard to sustain that that size. That's coming down a little bit and that's weighing upon the – on the snacks business. So, I think the trick here on innovation is ensure the innovation is sustainable and to invest behind it over time. To invest behind it over time, you need more brand building; hence, Project K gives us money to keep the brand building behind the innovation to sustain it in the marketplace.

<Q - Thilo Wrede>: All right. Thanks a lot.

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

Operator

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

<Q - David C. Driscoll>: Great. Thank you. Good morning, everybody.

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

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

<Q - David C. Driscoll>: Well, first off, the program from my point of view seems like a good response to the environment, so congratulations on that announcement. I want to ask a little bit about the fourth quarter, specifically when I just look at what's implied by the guidance, to get to the low end of your sales range, you have to have a fairly sizable decline in total revenues in the fourth quarter to get to the full year to be up 4%, you have to have I think minus 4% in the fourth quarter. If I've done my math right, can you just talk a little bit about how that will work its way through the different divisions? I almost feel like it's got to be negative growth across every one of your major geographies, just given the size of that figure. So, can you spend a moment and talk about Q4?

<A - Ronald L. Dissinger>: Sure, David. Remember we guided sales at a range of 4% to 5%, down from the approximate 5% that we guided in the third quarter. So, as we looked at our year-to-date performance, we synced up our adjusted Q4 to be more in line. So, we are expecting internal growth in sales in the fourth quarter. As I mentioned in the prepared remarks, we do see some challenges, particularly in the U.S. around our U.S. cereal business and the snacks business, but we're making the appropriate actions to get those back on track in the future.

And then, when you look at the growth from an operating profit and earnings per share standpoint, I think it's important to understand that we have the internal sales growth we are expecting, consistent with our year-to-date trends, and then we have the net deflation as well, which is providing a benefit to us in cost structure that's allowing us to get confidence in our operating profit and earnings per share expectations.

<Q - David C. Driscoll>: If I just follow up, though, your guidance is on reported net sales, and you just were just talking about internal net sales.

<A - John A. Bryant>: Yeah, that's--

<Q - David C. Driscoll>: So, if you hit the bottom end of that reported net sales number, your year-to-date number is like plus 6%?

<A - Ronald L. Dissinger>: Don't forget there's a little currency headwind as well in the fourth quarter, David.

<Q - David C. Driscoll>: How about big is that?

<A - Ronald L. Dissinger>: The currency headwind is a little less than a point.

<Q - David C. Driscoll>: Okay. Final question from me is just on brand building. What's your full-year expectations, and then have you changed your fourth quarter brand-building plans?

<A - Ronald L. Dissinger>: Yeah, David, on the advertising for the year, we expect advertising to essentially be flat year-on-year. It's up if you include the Pringles acquisition, but if you back out the Pringles acquisition, it's essentially flat. Within that, obviously we have efficiency programs. We believe the underlying performance program's actually up, but in absolute dollars relatively flat year-on-year.

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

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

Operator

The next question is from Ken Goldman of J.P. Morgan. Please go ahead.

<Q - Ken B. Goldman>: Hi. Thanks for the question. I think on the second-quarter call you had discussed some innovation in Europe coming to market in the back half of the year. As we think about the pacing of the top line in Europe, it was pretty impressive this quarter; how should we look at the impact of that innovation on 3Q versus 4Q? In other words, was there anything in terms of temporary sell-ins, promotions, et cetera, that may have affected the timing of shipments versus consumption this period in Europe?

<A - John A. Bryant>: Well, Ken, I think we're very pleased with the European performance in the third quarter. I think this represents now three quarters of growth out of the last four in what's a very, very difficult environment in Europe. The big driver of the European performance in the third quarter was actually Pringles, behind a very strong summer promotion program, as opposed to a sell-in behind innovation on the breakfast side of the business. Having said that, I don't think we'll have the same level of growth in the fourth quarter as we had in the third quarter.

<Q - Ken B. Goldman>: All right. Thanks, John.

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

Operator

Our next question is from Chris Growe of Stifel. Please go ahead.

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

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

<Q - Christopher R. Growe>: Hi. I had a question for you on Project K. And I wanted to understand, as you look ahead, even looking out to the end of the program or later years of the program, do you expect any of these savings to benefit the bottom line, where you actually would have these savings benefiting earnings? And maybe related to that, in the short run, is there a heavier level of reinvestment that you want to get at, maybe it's in 2014 or even in 2015, relative to the savings that come through from the program, will be a timing differential there essentially?

<A - John A. Bryant>: Thanks, Chris. Our goal with this program is to reinvest back in our business and to gain momentum in our business and get back on our sustainable growth model, and we'll continue to reinvest back in the business until we see that happen. And so, I think that's going to be over the next few years. So, I think it's very hard for us to predict today what might be happening in 2017, 2018. We haven't given 2014 guidance yet; we'll do that in the fourth quarter conference call. It is fair to say because these are structural cost changes, they take time to execute and see the savings come through. So, the 2014 savings will be meaningfully lower than the normal run rate of savings that we'll achieve in later years.

<Q - Christopher R. Growe>: Okay. And then I had a follow-up question if I could, or a second question on the lower inventory levels you mentioned being at very low levels; I think it was in the U.S. was the reference. I'm wondering are you likely to hold at those levels just given the sluggishness of the category? Will retailers hold less inventory in this environment because of that?

<A - John A. Bryant>: We are planning to hold at those low inventories. So, we haven't built into our expectations the inventories to jump back up again, but they are unusually low at the end of the third quarter.

<Q - Christopher R. Growe>: Okay. Thank you very much.

<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. I guess, two questions. John, I was wondering in U.S. cereal, if I exclude Pop-Tarts and the beverage business, can I assume that U.S. cereal was down about 5% or so, and how much of that is due to the tough comp to year ago Summer Olympics? And then the other part of the question is when you had K-LEAN, I remember there was a three-year executive performance plan that was entirely based on executing K-LEAN. And I think what happens is if you incentivize executives to cut costs, they will cut costs. And I wanted to know how Project K is going to be integrated into your three-year program? Have you learned from that experience?

<A - John A. Bryant>: Rob, if I come back to your first question about the performance of the cereal business, I think the category is down around 3% to 4% and our consumption is down around 5%. So, I think if we hadn't had had the Olympics in the year prior, we probably would have done in line with if not better than the underlying category. So, that's what's going on in terms of the numbers within cereal.

On the executive compensation and Project K, we do not have an executive compensation program beyond our normal compensation programs. Our normal compensation programs focus on net sales, operating profit, cash flow, both in the year which we're in as well as on a three-year period. And I believe those programs are consistent to drive the right motivation and behavior behind executing Project K flawlessly.

<Q - Robert B. Moskow>: Okay. So, there's no change to your EPP related to Project K; it'll be your normal measurements?

<A - John A. Bryant>: That is correct.

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

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

Operator

Our next question is from Jason English of Goldman Sachs. Please go ahead.

<Q - Jason M. English>: Hey. Good morning, folks.

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

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

<Q - Jason M. English>: John, It sounds like there's a lot of change going on within the organization. I was hoping you could elaborate more with some additional detail. Maybe what change Paul's bringing to the organization in his new role. Your global category teams, can you elaborate more on the structure, the roles, responsibilities? And then also on Global Business Services, what services are being folded into this global model?

<A - John A. Bryant>: Sure, Jason. Let me take part of the changes in the company over the last few years and I'll then hand it over to Ron to talk about Global Business Services. If you step back and look at our company over the last three years, we've made some pretty significant changes to our leadership team. We have had a number of very experienced leaders come in from other companies on our international businesses with an ex-Colgate executive running our Latin American business, ex-Cadbury running our Asia Pacific business. And with the Pringles acquisition, we also got some great talent into the company, and now we have Chris Hood who came out of Pringles running our European business. So, we feel very good about those changes.

At the same time, what we've done is we have eliminated a level in our organization. We've taken out the Kellogg North America and Kellogg International President roles. I think that enables us to execute faster and execute better by allowing the underlying international area president and business unit president in North America to make decisions and move quickly. However, we also recognize it's not just about execution, it's about creating the future of the company. And that's why we created the Chief Growth Officer role, that's Paul Norman's new role. That role has reporting to the two global category teams that I mentioned this morning, as well as a Chief Marketing Officer, the Head of R&D as well as the Head of Communications for the company.

And the objective of that team is really to help us create the future. To create the category plans that will help us drive our cereal category, drive our snacks category, and step up and look at a longer term innovation pipeline and idea stream so that we are driving to the future of the business, not just executing as much in the short term. So, I believe this is the right structure that enables us to balance between the need to create the future and deliver today. So, they are the primary organizational changes in place. Ron, do you want to talk a little bit about Global Business Services?

<A - Ronald L. Dissinger>: Absolutely. So, as you're probably aware, Jason, this is not a new concept; a number of other companies have gone down this path. The intent is to create a much more efficient and effective basis for our processes and to standardize those processes across the globe. So, some examples of the processes would include things like purchase-to-pay or procure-to-pay, the order to cash process as well. At this point in time, there are really four functions that are involved in this Global Business Services initiative: finance, human resources, IT, and supply chain. Of course, the intent is to enable these processes by technology, and we believe that it will set us up with an extraordinarily strong foundation for the future in this area.

<Q - Jason M. English>: Thanks a lot. I'll pass it on.

Operator

The next question is from Todd Duvick of Wells Fargo Securities. Please go ahead.

<Q - Todd Duvick>: Yes. Good morning.

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

<**Q - Todd Duvick**>: You mentioned about the expectation of about $0.5 billion increase in debt to fund Project K. Can you tell us if you expect that to result in your leverage ratio debt-to-EBITDA being roughly flat as EBITDA grows, and if you expect there to be much of an impact on your credit rating long term?

<**A - Ronald L. Dissinger**>: In terms of impact, obviously we continue to generate very strong cash flow in our expectation, though debt levels will rise to pay down debt over time and maintain our credit rating at this point.

<**Q - Todd Duvick**>: Okay. And do you expect those costs to be front-loaded or loaded more towards 2014 than – or balanced throughout the course of the program?

<**A - Ronald L. Dissinger**>: It'll be a little bit more front-loaded, which is why I mentioned that we might see our debt levels go up over the next two to three years by about $0.5 billion. As you can imagine, we're making the investments both P&L type investments and capital spending type investments more at the front of the program to generate the savings over the four-year period.

<**Q - Todd Duvick**>: Okay. That's helpful. Thank you.

<**A - Ronald L. Dissinger**>: You're welcome.

Operator

The next question is from Tim Ramey of Davidson. Please go ahead.

<**Q - Tim S. Ramey**>: Good morning. Thanks. Just an observation, one of the things you did really super well with Kashi over the 10 or 12 years that you've owned it is keep the authenticity to the brand and keep influentials on board with it. And I was just thinking about the Raisin Bran with flaxseed, which influentials will be quick to say, oh, that's the wrong Omega-3. And I just wonder if that's sort of part of the problem at the center of the grocery store that we're not sort of honing in on the things that consumers are actually looking for, but kind of going for the headline look, but not the performance.

<**A - John A. Bryant**>: Well, I guess the good news, Tim, is the Raisin Bran Omega-3 is doing well, and Raisin Bran is in growth behind both that innovation as well as the broader healthy dividends campaign. So, we've demonstrated the ability to engage consumers on that key messaging with those core Kellogg equities such as Raisin Bran. I think on Kashi, you're absolutely right. I mean Kashi has been a great source of growth over many years. And our opportunity on Kashi is to push it back towards that pioneering nutrition that became a little bit too mainstream. That's one of the reasons why we have an issue with Kashi right now, and why we are innovating more towards those forward-leaning nutritionists, the people who are on the edge of the nutrition forward thinkers, forward leaners, however you want to describe them. And so, parts of our portfolio will do that, and other parts of our portfolio will be more mainstream.

<**Q - Tim S. Ramey**>: Got you. Okay. Thanks.

<**A - John A. Bryant**>: Thanks, Tim.

Operator

Your next question is from Ken Zaslow of BMO Capital Markets. Go ahead.

<**Q - Kenneth B. Zaslow**>: Hey. Good morning, everyone.

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

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

<**Q - Kenneth B. Zaslow**>: What makes Kellogg's somewhat unique is your portfolio across geographies have a great degree of similarities. So, I guess my question is really, what drove the disparity between international and domestic

growth? Was it management issues, was it product innovation, was it a change in category dynamics? Am I missing something? Can you just help us out with that, because it's such a discrepancy between the two, but yet your portfolios are generally similar across the globe.

<A - John A. Bryant>: Well, Ken, I think it has in part to do with the development of the market. So, we saw, say in Latin America and Asia Pacific growth in both cereal and in snacks. We saw growth in snacks in Europe, but not growth in cereal, and obviously we're struggling a little bit here in the U.S. So, I think it had to do with the developing emerging nature of the markets in Latin America and in Asia Pacific as well as – Pringles is a slighter bigger percentage of some of those regions than what it is say in the U.S., so we had some additional Pringles benefit there as well.

<Q - Kenneth B. Zaslow>: So, you don't think it's anything with an innovation or a structural issue within the company?

<A - John A. Bryant>: No. If anything, I would say that the work we do in Asia Pacific and Latin America, say, on cereal is more category building in nature, and quite frankly, you come back and look at our U.S. cereal business, I think that's where we have an opportunity to do more category building work. If you look at the pressures on the U.S. cereal category, it's actually not so much pressure within the category as pressure from categories around cereal. I think we, as manufacturers in cereal, have the opportunity to step up and re-engage consumers in why cereal is such a good benefit at the breakfast occasion. I think we can do more of that in the U.S.; quite frankly, we already do that in some of the emerging markets.

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

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

Operator

The next question is from Bryan Spillane of Bank of America Merrill Lynch. Please go ahead.

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

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

<Q - Bryan D. Spillane>: A question related to Project K and your sustainable growth model. I guess in looking at it at the impact from Project K, it just seems like, especially with taking capacity out and closing plants, does it actually make your model a little less volume dependent? I mean, I think one of the things – one of the challenges for Kellogg over the last year or two has just been – it is a very revenue-dependent and volume-dependent business model, and sales growth has been slow. So, I guess, does it give you a little extra flexibility to the extent that achieving a 3% to 4% revenue growth goal is challenged because the environment is challenged? Does this actually give you a little more flexibility than you have currently?

<A - John A. Bryant>: Bryan, I think if you look over the next few years, it's likely that our sales growth will probably be a little below that 3% to 4% growth because we're building momentum back into the business. As you go forward and we have the sustainable growth model working the way we want it to work, I think we should be looking at fairly balanced sources of growth between volume, price and mix. Obviously, over the next few years, I think volume will be a little bit harder to come by as we're driving that sustainable growth model and reinvesting back in the business.

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

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

<A - Simon D. Burton>: Emily, we have time for one more question, and then John's going to do some closing commentary.

Operator

Our last question is from John Baumgartner of Wells Fargo. Please go ahead.

<Q - John Baumgartner>: Good morning. Thanks for the question.

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

<Q - John Baumgartner>: John, in terms of the Project K, one of your stated goals here is to reduce excess capacity. Are there any product categories which you would think about in particular where excess capacity exists? Is it fair to say some exists in cereal?

<A - John A. Bryant>: I think it is fair to say that in a market like North America we have excess capacity in the cereal network.

<Q - John Baumgartner>: Okay. Thank you.

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

John A. Bryant

Well, thank you, everyone, for joining us. Our strategy hasn't changed. As you know, last year as part of that strategy, we acquired Pringles, which opened up additional opportunities for growth. We have some businesses around the world that are performing well and they're gaining category share; we are seeing great results from the Pringles business in an exciting category; we have some great ideas for investing, both in innovation and in brand building; and we have some white spaces in which we can invest and drive new sources of growth.

We need to pursue the opportunities we have in our existing businesses and categories and in new areas of growth. So, as a result, we've announced Project K, a significant growth and efficiency program. With it we will change the cost structure of the company. We will invest in each of our strategic priorities. And over the long-term, we will focus our investment in those areas where we expect to see the most growth in the years to come. This is a difficult process, but Project K is a pragmatic program designed to be a catalyst for future growth, and it's the right thing to do for the company over the long term. So, as I conclude, I'd just like to say thank-you to the Kellogg employees around the world. They are the heart and soul of this company and it is their hard work that will drive the company's success in the years to come. Thank you.

Simon D. Burton

Thanks, everyone. We'll be around the rest of the day to have further discussions. Thanks, again.

Operator

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