Kellogg

Second Quarter Earnings Call

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CORPORATE PARTICIPANTS

Simon Burton – *Vice President, Investor Relations*

John Bryant – *Chairman and Chief Executive Officer*

Ron Dissinger – *Chief Financial Officer*

Paul Norman – *President, Kellogg North America*

PRESENTATION

Operator
Good morning. Welcome to the Kellogg Company Second Quarter 2015 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. If you would like to ask a question during this time, simply press star and the number one on your telephone keypad. Please limit yourself to one question during the Q&A session. Should you need assistance during the call, please signal a conference specialist by pressing the star key followed by zero. Please note this event is being recorded. Thank you.

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

Simon Burton
Thanks, Gary, and good morning and thank you, everyone, for joining us for a review of our second quarter 2015 results. I am joined today by John Bryant, Chairman and CEO; Ron Dissinger, Chief Financial Officer; and Paul Norman, President of Kellogg North America.

The press release and slides that support our remarks this morning are posted on our website at www.kelloggcompany.com. As you're aware, certain statements made today, such as projections for Kellogg Company's future performance, including earnings per share, net sales, margin, operating profit, interest expense, tax rate, cash flow, brand building, upfront costs, investments and inflation are forward-looking statements. Actual results could be materially different from those projected. For further information concerning factors that could cause these results to differ, please refer to the second slide of this presentation as well as to our public SEC filings.

As a reminder, a replay of today's conference call will be available by phone through Tuesday, August 11th. The call will also be available via webcast, which will be archived for at least 90 days.

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

John Bryant
Thanks, Simon, and thank you, everyone, for joining us. Results for earnings were in line with our expectations for the second quarter. Comparable sales were approximately flat to last year and comparable earnings were $0.92 per share. The better performance we saw in the US Cereal business in the first quarter continued in the second quarter, and we again saw good performance across the international regions as well.

The benefits we have seen from our initial investment Project K have continued and we expect it to continue to build momentum in the second half of the year. We're on track to meet our guidance for the full year. Specifically, we expect approximately flat currency-neutral comparable sales, a decline in currency-neutral comparable operating profit of between 2% and 4%, including a negative impact of 3 to 4 points from rebasing of incentive compensation, and currency-neutral comparable earnings per share to be between flat and down 2%, also impacted by compensation.

Our performance in 2015 represents a significant improvement from 2014 and we believe that we are building a foundation for better results in the future. As a result, our improving momentum and increasing visibility into productivity programs are driving our confidence that we will achieve our long-term targets for sales and operating profit growth in 2016.

So with that in mind, I'd now like to talk about some of the things that give us that confidence. First, let's turn to Slide 4 and a discussion about momentum. Paul and the team have done a great job of improving the performance of our US Cereal business this year. And while we definitely have more to do to improve category performance, we're confident that we're focusing our investment on the right drivers of sales growth to continue recent trends. We're improving our food. We've invested in our sales force and we're improving the effectiveness of our brand building.

In addition, as you've seen in recent quarters, our international businesses have been performing well. Europe has seen some better results in a difficult environment, and growth has been good in Latin America and in Asia.

Secondly, our investment in Project K has helped to drive the improved momentum. It has provided us with the funds to invest in the Kashi organization and a significant number of new sales reps in both our warehouse and DSD sales forces in the US and in our coverage of high-frequency stores, largely in emerging markets. These investments have already had an impact and will help to drive even better results next year.

Finally, we've made some significant structural changes to our business. Paul will bring his experience and knowledge to running the North American business. Also, we have recently hired Craig Bahner to run our Morning Foods business and we've also hired Deanie Elsner, who was most recently CMO at Kraft Foods, to run our US Snacks business. I believe that our management team is now the best we've had in years and represents the right mix of experienced industry professionals from outside the organization, and talented long-term Kellogg employees.

With that, I'd like to turn it over to Ron.

Ron Dissinger
Thanks, John, and good morning. Slide 5 shows the financial results for the second quarter. As you've likely seen, our reported results include a remeasurement of our Venezuelan business to the SIMADI rate of 198 bolivars to the US dollar. Venezuela is a volatile market, and our circumstances changed in the second quarter. We experienced disruption in our business operations, driven by reduced access to US dollars for inputs to support production. As a result, we remeasured our business accordingly. The financial impact of this remeasurement is disclosed in detail in the appendices to our presentation materials.

Reported net sales declined by 5.1% due to the devaluation of international currencies. Currency-neutral comparable net sales were essentially flat, in line with our guidance for the full year. We saw strong broad-based growth in Latin America and Asia Pacific and in addition, our US Frozen Foods business grew, as did our Canadian business. Reported quarterly operating profit was $412 million and included Project K execution costs and the impact of the remeasurement of the Venezuelan business.

Quarterly currency-neutral comparable operating profit decreased by 6.8%, in line with our expectations. The decline was due to timing of manufacturing costs and higher distribution costs as well as the impact of resetting incentive compensation. Comparable earnings per share, which exclude integration costs, mark-to-market adjustments, Project K costs, $0.37 per share from the remeasurement of the Venezuelan business, and other items that affect comparability, were $0.92 per share in the first quarter. These results include $0.05 of currency headwind as a result. Currency-neutral comparable earnings were $0.97 per share.

Slide 6 shows details regarding the second quarter sales growth. Comparable revenues for the quarter increased 0.1%, a slight improvement from the first quarter, and included a 0.5% increase in price/mix, driven by our Latin America business. We saw good volume growth in Asia Pacific and Latin America, driven by growth in Cereal, and several of our North American businesses grew volume as well. The slight decline of 0.4% is primarily due to Cereal in developed markets, but as Paul will discuss later, we are seeing improving trends in US Cereal. Currencies [indiscernible] reported net sales by 5.5%, driven mostly by the euro, the peso, the Canadian dollar and the pound.

Slide 7 shows our year-to-date currency-neutral comparable gross profit and gross margin. Year-to-date gross margin was broadly in line with last year and with our guidance for the full year. While we have recognized lower material costs, and we continue to generate strong productivity improvements across our supply chain, we are seeing higher inflation and distribution costs and, as I mentioned earlier, some timing on our manufacturing costs versus prior year.

In addition, we are investing in our food across the globe. Recall that we mentioned that some of the Project K-related savings would be invested in our food. This includes the renovation of Kashi and Special K as well as the launch of granolas and mueslis in a number of countries.

Slide 8 shows the quarterly currency-neutral comparable operating profit performance for each of the regions. North America's operating profit decreased by 13%. This was the result of sales declines, increased distribution costs, timing of costs in our factories, and the resetting of incentive compensation levels. We do expect results to improve as we progress through the balance of the year.

Europe's operating profit increased by 6% in the quarter, driven by broad-based improvement in cost of goods sold, including Project K savings, and the timing of brand building investments, which are weighted more to the second half of the year.

Quarterly operating profit increased by 9% in Latin America as a result of strong sales growth. This quarter's growth included a significant increase in investment in brand building.

Operating profit increased by 76% in the Asia Pacific region. This is the result of double-digit sales growth in Asia and South Africa, lower cost of goods sold, and comparisons to last year. In addition, the region saw some benefit due to the timing of brand building between the second quarter and the third quarter. The growth in operating profit also included continued investment in capabilities in the region.

Slide 9 shows our year-to-date cash flow. Year-to-date operating cash flow, after capital expenditure, was $323 million. Cash flow in the second quarter was $311 million, which represented an improvement of more than $50 million from the second quarter of last year. We saw good performance in our core working capital, as I'll discuss in a minute. We continue to expect full-year cash flow of approximately $1 billion. Our cash requirements for Project K are the highest in 2015, and this is impacting our year-to-date position, but we remain on track to meet our outlook for the year.

And, of course, returning cash to shareowners remains a priority for us. In total, we've returned more than $2 billion to shareowners over the last two years through dividends and share repurchases.

Slide 10 shows our core working capital as a percentage of net sales. As you can see, our performance had flattened out over the past several years, but we've made a lot of progress improving our position recently and have best-in-class levels of working capital. We said that we would improve performance further to unlock cash flow after the acquisition of Pringles and to help us fund cash requirements for Project K. And our supplier-financing initiative has contributed significantly to this improvement.

Slide 11 details our currency-neutral comparable guidance for 2015, which has not changed. We continue to expect that net sales will be approximately flat for the year. We now expect a relatively neutral balance between inflation and the combination of productivity improvements and Project K savings. We've seen slightly more cost come through our materials and distribution, but we have been able to manage the impact in our outlook. Our materials are more than 90% covered. As a result, we expect gross margin for the year to be flat to up slightly. We expect that operating profit will decline by between 2% and 4%. We also still expect that currency-neutral comparable earnings will be between \$3.74 and \$3.82 per share, or in a range between flat and down 2%. Guidance for both operating profit and earnings per share include the impact of resetting incentive compensation.

The expectations for sales, operating profit and earnings per share exclude the impact of last year's 53rd week, the impact of the remeasurement of the Venezuelan business, and the impact of foreign currency translation. Our expectation for the impact of foreign currency translation is now approximately \$0.29 a share, up from the \$0.24 per share we expected last quarter. This includes our estimate that the currency headwind from translating future 2015 earnings for our Venezuela business at the SIMADI rate will be approximately \$0.10 per share. This will offset some improvement we've seen in other currencies. Our tax rate is still expected to be between 27% and 28%, and interest expense is expected to be between \$215 million and \$225 million.

We continue to anticipate that cash flow after capital spending will be approximately \$1 billion, as I mentioned, and this includes total incremental cash costs of \$350 million for Project K, partially offset by benefits from our supplier-financing initiative and other cash flow initiatives. Total capital spending should be in a range between 4% and 5% of sales, including approximately one point of sales for incremental capital associated with Project K. And our current plan is that we will repurchase between \$700 million and \$750 million of shares in 2015.

Slide 12 shows our full year earnings per share walk. Costs for the integration of Pringles and BiscoMisr in Egypt are still expected to be between \$0.04 and \$0.06 per share. Project K's pre-tax P&L costs are anticipated to be between \$400 million and \$450 million, or approximately \$0.80 to \$0.90 per share for the year, 75% of which will be in cost of goods sold. And the impact of the remeasurement of Venezuela, in addition to the translation impact of \$0.10 per share, is expected to be approximately \$0.43 per share in total. A small amount of the remeasurement will impact our second half of the year. Incremental savings from Project K are still expected to be between \$90 million to \$100 million for the full year, and approximately two-thirds of this will come from cost of goods sold.

For the remainder of the year, we expect comparable earnings per share delivery, including the impact of foreign exchange, to be approximately evenly split across the next two quarters. Our foreign currency headwind is much greater in the third quarter, as currencies had already begun to devalue in the fourth quarter of last year.

And with that, I'll turn it over to Paul for a discussion of our North America business.

Paul Norman
Thanks, Ron. Good morning, everyone. Let's first turn to the performance of the businesses within the North America segment. Let's start with the Morning Foods business. As you may have seen in public consumption data, the performance of the cereal category has improved this year. Total consumption across all channels was approximately flat in the second quarter, and, importantly, Kellogg branded sales were essentially flat, too, with our sixth largest cereal brands collectively growing sales and share in the quarter. This performance was driven, in part, by the good performance of the Special K brand, one of our main areas of focus over the last year. I'll talk more about this and Morning Foods in a minute.

Moving onto US Snacks, we saw mixed results in the second quarter, with sales down 1.8%. Pringles grew nicely. Consumption trends in crackers and cookies improved, but we experienced continued weakness in wholesome snacks. In Crackers, our Cheez-It brand grew sales on a full point of share in the quarter. In fact, excluding Special K Cracker Chips, our total Cracker business grew sales and share. On Special K Cracker Chips, velocities are improving; however, prior losses of distribution continue to weigh heavily on our year-over-year performance. In Cookies, consumption and share trends also improved in the quarter, with our Fudge Shoppe, Sandies and Simply Made brands all showing consumption growth.

In both Crackers and Cookies, our innovation is weighted to the back half, with new items such as Cheez-It Extra Toasty, Town House Focaccia, Chips Deluxe Peanut Butter with M&Ms, and Simply Made Sandwich Cremes amongst the numerous launches coming to market now. Whilst Pringles, crackers and cookies all showed positive signs in Q2, wholesome snacks continued to underperform. Rice Krispies Treats and our base Nutri-Grain foods performed quite well; however, distribution losses on prior innovation have impacted our businesses this year. We are committed to improving the performance of U.S. Snacks, and this will be an area of focus for me in coming months.

Moving on to the Specialty Channels business, sales declined by approximately 1% in the second quarter, although our business improved as the quarter progressed. In the Convenience channel, we saw share growth in five of the seven categories in which we compete, although we did see some weakness in foodservice, partially due to the exit from some unprofitable business. We are confident that our Specialty Channels business will grow in the second half.

The final business is the North America Other segment. This is the combination of Frozen Foods, the Canadian and the Kashi businesses. Frozen Foods posted currency-neutral comparable net sales growth, driven by strong results from the Eggo brand. Eggo Waffles saw momentum in consumption, increased share, increased base sales, and gains in penetration and buy rate. In addition, Eggo handheld Breakfast Sandwiches continue to do really well in their first year. And we also saw good sales growth in the Canadian business, as Cereal, Frozen Food, and Snacks all posted growth, with sales of Pringles up at a high teen rate. As expected, sales of the Kashi business declined in the second quarter, which led to a decline in total North America Other segment sales of about 1.3%. While sales were down, the trend improved as the team began to launch new products and reestablish distribution. I'll come back to Kashi in a minute.

And now over the next few slides, I'd like to focus on the US Cereal business and some of the progress we've made. Let's start with Slide 15. Over the past nine months, we have made good progress on the agenda we set out and have seen a stabilization of our Kellogg's branded business. This is illustrated by our improving top-line performance and Kellogg's branded share being up year-to-date. Back at CAGNY, we spoke about four critical elements to returning Cereal to growth, as illustrated on this slide. These were focusing on wellness; investing in our foods; engaging with consumers in new ways; and dialing up the fun and executing with impact.

Slide 16 focuses on the first of these, wellness in today's world. One of our biggest challenges has been to return the Special K brand to growth. We have moved the focus of the brand away from diet towards wellness. In the past few months, we have launched a new protein offering and introduced a gluten-free Special K. We've also launched taste to innovation by adding more berries to our largest variant, Special K Red Berries and we have improved our Special K Vanilla Almond food, too. We've introduced new packaging and new communication to support all of this. I'm pleased to say we have seen steady improvement in performance over the past few months, as you can see on this slide. In fact, consumption increased by 2.4% in the latest public data. We also have more news to come in August with the launch of new Special K Apple Cinnamon Harvest.

Now let's turn to Slide 17. Our other challenge has been Kashi. Whilst we have yet to see the kind of turnaround we've seen on Special K, we are seeing distribution losses subside and velocities begin to stabilize. The team is making good progress on renovation and innovation plans, and we expect to see the fruits of these efforts begin to come through in improving trends over the coming months and as we enter 2016.

You can see on the slide some of the Kashi innovation we have launched recently or have coming soon, including overnight mueslis, granolas, gluten-free waffles, organic chewy granola seed bars, and Sprouted Grain and Sweet Potato Sunshine Organic Promise cereals. As you know, we've made a significant investment in the Kashi team and organization and we believe we have the right structure in place. The team is focused on delivering on-trend food to holistics and we'll leverage the Kellogg Company's infrastructure to the degree that it helps them achieve that objective.

Earlier in the year, I also mentioned the launch of Kellogg's Origins, which you can see pictured on Slide 18. This is a range of cereals, granolas, and mueslis made with simple ingredients and designed to meet evolving consumer needs. The brand is now launched, and early acceptance has been good.

The second critical element to returning Cereal to growth is investing more in our food. Our work on Kashi, Special K and Origins all demonstrate actions to invest more in our foods. You can see on Slide 19 that this year, we have also launched new and improved Froot Loops and Apple Jacks with lower sugar. And as we look forward, we will continue to renovate our core offerings to give consumers more of what they want in the way of nutritional benefits, such as protein, gluten-free choices and simpler ingredient lists.

We know consumers are looking for foods with simpler ingredients, and work is well underway to answer that call. Already in North America, 75% of our cereals are made without artificial colors, and more than half are made without artificial flavors. Further, we have been working to remove artificial colors and flavors across Kellogg's branded cereals and a variety of Kellogg's branded snack bars as well as Eggo frozen foods. Our goal is to complete this transition by the end of 2018.

The cereal category is, and always has been, a repertoire category, offering health, taste, and importantly, fun, too. We believe getting this blend right is as important today as it has ever been. You can see on Slide 20 that keeping our category vibrant and on-trend also means bringing fun to life on pack and in-store in impactful ways. We have seen good results behind our Disney *Frozen* cereal this year and also strong in-market performance behind our in pack Avengers promotion, an event in April. Looking forward, we believe initiatives like these are just as important as what we do on the home health and nutrition front to drive category engagement.

The final area I wanted to mention is in-store execution on Slide 21. With our dedicated sales force, including field sales reps back in place, we are seeing tangible improvements come through in the area of assortment gains, in-stock performance, and merchandising behind the initiatives I outlined earlier.

So, in summary on Slide 22, whilst we still have plenty to do, we are pleased with the progress we're making on our Cereal business behind better core brand performance, relevant innovation and renovation, and better execution through the path to purchase. In fact, sales are on-trend to be flat to up in 2016, a great improvement.

Finally, I would like to thank the entire Morning Foods team, who have done an incredible job over the past year improving all parts of our plan.

With that, I'll turn you back to John.

John Bryant
Thanks, Paul. Now, let's turn to Slide 23 and detail regarding our European business. The Pringles business in Europe had another great quarter and delivered mid-single-digit currency-neutral comparable sales growth on a difficult double-digit comparison last year. The business in the UK posted double-digit growth and share gains, partially as a result of increased distribution. In addition, the launch of Pringles Tortillas made an important contribution to sales, although it only launched recently.

We have a significant Pringles business in Germany as well and we saw high single-digit sales growth there, as a result of distribution gains and increased commercial activity. Consumption trends improved in our Wholesome Snacks business in the second quarter. We have restaged Special K Bars in the region, which is helping the brand's performance. This, and the renovation of some of our foods, will continue to contribute and we expect the Wholesome Snack business to return to growth by the end of the year.

Total comparable net sales in the region decreased by 2.5% in the quarter, as the Cereal category continued to be a challenge. We restaged our Special K Cereals in July and had other activity launching at the same time. In addition, we are introducing new Special K Cereals on the continent in the second half. We've introduced mueslis in Germany and are expanding the interaction to other parts of the region.

Slide 24 shows some detail regarding our Latin American business. Total currency-neutral comparable net sales in the region increased by 14.5% in the second quarter, driven by growth in both Cereal and Snacks. Sales in the Cereal business were ahead of our expectations and included both volume growth and improvement in price/mix. In addition, we gained category share across our key businesses and we increased investment in brand building at a double-digit rate in the quarter. Specifically, we saw good growth in our portfolio of kids' cereals and a benefit from the parent brand products we've launched this year.

Sales in the Snack business increased at a high single-digit rate, largely driven by new products and go-to-market programs. In addition, underlying consumption growth in Pringles was good, all of which led to increased year-to-date share gains in the Mexican, Brazilian, and Columbian businesses.

As we discussed on last quarter's conference call, we executed the Copa América soccer-related initiative in the second quarter and it was a huge success. They had the highest customer engagement ever from a program in Latin America, and it has helped to drive the sales growth we saw in both Pringles and Cereal.

Also as we discussed last quarter, we have started investing in high-frequency stores in the region. This initiative is relatively new, but it is already driving distribution gains and sales growth, and we see significant opportunity for further gains as we expand our efforts. The team in Latin America has done a great job with new products, investing in growth, and executing the plans. The results this quarter reflect all this effort.

Let's turn to Slide 25 and our Asia Pacific business. Currency-neutral comparable net sales in Asia and Sub-Saharan Africa increased at a double-digit rate in the quarter, due to broad-based growth. The Indian business also grew at a double-digit rate, and the [audio disruption] with some of our new packaging initiatives driving results. The business in Japan also grew at a double-digit rate, due to the continued popularity of granolas and strong growth from All-Bran.

New advertising and innovation helped drive sales of the Special K brand up significantly in South Korea. We also saw good growth in Southeast Asia. The Pringles business also posted strong net sales growth in the quarter, and consumption increased at a double-digit rate, due to geographic expansion and the success of a music campaign similar to the one we run in Europe.

Sales declined in the Australian business which led to total quarterly sales growth for the region of 6.8%. While we expect the environment in Australia to remain challenging, we have plans for improvement, which include new product introductions; support, which stresses the nutritional benefits of our food; and a focus on increasing distribution. The first half of the year has been strong for the Asia Pacific segment, and we expect that the team will continue to execute well over the remainder of the year.

Let's turn to the summary on page 26. We are on track to meet our expectations for 2015 and importantly, this performance represents progress over 2014. As I mentioned earlier, we're building momentum. We are seeing improvement in our US Cereal business, improvement in our European business, and good growth in both the Latin American and Asian businesses. And we're confident that this improvement will continue into 2016.

We've invested savings from Project K and have seen the benefits. This investment will continue to increase next year. We have a talented management team that will drive the results of the individual segments. We have a well-defined strategy that we are continuing to execute and we're starting an aggressive zero-based budgeting program, which we expect will generate significant savings in addition to the savings flowing from Project K.

These two programs will allow us to invest in the business while also driving improvement in operating margin. All of this gives us confidence that we will achieve our long-term targets for comparable sales and operating profit growth in 2016. We're planning an investment day in November and we'll give you more detail then regarding our plans for next year.

And with that, I'd like end by thanking our employees around the world for all their hard work. Now, I will open up for questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time we will pause momentarily to assemble our roster.

The first question comes from Alexia Howard with Sanford Bernstein. Please go ahead.

Alexia Howard
Good morning, everybody.

John Bryant
Good morning, Alexia.

Alexia Howard

Can I ask, just in terms of the improvement in profitability in the second half, just to help me understand that a little better,it was obviously down quite a bit this quarter, I think 6.8%. Does that include roughly a 6% headwind from incentive comp that basically goes away from here on out because you started taking guidance down in the second half of last year? If we could just run through that and then I have a follow-up.

Ron Dissinger
Sure, Alexia. A couple of things on that, first of all, we do have an expectation that sales will improve over the second half of the year. We have seen improvement from the first quarter to the second quarter, and we expect that to improve as we go into the second half. We did have some incentive compensation headwind in the second quarter. It's a couple of points impact to operating profit. We do have some of that impact going into the third and fourth quarter as well, though, so that isn't the primary driver. Really, it's the sales performance. And then from a productivity standpoint within cost of goods sold, we are seeing our savings ramp up a little bit as we go through the balance of the year. That will help both gross margin as well as operating profit performance.

Alexia Howard
Okay. Thank you for that. And then the North American operating profit trends, you're expecting to get back onto your long-term earnings growth algorithm in 2016. Does that mean that operating profit growth in North America should pull around very quickly here, certainly within the next two or three quarters?

Ron Dissinger
Yes. As I mentioned, we do expect improving trends in operating profit in the back half for North America and as we move into 2016, as you'd expect, we do anticipate growth in North American operating profit.

Alexia Howard
Okay. That's very early in the year. Thank you very much. I'll pass it on.

Operator
The next question comes from Andrew Lazar with Barclays. Please go ahead.

Andrew Lazar
Morning, everybody.

John Bryant
Morning, Andrew.

Andrew Lazar
Just following on that. This is, I guess, as early in the year that I can remember in quite some time where Kellogg kind of discussed at least preliminarily their view for the out year, in this case, 2016. So again, I'm just trying to get a sense of maybe why, what drives the timing of that, to be this early in the year to talk about next year. And I think, as you discussed earlier, it does require Morning Foods to certainly be more stable and really into sort of modest growth mode. So is this just really a thought around your confidence level of that happening kind of sooner than later and really, what's driving that?

John Bryant
Good question, Andrew. I think it's, as you say, very early in 2015 to give guidance for 2016. What we're essentially doing is letting investors know that we expect to be on our long-term top-line and operating profit growth goals for 2016. And the reason we're doing that, as you look at the performance

in 2015, we believe that we're building momentum. It's a significant improvement from where we were in 2014. We expect that momentum to build into 2016. What's driving that momentum is the returns on our Project K investments. So whether that be the globe category teams and rapidly transferring ideas around the world; the Kashi team and the stronger innovation pipeline we see coming from that business; investing back in in-store execution; feet on the street in our US Cereal business; and the investments in our emerging market capabilities, such as high-frequency stores.

Also, we have excellent productivity programs into 2016. We have additional savings from Project K, we have our underlying continuous improvement programs, and on top of that, we have the zero-based budgeting initiative.

So while it's too early to give specific guidance for 2016, we wanted to give investors a sense as we go into 2016 we do expect to be back on our long-term goals. We could obviously halt for the third quarter call or the fourth quarter call to do that, but we've given a commitment to investors to get back on those goals as quickly as possible, and we wanted to get that out there that we see that happening in 2016.

Andrew Lazar
Thank you.

John Bryant
Thank you.

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

David Palmer
Good morning, and thanks for the deep dive on North America. I just wanted ask, Paul, if we were to use the Special K extensions in snacks as a case study as to what you're trying to do with Special K, you've made some progress with Special K in cereal. It seems to be a little bit more slow to recover in the snack side and you're talking about feet on the street investments there. Could you perhaps talk about what the issues are between execution, reformulation or other with that side? Thanks.

Paul Norman
Hi, David. I'd say we've been a little ahead on some of the work we've been doing on cereal, and we have touched all parts of the brand. If you take Special K, where it plays in snacks on crackers, on the Special K Cracker Chips, we are seeing some improving velocity through the renovated foods we've put back in market. However, we're lapping some pretty significant distribution losses. So the biggest issue there is recapturing lost distribution to be able to get that part of the business back on trend.

As you go towards wholesome, we did do some renovation on our core bars earlier in the year, and they're holding steady. We're just launching, as we speak, Special K Chewy Nut Bars, which is a step-change in food and that's just entering the market, as we speak, mid-year. So we'll be watching that closely as we look forward on Special K.

So the work is coming. The innovation is there. The renovation is there. It's a little behind in Wholesome relative to where it was in the Cereal business.

David Palmer
If I could just follow-up on that, just the reinvestments that were made in DSD, the feet on the street, I think that began last year. How is that reinvestment there or investment there progressed over the last couple of years, and if there's any sort of detail you can give us about how that's going? Thanks.

Paul Norman
We did add some additional reps to the DSD system back, I think it was early last year, and we've had some impact from that. I think what we're seeing on the Morning Foods side of the business is even more impactful, where we've put the feet on the street back on the warehouse side. And as a proportion of the change, the impact to warehouse was much bigger than the impact we did to the DSD system.

David Palmer
Thank you.

Paul Norman
Thank you.

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

Bryan Spillane
Hi. Good morning.

John Bryant
Morning, Bryan.

Bryan Spillane
Hey, a question about the zero-based budgeting, if I recall correctly, where we left off last was that you were kind of watching and what was happening at perhaps at Kraft or some other companies, and we're going to kind of look at it closely. So I guess if you could talk about maybe what's changed in the last three months that caused you to think about, or caused you to go further down that path on zero-based budgeting. And then connected to that, will you consider any change in the way that you change incentive compensation related to it, just simply because it's such an investment for the employee base and it's a little bit long-term in terms of driving value? So those two things, what's changed in terms of adopting it and will it come with a change in the way you calculate or look at incentive comp?

Ron Dissinger
Hi, Bryan. This is Ron. Hey, first, in terms of our zero-based budgeting initiative that John mentioned, timing is absolutely right for us at this point in time. Remember a couple of years ago, we undertook Project K, big initiative for us, touching all parts of the globe. That project is progressing very well. It's on track at this point in time, both from an operational execution standpoint as well as the financial elements of the program.

Fact is we already ran some pilots on zero-based budgeting back in 2014, so we've learned from those pilots. We have determined now the application is right. We're going to begin in North America and actually that gives us some support for confidence in growing profit in North America next year. So we'll roll it into North America end of 2015 and into 2016 and then cascade it across the globe after that. A little bit early for us to talk about savings estimates at this point in time, but it does give us more confidence, as I said, in our 2016 outlook.

John Bryant
And on the incentive compensation, I wouldn't see us changing our macro plan design, but I could see us working to ensure we incentivize the savings for the people who are driving that program.

Bryan Spillane
Okay, thank you.

John Bryant
Thank you.

Operator
The next question comes from Jason English with Goldman Sachs. Please go ahead.

Jason English
Hey. Good morning, folks. Thanks for the question.

John Bryant
Morning, Jason.

Jason English
I guess I was a little surprised in terms of your gross margin outlook where you talked about inflation and productivity now sort of neutral for the year. It sounds like there is some incremental cost rolling through the P&L. Can you give us a breakdown of what that is? And also, any incremental color you can add in terms of the magnitude of investment that you're absorbing in gross margin regards to the product quality and rejuvenation efforts there?

Ron Dissinger
Sure, Jason. In terms of our outlook on our inputs, our productivity, and then input costs, there has been a little bit of a change. Remember when we started the year, we said that all up with the productivity savings, the input inflation and then Project K savings, we may be net a little bit deflationary. Well, as we've come through the front part of this year, we've encountered avian influenza. That is having an impact on our egg costs and that's relatively significant for us. So it's having an impact, particularly on our back half cost structure. So we're expecting it to be relatively neutral now. We do believe our gross margin will be flat, though, to up slightly.

John Bryant
While it's difficult for us to tease out the additional costs of renovating our foods, certainly there are additional costs in this year from doing that, and there will be meaningful costs over the next couple of years from continually evolving and improving our foods. And we will fund those through a variety of productivity programs within the company to absorb those costs.

Jason English
Got it. That's helpful. And one more, if I may, a question for you, Paul, in terms of North America cereal, can give us a sense of how much capacity you've taken out of the cereal market in the US and how much, from where you sit, you think has come out of the industry? And as we look at some of the scanner data, it is encouraging to see that the amount of volume that's being sold on promotion has been steadily eroding. Do you think that we're seeing more rational behavior in terms of discipline on promotion and price investment, and do you think there's any relation to the capacity reductions that have happened?

Paul Norman
Obviously, we did close a facility last year in Canada, so that came out of the Kellogg business. I can't talk to all the stuff that's going on with our competitors, but I know they're making moves as well. I think the marketplace is pretty rational at the moment. We're seeing a little bit of price realization. We're

putting our money, as I said, back into our food. We're investing back in our core brands. We're renovating, innovating and trying to drive those sales fundamentals right through to the store. I think that's where we'll get the benefit. I don't think there's going to be a lot more heavy promotion per se. I think the category dynamics are pretty good at the moment.

Jason English
Thanks a lot, guys. I'll pass it on.

Operator
The next question comes from Kenneth Zaslow with BMO Capital Markets. Please go ahead.

Vishal Patel
Hi. This is Vishal Patel in for Ken. I just had a question kind of on the recent agreement with the union that you announced over the weekend. You're not reducing workforce as a result; is that a fair statement?

John Bryant
Yeah, Vishal, I think if you look at our cereal network, as Paul mentioned, we closed a fairly meaningful facility last year in London, Canada that's reduced the size of our footprint in North America. The contract that was signed with the union, I think is a very good contract. It enables us to be more cost competitive. It gives us operational flexibility going forward. So it has us holding the number of cereal plants we have today open, but we have flexibility within that to change the scheduling and the production of cereal based upon what we need to produce for the category.

Vishal Patel
Okay, great. Thank you.

John Bryant
Thank you.

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

Alexis Borden
Hi. This is Alexis Borden in for David this morning.

John Bryant
Good morning.

Paul Norman
Hello.

Alexis Borden
Hi. Question, so comparing Special K with Kashi, so basically you've been seeing Special K trends improve and the retail scanner data kind of shows this, but when you kind of look at Kashi, it's still kind of struggling with double-digit sales decline. Can you maybe tell us what's going right in Special K and kind of why it's being harder to turn around Kashi, kind of how do you see that progressing?

Paul Norman
Okay. As I spoke through in the prepared notes, I think we were a little ahead on Special K again versus where we were on Kashi. We've innovated with on-trend food. We've reinvested in some of our

core SKUs. We have migrated to positioning of the brand more to wellness from diet, and we've invested and activated heavily. Kashi, we have a bit of a lag because we've had to do quite a lot of renovation to our foods, including GOLEAN, for example, which I'm pleased to say in Q3 2015 will now be non-GMO project certified.

The rest of the portfolio will go that way in Q1 2016. So we've more or less got through the renovation phase of our work on Kashi. We also moved to put a team back in place in Kashi back in California. That team now is fully functional and in place, and we're beginning to see the benefits of the renovation and innovation work they've been doing coming through. So I think you'll see Kashi trends improving in the back half of this year, into the beginning of next year. We are seeing distribution losses, which were a big driver of those declines, subside and velocity stabilizing. So I think the recipe or the ingredients are coming together for Kashi to start to get back into growth as we finish this year and move into next year. So I think you'll see sequential improvement from now on with Kashi.

Alexis Borden
Okay. Thank you.

Operator
The next question comes from Robert Moskow with Credit Suisse. Please go ahead.

Robert Moskow
Hi. Just a follow-up on the zero-based budgeting question that Bryan asked, my understanding is that Kellogg had done this benchmarking work in the past and found that like in North America, ex the DSD costs, that SG&A and admin expenses were pretty much in line with its peers. Am I mistaken in that assumption? And so what did you find in that pilot last year? Did you find opportunities and, if so, in what areas?

Ron Dissinger
Yeah, Rob, so when we look at benchmarking our SG&A costs, and let's set aside the advertising costs and other brand building costs and just get to pure overhead, we do find that we tend to benchmark pretty well. But peers are moving on us as well. We believe there's opportunity by executing a zero-based budgeting initiative starting, as I said, in North America and then cascading it across the globe. So we see it as an opportunity for us to be more competitive and perhaps unlock some funds for reinvestment into the business or to drop to the bottom-line.

Robert Moskow
Okay. So it's just a function of everyone else is cutting, so you think the bar keeps getting higher, so to speak?

John Bryant
Well, I think again, we've run a couple of trials, some projects internally, and we've found some savings. Some of the savings have been in areas that we would not have anticipated, such as non-people-related overhead costs. And we're also going to apply the ZBB tools into the brand building element as well, which we are finding significant efficiencies even this year, whether it be in agency fees, media buying, point of sale materials, all those sorts of elements as well.

Robert Moskow
Okay. Thanks, John.

John Bryant
Thank you.

Operator
The next question comes from Eric Katzman with Deutsche Bank. Please go ahead.

Mario Contreras
Hi. Good morning. This is Mario Contreras on for Eric.

John Bryant
Good morning.

Mario Contreras
Hi. I had a couple of questions on I guess a couple of the adjustments you had this quarter. First, on the VIE deconsolidation, can you talk a little bit about what that business was and what led to that decision? And then second, on the Venezuela currency adjustments, obviously, that's been a pretty volatile economy for a good amount of time now. So can you just talk about what got worse this quarter that led you guys to make the decision to change that accounting?

Ron Dissinger
Sure. So first on this variable interest entity, we recognized a gain due to deconsolidating this third-party business. This is a co-manufacturer that was making food for our US Snacks business. It was consolidated into our results over the past several years based on the accounting rules. In this quarter, the business sold itself to a third-party, and that triggered a change in our accounting. If you look at our 10-Q, it's been disclosed in the past and you'll see it disclosed again, obviously, and the impact. It's a one-time non-cash item that we've excluded from our comparable results.

Now if we move on to Venezuela, our situation did change in the second quarter in Venezuela. As I've mentioned in the past, we buy a small amount of inputs from outside of Venezuela to manufacture product in the country. And we typically get access to US dollars to be able to do that. In the first quarter, we got access to those US dollars.

In the second quarter, we had no access to US dollars and, in fact, the government has indicated that it is going to slow payments going forward. This created disruption to our business in the second quarter, so we reevaluated the matter. And we determined that the best rate for us to measure the business at was a SIMADI rate of 198 bolivars to the US dollar, but we still remain a priority industry within Venezuela. We do expect to continue to manufacture and to serve our consumers. We have a good business there and we have a great team that's managing in a very difficult environment.

Mario Contreras
Okay, great. Thanks for the time.

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

Ken Goldman
Thanks. Good morning, everyone. On cereal, one of your top customers has spoken about, in general, not promoting as often across food, maybe going back a little bit toward EDLP and I guess that would lead to display space for promos in general reverting to a more normal level. And bear with me here, but I'm just wondering if this has benefited cereal in any way, because I think of cereal as a product that maybe relies on successful promotions to succeed. And if there is less competition for display space, right, if consumers are no longer seeing displays all over the board, but they're seeing sort of the legacy ones like cereal, has that helped the category at all or is it not really taking place in your mind?

Paul Norman
Thanks for the question, Ken. Obviously, I cannot talk about specific customers. If I focus on our Cereal business, I think what we're seeing is the good return on our focus on driving our core brands better, with better innovation promotions, renovation ideas, and really focusing through the path to purchase with impact for sales execution and that's driving display. If you look at the data from Nielsen, I don't think you're seeing a lot more display necessarily. We are getting more impact and quality merchandising because we're leveraging the scale of these events and bringing fun and news to the point of purchase. So I don't see any relation to the theory you put forward. I think we focus on delivering our business and executing and exciting consumers in every retail environment.

John Bryant
If I could add to that too, Ken, I think if you look beyond the US, we've seen the Canadian cereal category get a lot better as well and we're also seeing improving category trends, although they're not quite where we'd like them to be in the UK and Australia as well. So I think you're seeing cereal get on a stronger footing in some these large cereal markets and even on a global basis, we actually grew our cereal sales globally in the first quarter and in the second quarter.

Ken Goldman
Thanks, John. That's helpful.

John Bryant
Thank you.

Operator
The next question comes from David Hayes with Nomura. Please go ahead.

David Hayes
Hi, gentlemen. Thank you. I think this is for Paul, this question. Just in terms of this encouraging momentum on US Cereal and obviously this impressive array of innovation, I guess if I was being concerned or nervous about the ongoing trend, the question would be can you give us some kind of indication of your confidence that there isn't any channel pipe fill from these innovations in these numbers? And I guess, more importantly, in some ways, the consumer pull-through or the consumer repeat purchasing, in terms of people trying it because it's new and then you don't get it pulled through? If you can give us some kind of indication, ideally quantitatively, in terms of focus group feedback and repeat purchase information, just to sort of give us that feel that this is actually ongoing business rather than people trying and then we've got to wait to see what happens in the next 6 to 12 months in terms of pull-through. Thanks.

Paul Norman
Hi, David. Two points to probably go towards, one is the data I was quoting is consumption data, so it's actually purchased data, total category's flat. Our biggest six brands are growing consumption dollars and share, so this is being pulled through. This isn't us pushing into the market. We have no inventory issues within the US.

Special K is interesting because the brand was up. Base sales as the quarter progressed went into progression as well. So when you've got base movement off the shelf, this isn't purely incrementally driven through display and price promotion, it's actually good fundamentals coming through in terms of base consumption.

So we know that consumers want nothing more than more goodies in their food when it comes to red berries, and giving them more of what they want, we're seeing them buy more from the shelf importantly. So I think the underlying trends are positive. That's why I feel positive about the future. This isn't share rental or overly pushing the business. This is good consumer demand coming through.

David Hayes
Okay. Thanks, Paul. Thank you.

Operator
Again, if you have a question, please press star then one. The next question comes from Matt Grainger with Morgan Stanley. Please go ahead.

Matt Grainger
Hi. Good morning. Thanks for the question.

John Bryant
Morning, Matt.

Ron Dissinger
Morning.

Matt Grainger
John, just coming back around to the 2016 outlook, you gave us a number of factors that give you confidence in the achievability of those targets, and the willingness to talk about them today. Just curious here what you see as the biggest challenges or areas of uncertainty or areas where you're pushing the employee base to work harder to make sure you actually do deliver on those targets.

And, Ron, I know this essentially is sort of asking for guidance, but is there any incremental color you can give us on the phasing of Project K savings you're looking for next year, not necessarily an absolute, but maybe relative to what we're seeing this year?

John Bryant
If I answer your question first on 2016, I think the important thing to remember is we are building momentum. In 2014, a tough year for us, we're building momentum in 2015 and we see that continuing into 2016. You're seeing it with continued strong Pringles growth around the world. You're seeing it with the larger cereal businesses starting to perform better, particularly in the US and Canada so far. You're seeing also very strong emerging market growth. We grew cereal double digits across Latin America and Asia. And so that's helping our results as well and we're seeing these overall trends put us in a better position as we go into 2016.
But I think what really helps give visibility to 2016 is the excellent cost and productivity outlook that we have for 2016. Obviously, we'll have Project K savings come through. We'll have continuous improvement programs and we'll have zero-based budgeting also start to help 2016. So clearly, I'd like to get the top-line growth in place, but even if the top-line growth is lower than we would like, we still have good productivity visibility for next year.

Ron Dissinger
And, Matt, in terms of Project K savings, recall our guidance for 2015 is that we expect savings in the range of $90 million to $100 million. And we're tracking in line with that. Remember we always said that our savings would ramp up as we went through the years. As we look at 2016, at this point in time, and it's early to provide guidance on Project K savings, but we expect savings to be north of $100 million.

Matt Grainger
Okay, great. That's helpful. Thanks.

CONCLUSION

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

Simon Burton
Okay. Well, thanks, everyone, for joining us today. We'll be around for the next day or two for follow-up questions. Look forward to talking to you then. Thanks.

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