Company Name: Kellogg
Company Ticker: K US
Date: 2014-07-31
Event Description: Q2 2014 Earnings Call

Market Cap: 21,535.51
Current PX: 59.98
YTD Change($): -1.09
YTD Change(%): -1.785

Bloomberg Estimates - EPS
Current Quarter: 0.994
Current Year: 3.991
Bloomberg Estimates - Sales
Current Quarter: 3767.917
Current Year: 15033.125

Q2 2014 Earnings Call

Company Participants

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

Other Participants

- Christopher R. Growe
- John J. Baumgartner
- Alexia Jane Howard
- Robert B. Moskow
- Ken B. Goldman
- Jason M. English
- David S. Palmer
- Andrew Lazar
- David Cristopher Driscoll
- Eric R. Katzman

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Second Quarter 2014 Earnings Call. [Operator Instructions] 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 will turn the call over to Simon Burton, Vice President of Investor Relations for Kellogg Company. Mr. Burton, you may begin your call.

Simon D. Burton

Thanks, Laura, and good morning. And thanks, everyone, for joining us today for a review of our second quarter 2014 results. I'm joined here by John Bryant, Chairman and CEO; and Ron Dissinger, Chief Financial Officer.

The press release and slides that support our remarks this morning are posted on our website at www.kelloggcompany.com. 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 our 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 Monday, August 4. The call will also be available via webcast, which will be archived for at least 90 days.

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

John A. Bryant

Thanks, Simon, and thank you, everyone, for joining us. Today, we announced second quarter earnings per share that were broadly line with our expectations. We saw growth in Europe, Latin America, Asia Pacific and in Specialty channels in the U.S., and Pringles continued to do well around the world.

However, as you've heard from other companies recently, the sales environment continues to be very difficult in major developed market. And this affected our performance in the second quarter as well. As a result, sales growth and operating profit were lower than we anticipated. However, earnings per share were broadly in line with expectations in a challenging environment. As Ron will discuss in more detail in a few minutes, as a result of the environment we've seen so far this year, we're lowering our guidance for 2014. We now expect that internal net sales will be down between 1% and 2%. Underlying internal operating profit will be down between 1% and 3% and that currency-neutral comparable earnings per share will be between up 1% and down 1%. We are disappointed by our performance in 2014 and are committed to returning our business to long-term growth.

We already invest a significant $1.5 billion a year in brand building, an industry-leading level as a percentage of sales. And, as you know, we intend to increase our investment in revenue-driving activities, including brand building and sales execution as part of the Project K initiative. But before we talk about that in more detail, let me turn to Slide 4 and a brief overview of Project K and how we're funding the extra investment.

Project K is our four year global efficiency and effectiveness program and it continues to progress well. As you know, Project K is designed to ensure that we have the right capacity in the right locations to enable us to meet customer demand and market trends. As a result, we have made the difficult decision to close our London, Ontario cereal plant and are in consultation to take production out of that plant in Manchester, UK. Despite these actions, we may still have more capacity than we need in our cereal network.

In addition to the items we've discussed with you previously, we recently announced that we have plans to reduce excess capacity in the Snacks business in the U.S. Also, as we highlighted last quarter, the move to Global Business Services continues to go well. This is a three-tiered model, which will include local, regional and global services. We remain on track to open the first regional center, which will support North America, in the third quarter this year. And we've announced our intention to open a center in Europe.

Now, let's turn to Slide 5 for a discussion of some of the actions we're taking with the savings generated by this program. We currently invest in advertising at industry-leading levels and have so for some years. Part of that is due to the categories in which we compete, as they are large, profitable and highly branded. So while we intend to continue to increase investment over the long-term at or above the rate of sales growth, we are also taking steps in the near-term to increase the effectiveness and impact of the $1.5 billion we currently invest in brand building.

First, we have a portfolio of strong brand equities and we'll continue to nurture and enhance their relevance through the use of strong campaign ideas that differentiate and break-through. For example, we're driving the relevance of the Kellogg's [ph] parent brand (5:26) with consumers by communicating about our sustainability initiatives and philanthropic initiatives, such as Breakfasts for Better Days. We know that consumers are looking for companies that share their values. And these campaigns demonstrate our commitment to the environment and the community.

Second, in a fragmented media landscape, we are focused on following the consumer as their media consumption habits evolve. Today, we invest more than 20% of our media in digital properties. And we will continue to shift media to where and when the consumer engages for the greatest impact.

Third, as many consumers seek personalized one-to-one communication, we will continue to expand our database of over 20 million consumers in the U.S. and reach out to them with personalized communications and offers on the brands of their choice.

Finally, recognizing we are competing in a multi-cultural landscape, we are actively engaging the Hispanic audience. So we're focusing on new investment and on increasing the effectiveness of what we already spend. We see this is a meaningful opportunity. We will continue to evaluate all of our spending and generate great ideas that will drive profitable revenue growth.

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

Ronald L. Dissinger

Thanks, John, and good morning. Slide 6 shows financial results for the second quarter. Internal sales declined by 1.5%, an improvement from the first quarter, but below our expectations. We had anticipated some improvement in developed cereal trends during the quarter and our U.S. Snacks business was softer than planned. But we did post good growth in other regions, including Latin America, Asia and Europe.

Underlying internal operating profit decreased by 7.2%, which, as John said, was below our expectations. This was due to our sales performance. It's also worth noting that our profit performance included a mid-single digit increase in investment in brand building, the benefit of lower overhead in SG&A, and slightly higher inflation and cost of goods sold. Comparable earnings per share, which exclude integration costs, mark-to-market adjustments from Project K costs, were $1.02 per share in the quarter, broadly in line with our expectations. We benefited in the quarter from a lower tax rate, lower interest expense and by $0.02 per share from currencies.

Reported earnings per share for the quarter were $0.82, including $0.02 of Pringles integration costs, $0.16 of up-front costs related to Project K, and $0.02 impact from mark-to-market adjustments.

Slide 7 shows the composition of the second quarter sales growth. Total internal sales declined by 1.5%. And total price and mix improved by 1%, with most regions contributing to the performance. Volume decreased by 2.5% in the quarter, mainly due to declines in developed cereal. As was the case last quarter, unit volume performance was better than tonnage. Finally, the impact of currency translation increased reported sales growth by 0.7% in the quarter, primarily as the result of movement in the British pound.

Now, let's turn to Slide 8, which shows our underlying reported gross profit and gross margin for the quarter. Our underlying gross margin decreased by 60 basis points in the second quarter. Our inflation is more skewed to earlier in the year. In addition, we saw some adverse impact from higher distribution costs and lower production volume, due to our sales performance across the quarter. While we generated solid productivity savings in the quarter, we experienced some net inflation. And these factors led to the decline in gross margin that we saw in the quarter. We are currently covered on commodities and packaging at approximately 90%, so we have good visibility into the phasing and levels of costs for the year.

Slide 9 shows the quarterly internal operating profit performance for each of the regions. North America's internal operating profit decreased by 9%. This was driven by lower-than-expected sales in cereal, increased transportation costs. And we also increased investment in brand building in the period. We expect improvement in the second half of the year in North America, although we expect operating profit to be down for the year.

Internal operating profit in Europe increased by 5%. Sales and strong productivity savings in cost of goods sold and overhead led to net deflation in the quarter. This was partially offset by a mid-single digit increase in brand building investment, including for our cereal category building messaging.

Internal operating profit grew 6% in Latin America. We had good top-line growth, which helped to offset inflation in cost of goods sold. Top-line growth was driven, in part, by a lower impact from the food tax increase in Mexico earlier this year. And Asia Pacific posted a decrease in internal operating profit of 65% in the quarter. This was largely due to a double digit increase in brand building investment across the region and our performance in South Africa.

In South Africa, we conducted construction in our plant and it took longer to bring production back online than we planned. This increased our cost of goods sold and impacted our ability to supply the market. It is important to note, however, that the plant is up and running again.

Slide 10 shows year-to-date cash flow for the quarter. Cash flow from operations was $654 million. We continued to make progress on the payables initiatives that we've discussed with you previously. And we still expect that this initiative will generate between $200 million and $300 million in cash this year. Also, we are investigating some other options that could improve working capital even further in the years to come.

Year-to-date capital spending was $226 million, slightly lower than last year, but our expectations for full-year capital spending remain unchanged at between 4% and 5% of sales to support Project K supply network initiatives, capacity expansion for Pringles, and our new cereal plant in India. So year-to-date free cash flow after capital spending was $428 million.

And finally, share repurchases in the first half of the year were $329 million, significantly more than the $124 million of options proceeds received. We now expect to reduce our average share count by approximately 1.5% over the course of the year, towards the lower end of our previous outlook.

Now, let's turn to Slide 11, which shows our revised guidance for 2014. As usual, our guidance excludes items that affect comparability. And please refer to our notes for the details on these items. As a result of a slower improvement in sales trends, we have revised our outlook for the year. We now expect that internal net sales will be lower by between 1% and 2% for the full year. This is primarily due to the softer sales performance we've seen in our developed cereal markets in the first half. We expect moderate material-related inflation for the year and total cost of goods sold inflation is still expected to be in the 3% to 4% range we provided previously.

Productivity and savings from Project K will be a little higher than we guided, leading to moderate net deflation for the year. We do still expect an improvement in underlying reported gross margin, but it may be up only slightly. We anticipate that underlying internal operating profit will be a range between down 1% and down 3%. And we continue to expect brand building to be at or above the rate of sales growth.

This outlook excludes the impact of the 53rd week, which will add between 1.5 and two points to reported operating profit growth. Currency-neutral comparable earnings are expected to be in a range between down 1% and up 1%, or at $3.81 to $3.89 per share. The 53rd week will add approximately $0.07 per share and currency may add approximately $0.03 per share, resulting in an EPS, including the 53rd week in currencies, of $3.91 to $3.99. The tax rate is still expected to be between 29% and 30%. And interest expense is now anticipated to be between $210 million and $220 million.

The EPS walk on Slide 12 shows you the details of our guidance. Our outlook still excludes any potential impact from a devaluation of the Venezuelan bolivar. If we were to recognize the devaluation to the [ph] CCAD 1 (15:53) rate now, it could impact earnings by between $0.07 and $0.09 per share for 2014. The annualized impact would be between $0.09 and $0.11 per share, due to the translation of profits at a lower rate for an entire year.

And finally, on this slide, we continue to estimate that integration costs will be between $0.07 and $0.09 a share and that Project K costs may be at the high end of the $0.60 to $0.65 per share range.

Now, let's turn to Slide 13. We expect cash flow to be at the low end of the range, between $1 billion and $1.1 billion due to our expectations for lower full year underlying internal operating profit. And as I said earlier, we still expect capital spending to be between 4% and 5% of sales. As you would expect, our revised outlook for the year has an impact on our expectations for second half sales and profit, while we anticipate that both internal sales and underlying internal operating profit will be down in the third quarter. And we expect comparable earnings per share to be down at a mid-single digit rate, including continued investment in brand building activities.

Our sales trends are expected to improve as we progress into the fourth quarter. And we expect growth in underlying internal operating profit, including the benefit from the build of productivity savings, including Project K and the lower inflation I mentioned. And, of course, we've also got the 53rd week affecting earnings per share as well.

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

John A. Bryant

Thanks, Ron. Now, if you'll turn to Slide 14, you'll see more detail regarding Morning Foods. Internal net sales declined by 4.9% in the quarter. As you know, we started our category building programs in the second quarter. This investment will continue across the balance of the year and into the future, with a focus on evening snacking beginning in the fourth quarter. And to be clear, this is not just an idea or two, rather it is an ongoing initiative to deliver our consumer-focused message on both a category and individual brand level. And it won't surprise you to hear that we are putting the final touches on a campaign that will launch in early 2015 as well.

As we drive this program, it is designed to build and grow the category and for Kellogg to capture that growth. We will do that by using our individual brands within the category building campaigns. So as you think about the business, we have distinct challenges with [ph] some valid innovation with Special K and with Kashi. And we have plans for each. (18:46-18:51) While Mini-Wheats has posted declines in consumption so far this year, the original bite-size version has performed relatively well. The overall decline has been largely due to innovation that hasn't worked, such as Mini-Wheats Crunch, but we're working through that impact.

As you can see on the slide, the broader category building campaign includes the Mini-Wheats brand. And we've also got new advertising planned for later in the year which focuses on [ph] out-of-breakfast (19:21) consumption. So we're strengthening our brand building program on Mini-Wheats and are confident that this is a brand that will respond and that will return to growth over time. And we've also had an issue with some other failed innovation in Crunchy Nut and FiberPlus. In fact, the impact of these two brands accounts for 0.5 point of share decline in the quarter.

While the category trends were not positive, we also faced some brand-specific issues. Special K continues to be impacted by the evolving consumer trends affecting weight management brands in general. As a result, we are actively repositioning the brand and emphasizing the presence of positive nutrition like protein, fiber, grains and other relevant nutritional benefits. We also have plans for renovation and innovation as well as new communication plans to further drive this repositioning of the food.

Finally, for Morning Foods, let's turn to Slide 15 and Kashi, which is one of the largest natural foods businesses in the U.S. Kashi has not performed as well as we would've liked over the past few years. And while much of the recent decline is due to lower distribution, we need to address the brand's positioning and our ability to execute quickly enough in the evolving world of natural and organic foods. We haven't kept Kashi focused enough on progressive nutrition. And, as a result we have decided to make some dramatic changes. David Denholm, who ran Kashi very successfully in the 2000s, is returning to the company to become CEO of the Kashi Company, which also includes the Bear Naked and Stretch Island Food Snack businesses. This will be a largely autonomous business within the Kellogg family.

Kashi will be based in La Jolla, where it began, and will be focused on returning the brand to the leading-edge of the natural and organic food world. This business requires an entrepreneurial approach, shorter developed periods and a more agile decision-making process. And David is the right person to lead this significant change, although we know it will take some time.

So as we said before, we realize that improvement of the Cereal business will take some time. However, we've just started to invest in all our developed businesses around the world and we're making plans for additional activities. This is a multi-year program and we're confident that we have the foods, the brands and the ideas to drive improvement in the future.

Now, let's look at the U.S. Snacks segment and Slide 16. Internal net sales declined by 2.7% in the quarter. The Cracker business and Pringles both did well in the quarter. And we maintained share with the Keebler brand in the cookie category; however, we underperformed the category in wholesome snacks. The Cracker business posted a gain in share in Q2 as the big three brands, Cheez-It, Club and Town House, all saw gains in consumption and growth in share. In combination, these three brands posted consumption growth of 7%, driven by core varieties and new products. Cheez-It Grooves, which were launched in the first quarter, continue to do well and initial results for Town House Pretzel Thins, which were launched at the end of Q2, have been good.

In addition, last year's new products, Cheez-It Zingz and Town House Pita, both continue to do well in their second year. And we have more big ideas launching later this year. The Keebler cookie brand maintained share in the quarter. The Chips Deluxe line saw good growth as the new cookies co-branded with M&M'S continue to do well. However, we posted lower consumption and shipments in our 100 Calorie Packs. And we actively reduced SKUs in this segment. We have some new products that recently launched, including Keebler S'mores and a new variety of our successful Simply Made cookies, which will have a positive impact on results. However, the effective reductions in number of SKUs in the tail will continue for the balance of this year and into early next year.

In the Wholesome Snack business, overall sales declined the second quarter, although we had some success as a result of innovation in Rice Krispies Treats and Kashi and as new Special K protein bars gained incremental distribution. However, we saw weakness in the rest of the Special K brand as it faces headwinds from evolving consumer trends in weight management. We are working on new products and have more activity planned for the second half; however, we expect this segment to remain challenging for the balance of the year.

The Pringles business posted both shipment and consumption growth in the quarter, with consumption lapping almost 7% comps in the 13-week period through the end of June. Pringles Tortilla continues to post very strong results and we have new varieties planned for introduction. And we saw strong support for the brand, including increased display activity in Q2.

Pringles is a great brand that has responded well to our initiatives. And we expect continued strong growth in the second half of this year and into the future. Although we gained share in Crackers and Pringles, and the Keebler brand held share in Cookies in the quarter, we were disappointed with the performance of our Snacks business. We are working hard to address the weakness this year, particularly in the Special K brand. And the team is working on plans for the longer-term, including improved brand building, better innovation and continued good in-store execution.

Now, let's look at Slide 17 and the U.S. Specialty segment. Internal net sales increased by 1.4% in the quarter. The Foodservice, Convenience and Vending businesses all posted growth. The Foodservice business benefited from increased sales in the school channel as well as new cracker distribution. The Convenience business posted sales growth greater than overall channel growth, due to strength in bars, crackers and Pringles. We ran successful Rice Krispies Treats activity and Pringles Tortilla and on-the-go single-serve Cheez-It also contributed. And in the Vending channel, good performance by Rice Krispies Treats and sandwich crackers led to mid-single digit net sales growth.

There was also a decline in sales in the [ph] Custom (25:59) segment, where we exited some less profitable businesses. And finally, the broader Pringles business did very well across the segment.

Slide 18 shows the sales performance of the North America Other segment, which includes the U.S. Frozen Foods and Canadian businesses. This segment posted an internal sales decline of 4.9% in the quarter. The Frozen Foods business posted a decrease in internal net sales in the quarter, primarily due to difficult comparisons. Last year's high single digit growth was largely the result of the introduction of Special K Flatbread Sandwiches, which was one of the most successful launches in recent years in the Frozen business. We saw growth in the quarter from new products, such as Eggo Bites, although consumption of the total Eggo brand was below expectations. To address this, we are continuing to focus on some great new products in the second half coupled with strong marketing programs.

Net sales also declined in the Canadian business, although we gained share in the Cereal, Snack Bar and Frozen Breakfast categories. Pringles also gained share in Canada, driven, in part, by incremental display activity. In the second half, the Canadian business will benefit from significant new product activity, including the launch of Eggo Thick & Fluffy waffles, Rice Krispies Shapes cereal and Pringles Tortilla. As we told you earlier, the business has been seeing good early engagement in customer execution on the Cereal and Milk category building activity.

Now, let's turn to Slide 19 and our European business. Internal net sales in the European business increased by 0.7% in the quarter, driven primarily by strong growth from the Snack business. We saw good underlying growth in emerging markets in Europe. And the Pringles business posted increased consumption and share across much of the region. In fact, Pringles posted a double digit increase in net sales. And Pringles net sales have also increased at a double digit rate in the year-to-date period. You can see on this slide that we had a summer soccer-themed promotional event tied to

Pringles, which was very successful across the region. And we started to see some improvement in the Cereal category in parts of Europe. In the second quarter, we selectively introduced Mueslix on the continent, which is tied to broader brand pulling activity. And we launched Special K Granola across the region, also supported by strong programs.

Tying all this together is a brand building campaign we call [ph] Origins. (28:34) This campaign helps consumers make the connection between our food and its origins and highlights the foods' natural ingredients and simplicity. This is an exciting program that encompasses TV, digital and social media, in-store activity and public relations. And, as you can imagine, we have plans for incremental activity and new product introductions across the region over the balance of the year.

So the economic environment in Europe is difficult. And the large developed cereal markets are facing similar issues to those seen in the U.S. However, we are growing in parts of the region and the Snack business is continuing to do well. While we expect sales to be down for the full-year in Europe, we will continue to execute our plans and remain confident that we are positioning the business for future growth.

Slide 20 shows detail regarding the Latin American business. As you can see, we posted 6.9% net sales growth in the quarter. This was driven by strong price realization, innovation and brand building activities. Net sales increased in Mexico, Venezuela and [ph] Mercosur, (29:42) with the breakfast category doing well, driven by children's cereals. The strong innovation I referenced came from Zucaritas PowerBalls, Special K Multi Grain and Nutri-Grain Frutela. And we had a very strong soccer-themed promotion in Latin America as well that exceeded our expectations.

We expect continued good sales growth in Latin America across the remainder of the year and have lots of activity coming in the second half.

In the third quarter, we have new Choco Krispis and All-Bran launching in Mexico and Central America, which will be supported with brand building. We have new packaging launching across a number of brands and we'll be supporting these introductions as well. And we've got more to come in the fourth quarter.

And finally, the region has whole grain and multi-grain messaging and category building activity planned for the second half. So hopefully, you can see that we've got a full plan of activity scheduled for balance of the year in Latin America, which should give us good momentum.

Now, let's turn to Slide 21 and the Asia Pacific business. Overall, the business posted internal revenue growth of 0.5%. In Asia, we saw mid-single digit growth, as sales in Japan increased at a double-digit rate, driven by granola. And sales in both South Korea and India increased at a mid-single digit rate. This was partially offset by the performance in South Africa, which Ron mentioned. Of note is the growth in India, which continued to improve after weakness earlier in the year resulting from a broader economic slowdown.

Pringles continued to perform very well in the region, with double digit net sales growth in the quarter. We recently launched the brand in India. And we had successful soccer-themed promotions that ran in Q2 as well. While the Australian business continued to see declines in the quarter, results were sequentially better. We launched All-Bran Muesli earlier in the year, with good results year-to-date. In addition, the team has good plans for the second half, including investment behind core cereal brands, new in-store activity and category building initiatives.

And finally, for the Asia Pacific region, while it's not part of the region's reported results, we saw good sales results for the JV we have in China, continuing the performance we saw in the first quarter. In fact, on a pro forma basis, the JV in China would've added approximately one point to the region's net sales growth rate. So overall results in Asia were good. And performance in Australia improved and we have more plans in place for the second half of the year.

So finally, let's turn to Slide 22 and the summary. We are pleased that the second quarter's earnings per share were in line with expectations. We continue to see weakness in net sales in developed markets, particularly in cereal, but we saw top-line growth in each of the international regions and Pringles performed very well globally.

Project K, our four year efficiency and effectiveness program, continues to go well and we've made great progress so far this year. The [ph] GBS initiative (32:59) is on track and we've announced further potential [ph] rationalization of (33:02) capacity. And we began to implement incremental programs designed to drive revenue growth around the world. It's very early in what is a four year program and we've got plans for some more exciting new ideas as well. And you'll hear more about these in the months to come.

And finally, we are improving the effectiveness of the investment we already make and this will only increase the opportunities that we believe are available to the company in the years ahead.

The transformation that we have begun is a significant one and it has already involved some difficult decisions. We know it will take time to see improvement, but I'm confident that our Kellogg employees will drive this change. And I'd like to end, as always, by thanking them for all of their hard work.

Let's turn it over now for Q&A.

Q&A

Operator

At this time, will begin the question-and-answer session. [Operator Instructions] And our first question will come from Chris Growe of Stifel.

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

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

<Q - Christopher R. Growe>: Hi. Let me just ask you a question if I could, John, about revenue growth. And, obviously, you've taken on your expectations for the year, but I just want to get a better sense of how you see that progressing through the remainder of the year? I guess what I'm getting to is that you have some investments coming up through the savings generated through Project K. I think you're starting to put some money back behind Cereal business and other parts of the business. And I'm just curious, should we just expect sequential progress? And then, more importantly, in U.S. Cereal, can we see sequential progress in that business as well?

<A - Ronald L. Dissinger>: Yeah. Chris, this is Ron. In terms of our total company revenue expectation for the balance of the year, as we look at the third quarter, revenue is a little bit better but pretty comparable to the second quarter. We do see an improving trend as we get into the fourth quarter, but, as you know, we're down about 2% on a year-to-date basis in terms of our sales performance on an internal basis. And our expectation is to be down 1% to 2% for the full-year, so we're not banking on significant changes in our revenue position for the balance of the year, but there is slight improvement.

<A - John A. Bryant>: Chris, specifically to Cereal, we do expect the category to improve slightly as we go through the back part of the year and our performance to be more in line with the category. Clearly, we've been a bit off that pace in the front half of year. A few things that we're doing to drive that: we do have the feet on the street going back into our U.S. Cereal organization. Today, we have about 30% of those positions filled. Next month, we should be at about 50%. By October, we should be fully staffed. I think that will help us improve our performance. And we are really focused on improving and driving our Cereal business as we go into 2015.

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

Operator

And our next question is from John Baumgartner of Wells Fargo.

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

<A - John A. Bryant>: Morning.

<Q - John J. Baumgartner>: John, wondering if you could speak maybe to the pipeline right now as it looks like the Q2 numbers were a bit better than Nielsen data would suggest. Are there any areas within Cereal or Snacks where maybe you could see [ph] a trade de-load of takeaway trail shipments (36:36)?

<A - John A. Bryant>: As we look at our trade inventories across the business, we think they're in fairly reasonable shape. Now, remember our Cookie, Cracker, Wholesome Snacks business is DSD delivered, so you to don't have a lot of inventory in the DSD system. Our cereal inventories in the U.S. are broadly in line with where they are at this time of year. So we don't see any big inventory overhang at this time.

<Q - John J. Baumgartner>: Thanks, John.

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

Operator

And the next question is from Alexia Howard of Sanford Bernstein.

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

<A - John A. Bryant>: Morning Alexia.

<A - Ronald L. Dissinger>: Morning.

<Q - Alexia Jane Howard>: I guess just following up on the cereal question, are there brands where you've decided to maybe channel less resource, manage [ph] your (37:19) cash a bit more and others where you've really thought about channeling incremental investment? And can you give us any examples of that? And then at a broader level, we've seen Campbell Soup making a number of changes to its portfolio over the last few years. You've obviously made the Pringles acquisition, but are you now thinking that more profound changes may be required? Thank you.

<A - John A. Bryant>: Alexia, let me take the cereal question first and then I'll move to your portfolio question. On cereal, and we've talked about this before, I think there's really two issues going on here. One is there's a category relevance issue and the second is there's some Kellogg-specific issues in some key brands. And if I think about where we are in the category, the category's down about 5%, the good news is the breakfast occasion is growing, but unfortunately there are more alternative breakfast.

And I think we need to change our communication to help people understand how cereal can better meet their needs at breakfast than some of their other alternatives. To do that, we're driving more investment behind things like our Cereal and Milk program in the U.S. and Canada, the [ph] Origins (38:24) program in Europe and a program in Australia we call [ph] Brains and Bones. That is about kid development. (38:31)

So as you look at those programs, they're trying different things around the world to determine what resonates best and we'll quickly share those learnings around the world. So we are focused not just on our brands, but also how we compete more broadly at a macro category level at the breakfast occasion.

As you go within our brands, there are some parts where we are reducing investment, to your question. In particular FiberPlus and Crunchy Nut are brands that, quite frankly, have not worked out for us. And they're about a half a share drag on our business in Q2 alone. We are still absolutely committed to investing and improving the performance of other key parts of the business that [ph] aren't (39:10) performing the way we'd like, such as Special K and Kashi. On Special K, we think this is a tremendous business with tremendous opportunity; however, I think we need to change how we communicate the benefits of Special K, as people's expectations of weight management changes around the world.

So we're seeing softness not just in Special K, but diet sodas, reduced-calorie frozen foods, et cetera. Weight management programs are also under pressure, so I think consumers are changing their views on weight management from reduced calories to nutritious foods. Now, Special K can absolutely meet that criteria. It's a very nutrient-dense food form, but we haven't been communicating it that way, so we are increasing our communication more down that path as opposed to reduced calories.

And then, I think the decision to put Kashi back in La Jolla will enable us to speed up our development process, be much more nimble, agile. And that, I think, will help us drive that business as well, so I think you can see us investing back in key parts of our Cereal business.

On the portfolio question itself, I think we have made a wonderful acquisition in Pringles and it has done a couple things for us. It has more than doubled our international Snacks business and tripled the size of the company in certain key emerging markets. And that growth platform, I think we're only in early days in terms of realizing the potential. And we just have capacity coming on now in Europe and this time next year in Malaysia.

So as we think about our business, we have growth strategies in the areas of breakfast, which is primarily cereal, snacks, frozen foods, in the emerging markets. And we'll continue to look at M&A opportunities to expand those platforms, particularly, say, international snacks, but I would say that we are very focused on our current portfolio. We think our current portfolio is very strong. And the goal for us is to return the current portfolio to growth as opposed to fundamentally reshape the portfolio.

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

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

Operator

And the next question will come from Robert Moskow of Credit Suisse.

<Q - Robert B. Moskow>: Hi. Thank you. Just had a question about the management changes you've made in U.S. Cereal. I understand that Paul Norman is now going to be running it. Was he intimately involved in the strategic decisions you made about how to change the marketing on cereal or is there a risk that you have to start over and rethink some of the decisions now that he's running it? And then secondly, I was looking at our Kantar data. It shows some pretty significant spending declines by Kellogg, Mills and Post. I know Kantar doesn't capture the whole thing, but it just makes it difficult to believe that there really was heavier weight by Kellogg in the cereal media kind of area. And I just wanted to know exactly how much media weight was thrown against cereal in the first half. Thanks.

<A - John A. Bryant>: Thank you. Let me take the first question on – so I can't think of a better person than Paul Norman to be running the U.S. Cereal business right now. Paul, as you know, stepped into the Chief Growth Officer role for us. Within that, he had the Global Breakfast Team and Global Snacks Team reporting to him, as well as R&D. He's been helping us create the long-term growth strategy for the company. Paul has tremendously deep experience in the Cereal business globally and in the U.S. in particular. Paul ran the Morning Foods business for about five or so years back in the 2000s, quite frankly, over the period of greatest success for the Kellogg Company in the U.S. Paul was running that business.

He knows absolutely what is required to get the business back on track. And he's helping us work on an exciting re-stage of the Cereal business in 2015. So as you think about the Cereal business, we need to have all guns loaded going into 2015. We need: category building activity; brand-specific activity; large tent pole events in-store, which enable us to execute in-store with excellence. Innovation and renovation is on trend for where consumers are heading and put the feet back on the street in terms of improved the merchandising support behind the business. So I'm excited to have Paul have responsibility for that business. I think he will absolutely help us get this business back on track and where we need it to be.

On the question on Kantar cereal advertising, we have increased our advertising in cereal, particularly here in Q2. What I will highlight is sometimes it's hard to track where that advertising is going because of increasing spend in areas like digital. And so I'm not sure how Kantar would even be able to track some of that spend. So I'm not sure the methodology that Kantar is using, but I can assure you, from a Kellogg perspective, we are absolutely spending more behind advertising in cereal in the U.S.

<**Q - Robert B. Moskow**>: So Paul's ascension to the role, is he going to rethink any of the decisions that were made already or not?

<**A - John A. Bryant**>: I think Paul is improving the plans as we go through the back half of 2014 and into 2015.

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

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

Operator

And the next question comes from Ken Goldman of JPMorgan.

<**Q - Ken B. Goldman**>: Hey. Good morning, everybody.

<**A - John A. Bryant**>: Morning, Ken.

<**Q - Ken B. Goldman**>: Just hoping to get your thoughts, John, on the promotional environment in food today. Walmart is talking a bit about backing off the sort of all-promo, all-the-time philosophy in food. It hasn't really driven tonnage to the extent the company wanted. So I'm hoping eventually that vendors to Walmart, like you, will be able to ease off the deal pedal a bit. Is this a view you share or is it, given the environment, just a bit too early to get optimistic about what could be a more rational pricing environment later this year?

<**A - John A. Bryant**>: Well, Ken, I can't talk about what the pricing environment might be later this year, but the way we think about the categories we operate in, they're all intensely competitive categories. I'd say they're all relatively rational. We are seeing some reduced promotional effectiveness. It's happening for a couple of reasons. Some retailers are putting multiple manufacturers under one display, which reduces the effectiveness of that display and, quite frankly, not just for us but for the retailer as well.

We have to look at the quality of quality merchandising. In some of our businesses we're seeing less front of store displays, more back of store displays. So as we look at the business, we think we have an opportunity to improve our merchandising performance. And we're doing that by adding Kellogg sales reps back into the Cereal business and investing back in our DSD business in Snacks.

Having said that, the primary way to drive this business is through brand building innovation, renovation and that's where we see the long-term growth opportunity, which is why when we talk about investing back in our business, it's investing back to improve the quality of our current merchandising programs and to improve the quality and amount of our brand building investment to engage consumers more effectively.

<**Q - Ken B. Goldman**>: Great. Thanks very much.

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

Operator

The next question comes from Jason English of Goldman Sachs.

<**Q - Jason M. English**>: Hey. Good morning, folks. Thank you for the question.

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

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

<Q - Jason M. English>: I guess I'll focus a little bit on your input cost and inflation. I think a lot of people are [ph] staring at the grand price charts (46:41) looking at corn, falling below $4 and probably scratching their head as to why you're going to be facing 3%, 3.5% type inflation. So could you talk a little bit about some of the components, what's driving inflation? And the next question that I'm sure people ask looking at the chart is whether or not you were just hedged and therefore, deferring the benefit into next year. Is that indeed the case?

<A - Ronald L. Dissinger>: As I mentioned on the call earlier, Jason, we are covered at approximately 90% at this point in time. I think the thing you have to remember also is you're looking at the exchange traded commodities, which are a small percentage of the total market basket of inputs that we buy that go into our food. We buy a number of things across commodities, packaging and energy as well. And we've said before, we've seen increases or inflation across packaging. We've seen increases in fruits and nuts, a number of things, energy as well.

Now, I did say that our inflation was much more front-end weighted. And as a result, we will see improvement in terms of our [ph] net deflation (47:46) position as we move into the back end of the year. Our inflation will come down to much lower levels. And our savings will ramp up as we go through the balance of the year. And that's helping us from a profitability standpoint, particularly as we get into the fourth quarter.

So some of what you are seeing within our performance also could be attributable to the positions that we took as we came into the year and the fact that we are now 90% covered on our commodities.

<Q - Jason M. English>: Thank you. That's helpful. And turning real quick to the expense side, can you quantify what brand building just on the consumer side, consumer marketing and advertising was up in the quarter? And your comments on sort of in line maybe a little bit better than sales growth for the year, you're guiding to sales down. So does this imply that brand building may not actually grow this year?

<A - Ronald L. Dissinger>: Yes. So in terms of our brand building, what I had said in the prepared remarks was that we were up at a mid-single digit rate within the second quarter performance. On our brand building, as we said, we expect to invest at a rate that's equal to or greater than our sales performance. Now, our sales have come down, so our brand building has come down a little bit. We've pulled some brand building out where we weren't seeing the effectiveness of that investment impacting our business. Now, what I would say, though, is we are still reinvesting the savings that we committed associated with Project K behind the Cereal category relevance messaging and also behind sales resources across our U.S. Cereal and our U.S. Snacks business.

<Q - Jason M. English>: Thank you.

Operator

And our next question comes from David Palmer of RBC Capital Markets.

<Q - David S. Palmer>: Morning, guys.

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

<A - Ronald L. Dissinger>: Morning, David.

<Q - David S. Palmer>: First, as a follow-up on your previous comments on Special K, that weight management brand, much like a Yoplait or a Diet Coke, were the trade-up foods of yesteryear, but all having a pretty hard time recently, as you said. Do you think that the nutrient-rich advertising angle you mentioned before will be enough to turn that brand and get it back on board with its core consumer, which, I guess, is high income female or are you thinking perhaps other renovations in the brand, in the ingredients are needed? And I have a second follow-up. Thanks.

<A - John A. Bryant>: So, David, I think the answer is both on Special K. So if you look at what's happening on weight management brands, to your point, whether it be diet soda, weight loss programs, various foods that are sold primarily on being reduced calorie, that's really not sufficient any more to engage with the weight management consumer. That consumer's now looking not just for lower calories, but for benefits of food. In some respects, they move from calorie deprivation to I want to eat great, healthy food.

And we do believe we have an opportunity to change our communications that our current food actually does meet that need of the consumer. And we have the ability to innovate with new product launches that are even more on trend and to renovate some of the food in some of the markets in which we operate in. So for example, our Special K business and Wholesome Snacks in the U.S., I think we have an opportunity to renovate that food and make it even more on trend from a weight management perspective.

<Q - David S. Palmer>: And with regard to your investments in the feet on the street and I guess you're shifting that brand building spending, are there any small signs that that spending is working that you can see in what is an otherwise tough environment? And then, what is your timetable that you will be looking at where you say these investments are working or not working where you think about making changes? Thanks.

<A - John A. Bryant>: We're watching these investments very closely to understand and track their impact and then learn and reapply rapidly. As I said, we're doing different programs around the world. Here in North America, it was more Cereal and Milk-related from a category building perspective. In Europe, it's [ph] Origins. In Australia, it's Brains and Bones (51:52). And we will rapidly reapply based on what we see gets the biggest impact.

Quite frankly, how well we execute these programs also is a key driver. So for example, in Canada in Q2, we had the Soy Milk program. It was actually very successful. The retailers really got behind it, merchandised milk with cereal. And we actually stabilized our Cereal business in Canada in Q2 and saw sales relatively flat and we gained almost a share point in the quarter. So we saw good outcome there. We had pockets of excellence in the execution in the U.S., but we were a little bit more patchy and, quite frankly I think we have an opportunity to continue to drive that execution. And that's part of the reason why we're putting some of the reps back into the U.S. Sales organization to help us with the in-store merchandising and to help us with the execution of these programs.

So if you think about how we track the performance of these programs, they're not programs that are necessarily designed to immediately turn the business. These are longer-term consumer brand building type programs. They take time to measure and track, but clearly we would hope to have seen a better response in Cereal in Q2 than what we received. We did see a better response, in fact, in Canada. Back part of this year we'll have a better sense of how well these programs are working and [ph] then we'll ultimately apply (53:05) as we go into 2015.

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

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

Operator

And our next question will come from Andrew Lazar of Barclays.

<Q - Andrew Lazar>: Morning, everybody.

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

<A - Ronald L. Dissinger>: Morning.

<Q - Andrew Lazar>: Just two quick things, one, I can't remember, John, was the original overall category building work in Cereal, did it always include sort of individual brand messages as part of the category message or is that a change?

<A - John A. Bryant>: It is a bit more of a change, Andrew. We are increasing the focus on individual brands. There was some individual brand orientation in the original work, but I think we're seeing the ability to bring it to life in-store and through the whole [ph] 360 degrees (53:49) is benefited by actually bringing specific brands into the programs themselves.

<Q - Andrew Lazar>: Thank you of that. And then, second, you mentioned that even after some of the capacity actions that you've taken, that Kellogg may still have still some excess capacity in Cereal. And I guess I'm wondering from maybe some of your benchmarking work if you think the industry sort of faces this too, even though it seems like all the other big cereal players have taken some capacity reductions already as well?

<A - John A. Bryant>: Well certainly looking at our network, as I said in the prepared remarks, we do believe we may have some excess cereal capacity. I think if you look at the performance of some of the other cereal manufacturers, I don't think [ph] it would be a surprise (54:27) if they have some excess capacity as well. I think, though, they're better positioned to talk to their capacity position than I am.

<Q - Andrew Lazar>: Okay. So all these things if there are other actions needed, I assume would all be part of the current Project K that you've got underway. Is that fair?

<A - John A. Bryant>: We would be looking at it in the context of Project K, yes.

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

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

Operator

The next question comes from, excuse me, David Driscoll of Citi Research.

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

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

<A - Ronald L. Dissinger>: Morning.

<Q - David Cristopher Driscoll>: Ron, I just wanted to get a clarification on a comment you made. So in response to Jason, I think that you said that the first half inflation was positive and related to specific hedge positions the company took, but that in the second half, it gets significantly better. First, do I understand you correctly? And then, I've got a question for John.

<A - Ronald L. Dissinger>: Yes, you do understand that correctly. So our inflation comes down significantly in the back half of the year and our productivity ramps up as well. So we experience net deflation and more so on the fourth quarter versus the third quarter.

<Q - David Cristopher Driscoll>: John, so just kind of going back to Cereal, but I want to be specific. So you had such tremendous optimism on the last call about the very specific programs on Special K, Mini-Wheats and Kashi. Just given the fact that it just doesn't look like it took much hold here in the quarter, would you agree that there are fundamental macro headwinds with the consumer that are impacting this category and until we see that low-end consumer get better, that this category is fundamentally challenged in that, even when you put in good programs, it's just hard to get people to buy it when they don't have the money? What's not correct about that statement?

<A - John A. Bryant>: I think if we go back to the last quarterly conference call, the guidance I gave on Cereal is that we expected the category to be down for the year and for our performance to improve through the year to be more in line with the category. It's fair to say we were a little bit disappointed with our performance in Cereal in Q2, but we still have confidence that we will improve the performance as we go through the year. I believe Cereal is a long-term growth potential category [ph] now and the macro in the U.S. (56:44) is probably low single digits, but the company did grow Cereal in the U.S. 3% to 4% on a dollar sales perspective across most of the 2000s. And when we did that, we had tremendous brand building programs. We had great innovation. We had excellent in-store execution. So I believe we have the ability to do that. I do believe the category's under some pressure right now from some of these breakfast alternatives.

I believe we resolve that by both having outstanding brand-specific activity, but also by coming back and reminding consumers of how the benefits of this category is stronger than a lot of the other alternatives at the breakfast occasion. So I do believe that ultimately this is up to the manufacturers to improve our performance. I believe we have an opportunity, as a company, to definitely bring better, stronger programs to market. As we think about restaging our Cereal business going into 2015, that's what we're working to do. So I'm not trying to suggest it's an immediate bounce-back, David. I think this category will be under some pressure for some time. But I do believe it can return to growth.

<Q - David Cristopher Driscoll>: But it's just not – in your opinion, it's just not more of a macro issue with the consumer. It's a specific issue of Kellogg's ability to get the category moving and as well as the other manufacturers. Is that what you're saying?

<A - John A. Bryant>: I absolutely believe that we can and will return this category to growth and that manufacturers are focused on doing that. And we are definitely focused on doing that.

<Q - David Cristopher Driscoll>: Thank you.

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

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

Operator

Okay. That last question will come from Eric Katzman of Deutsche Bank.

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

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

<A - Ronald L. Dissinger>: Morning.

<Q - Eric R. Katzman>: Ron, please give a bit about Venezuela. I guess you're sticking at the [ph] 6 rate. Companies like Meed are at 11 (58:36). I think there's some consumer packaged goods companies that have already gone to like north of [ph] 50 (58:43). So what, I guess, triggers a change in that accounting treatment?

<A - Ronald L. Dissinger>: Well, first of all, I guess let me talk about why we are valued where we are valued at this point in time. And let me remind you, Venezuela is a relatively small part of the business in comparison to the total company. It's around 1% to 2% of our sales. And it's around 2% of our operating profit. We do manufacture the majority of our product within the country. Now, we do pull some raw materials and packaging materials from outside of the country into the country to be able to do that manufacturing. But, Eric, we've been able to get access to funds at the official rate when we have done that. We are also deemed a priority industry by the government. The valuation of the business is really based on facts and circumstances. And based on these facts and circumstances, we're able to value the business at the [ph] 6.3 (59:44), the official rate.

Now, we're making sure that investors and analysts are clear. Within our disclosures, we're giving you the information on our net asset position and then, as well, the earnings per share impact. And I communicated that earlier on the call. If we were to devalue the business today to that [ph] CCAD 1 rate, (60:00) it would impact us by about $0.07 to $0.09 on an earnings per share basis. If we were to move to the [ph] CCAD 2 rate (60:08), it would be about double that, Eric.

<Q - Eric R. Katzman>: Yeah, okay, so I guess the key is that you continue to take the dollars out and that's what, at least at this point, is probably a major factor in keeping the rate where you are?

<A - Ronald L. Dissinger>: Priority industry and able to get the dollars out. That is correct – or dollars in, I should say, at the official rate.

<Q - Eric R. Katzman>: Okay. And then, John, just last question I guess on Kashi. I think that the company had said previously that the sales for Kashi had peaked at about $0.5 billion, but it's been a number of quarters, if not years, now where it's been declining. What is the revenue now? And I guess when do you think the switch to La Jolla, the new – or the return of the previous management to running that business, when do we think that that can start to show results?

<A - John A. Bryant>: Eric, the business now is in the [ph] low $400s Millions (61:16) in terms of size. And we believe it has tremendous growth potential from there. David Denholm will be with the company here in the back half of the year. And we expect to have that team up and operating at the end of the year. So we're going to go through a process of moving the business back to La Jolla. The whole purpose of moving the business back to La Jolla is to increase the rate of speed, the agility, the ability to get on trends much faster and be more aligned with that community. So I expect it to have a faster impact than, say, turning around more of a mainstream business; however, it will take some time because it is still one of the largest natural foods businesses in the United States, in fact, in the world.

So we'll need to innovate, renovate and [ph] get back on our front for that business. (62:07) I think we'll be doing that through 2015 and 2016. I'm not going to give a sales forecast for what I think is going to happen to one business, though, as we look out over 2015 or 2016.

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

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

Simon D. Burton

Okay, thanks, Laura. I think we're finished. If anybody has any more follow-up questions, please get a hold of us. We'll be around for the next couple of days.

Operator

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