Company Name: Kellogg
Company Ticker: K US
Date: 2017-10-31
Event Description: Q3 2017 Earnings Call

Market Cap: 21,584.72
Current PX: 62.54
YTD Change($): -11.17
YTD Change(%): -15.154

Bloomberg Estimates - EPS
Current Quarter: 1.007
Current Year: 3.980
Bloomberg Estimates - Sales
Current Quarter: 3093.600
Current Year: 12712.000

Q3 2017 Earnings Call

Company Participants

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

Other Participants

- Kenneth B. Goldman
- Steven Strycula
- Andrew Lazar
- David Cristopher Driscoll
- Bryan D. Spillane
- Rob Dickerson
- John Joseph Baumgartner

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Kellogg Company Third Quarter 2017 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period. [Operator Instructions] Thank you. Please note this event is being recorded.

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

John Renwick, CFA

Thank you, Gary. Good morning, and thank you for joining us today for a review of our third quarter 2017 results. I'm joined this morning by: John Bryant, our Chairman, who will provide an overview of the quarter in the context of our strategy; Steve Cahillane, our new CEO, who will introduce himself and make some initial observations; Fareed Khan, Chief Financial Officer, who will walk you through our financial results and outlook; and Paul Norman, President of North America, who will update you on our North America businesses.

Slide number 2 shows our usual forward-looking statements disclaimer. As you are aware, certain statements made today, such as projections for Kellogg Company's future performance, including earnings per share, net sales, profit margins, operating profit, interest expense, tax rate, cash flow, brand-building, 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, when describing our results and outlook during today's prepared remarks, we will be referring to them on a currency-neutral comparable basis, unless otherwise noted. The appendices to our presentation provide you with the details on our GAAP and non-GAAP performance.

Finally, a replay of today's conference call will be available by phone through Thursday, November 7. The call will also be available via webcast, which will be archived for at least 90 days.

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

John A. Bryant

Thanks, John, and good morning, everyone. As announced last month, I am retiring, after seven years as Kellogg's CEO and 20 years with the company, in order to spend more time with my family. There's never a perfect time to make a move like this, but the Q3 results and outlook and where we are on key initiatives make this an appropriate time to make this transition.

I also strongly believe that Steve Cahillane is the right person for the role. He has significant leadership experience, including as a CEO. His extensive background in CPG companies means he knows how to grow big brands. His experience in international markets means he knows how to expand abroad. And his latest stint at Nature's Bounty gives him keen insights on today's health and wellness definition. He brings fresh perspectives from the outside that can help drive new ideas.

Steve's spent the past month reviewing the plans of each of our regions. He takes the reins at a time when the company is undergoing an enormous transformation, amidst an industry that is undergoing significant change. And I'm even more convinced today that he's the right person for the job.

Steve, welcome aboard.

Steven A. Cahillane

Thanks, John, and hello, everyone. I'm excited to be here. Let me first thank John for his service and a very effective transition. I'm glad to have him staying on as Chairman into March of next year.

I'm only four weeks into the job, but I've had the opportunity to review the commercial and supply chain plans of most of our businesses. And what I've learned has only confirmed that I made the right decision to come to Kellogg. First, we've got incredible brands, outstanding food and a strong culture. These factors have made Kellogg special for over a century.

Second, the company's on sound financial footing. Project K included some very aggressive actions, and Zero-Based Budgeting required the entire organization to change the way it works. The cost structure has been reduced, underlying profitability has been improved and returns on investment are improving.

And third, based on what I've seen over the past few weeks, the company can and will return to top-line growth. Key elements are already in growth, from Pringles to our Frozen Foods brands, to our Specialty Channels businesses, for our expanding emerging market presence.

The entire organization is hungry to get back to growth, and it's open to new ideas. For instance, our 1894 venture capital fund invests in early stage technology and food businesses. We've been experimenting with direct-to-consumer for our Bear Naked brand, and we're learning from the pop-up cafes we've opened up around the world. And as evidenced by the acquisition of RXBAR, we're even willing to acquire growth. This is not a company that's sitting on its hands.

So Kellogg is already doing many of the right things to get back on track amidst a very challenging industry environment, particularly around cost structure and emerging market scale. Businesses are starting to turn and there's more we can do, so I'm very excited.

I'll have more thoughts to share after my first 100 days or roughly the time of CAGNY. I look forward to working with all of you in the investor community.

So for now, I'll turn it back to John and the rest of the business update.

John A. Bryant

Thanks, Steve. Let's turn to the quarter and slide 5. We generated strong double-digit growth in operating profit and we generated sequential improvement in our top line. These results keep us on track to achieve our guidance for the year. A few highlights; Project K and ZBB have reduced our cost structure, enabling us to continue to improve margins significantly and keeping us on pace toward our margin expansion goals. DSD transition continued to go as planned. We're now out of DSD completely, a tremendous joint execution by our team and our customers. Paul will talk more about this in a moment.

As expected, we posted sequential improvement in net sales during Q3, driven by what we said would drive it. Special K's declines moderated across categories and countries. Pringles regained its promotional footing in Europe, returning to growth there and globally. And North America Other returned to growth as Frozen gained momentum and Canada and Kashi continued to improve.

We also progressed on other growth avenues. eCommerce growth continued, reflecting a broad push to win wherever the shopper shops. Emerging markets expansion continued, especially when you consider our unconsolidated and rapidly-growing joint ventures as well as the integration and growth of Parati, the business we acquired in Brazil last December. And we acquired a new growth platform in RXBAR.

Let's take a closer look at some of these areas of progress. We'll start with slide 6 and how we're doing on stabilizing the health and wellness elements of our portfolio. We've mentioned previously that one brand, Special K, accounted for all of our net sales decline, and then some, through the past couple of years. Stabilizing this brand is an obvious priority. Through renovation and innovation of our food and packaging, strengthening our food credentials and through a new inner strength positioning, which media only just went on air at the beginning of Q3, we are seeing signs of progress.

Specifically, we've seen a clear moderation in its net sales decline in cereal globally. And we have cut its consumption and share declines in half in cereal markets ranging from the U.S., to Canada to Spain and even more dramatically in markets like the UK and Mexico. This is encouraging progress for a very big brand whose declines had a significant impact on our total company net sales.

Next, you can see on slide 7 that our Pringles sales returned to growth in Q3, as we had indicated. As you know, this is our biggest brand globally, with excellent prospects to sustain growth. And it had been growing consistently in the mid-single digits ever since we acquired it in late 2012. Unfortunately, you'll recall that we ran into a temporary setback earlier this year, when prolonged customer negotiations kept us out of normal promotion activities in Europe during Q1 and Q2.

The good news is that over the course of Q3, we did return to promotional activity and this turned our European Pringles sales from sharp decline into resumed growth. Just as important, Pringles recorded net sales growth in Q3 across all of our regions globally.

Slide 8 offers another encouraging sign. We've returned to share gains in our three core developed cereal markets outside the U.S. They are Australia, Canada and the UK. You'll recall that stabilizing these markets was a major priority for us this year. And we're executing well on the three things that we know drives cereal consumption: food use, in the form of renovation and innovation that emphasized nutrition credentials or enhanced taste; great commercial ideas to engage consumers; and winning in-store during key promotional events. As a result, we're winning in these markets across a number of brands.

The U.S. is a different story this year and this is disappointing. After having stabilized that business in 2015 and 2016, we haven't brought enough excitement to the category this year, but as Paul will address in a moment, we're implementing a much stronger 2018 plan. The point is we are proving that we can stabilize these big developed cereal markets and we can return them to growth in the future.

Finally, I'd like to say a few words about RXBAR, the acquisition we announced a few weeks ago and closed just a few days ago. This is on slide 9. This is a high quality premium brand in a unique position, at the intersection of simple natural ingredients and high protein. It's growing rapidly. Its sales will nearly quadruple in 2017. And somewhat rare in this space, it is already very profitable.

RXBAR will operate independently, preserving what makes it special, including its talented people and entrepreneurial culture. Kellogg is here to help RXBAR in its next leg of growth via our substantial R&D resources and through our ability to expand its distribution. This will serve as a new additional platform for growth for us. This is a special opportunity, and we're excited about its growth prospects.

So overall, we feel good about the direction we're heading. Let me now turn it over to Fareed to talk you through your financials.

Fareed A. Khan

Thanks, John. Slide 10 shows a summary of our financial results in Q3 and year-to-date. Our third quarter results came in largely as expected. Net sales declined in the quarter on a currency-neutral comparable basis, but again showed sequential improvement, even despite the negative impact of the DSD transitions planned price adjustments and disruptions as we moved our U.S. Snacks business to a warehouse model.

Operating profit continued to increase in the quarter, with growth accelerating, largely because our DSD overhead savings began to be realized. Earnings per share grew, despite comparing against an unusually low tax rate a year ago, keeping us solidly on track for our full year guidance. There's a little bit of timing favorability, which I'll discuss in a moment, but, overall, a good quarter.

So let's get into a little bit more detail. Slide 11 breaks our currency-neutral comparable net sales performance into its key components. As you can see from the slide, our volume declines moderated again, as we saw marked improvement in the trends for specific brands and businesses that we had called out previously. For example, Pringles returned to growth in Europe after an unusual decline in the first half. We saw a moderation of declines in Special K and Kashi, as renovated product lines took hold on shelf and new media campaigns went on air. And our U.S. Frozen brands, Eggo and Morningstar Farms, picked up momentum that started in Q2.

And, as planned, the DSD transition had a bigger negative impact on sales in Q3 than it did in the first half. This impact is comprised of two factors: first, the volume impacts of pulling back on merchandising early in the quarter to facilitate the transition, as well as the impact of SKU rationalization; and second, the list price adjustment we gave our customers because we no longer provide the services of ordering, warehousing, delivery and stocking. So, roughly speaking, we estimate these DSD transition-related items collectively to have impacted net sales by less than minus 2% in the quarter.

It's important to realize that our price/mix was again positive, and that's in spite of the realized price adjustments in our DSD exited categories. So overall, we think net sales in Q3 did pick up about a percentage point of growth from trade inventory build ahead of hurricanes in the Southeastern U.S., and we believe this trade inventory will come out in Q4. Once again, while we are not content with our net sales declines, by any means, Q3 did reflect continued improvement, even excluding unusual factors like the DSD transition and hurricane-related shipments.

Turning to slide 12, you'll see that our profit margin initiatives remain on track. From Project K, to ZBB, to the various capabilities that we've developed to improve ROI, we continue to progress towards our margin expansion goals. The bulk of the investments and actions at Project K are now largely behind us, with incremental savings running through 2019. The same goes for ZBB, which is now incorporated into our daily operations. Our ROI efforts are ongoing, and we have much of the infrastructure and processes in place. This includes deeper analytics that help us prioritize investments and more real-time measurement that allows us to course-correct. The impact of these initiatives is why we say we have such good visibility into our cost structure going into the next couple of years.

The impact of these margin expansion efforts can be seen in our Q3 and year-to-date profit margins shown on slide 13. Gross profit margin was flat in the quarter, but, remember, this includes the reset of our U.S. Snacks gross margin as it shifts out of DSD and into warehouse. Specifically, the DSD transition involves the adjustment of our list prices and it also involves increased resources in warehouse logistics, which are now is COGS. Excluding this DSD-related reset in U.S. Snacks, our gross margin continued to increase during Q3, as savings from Project K supply chain restructuring and from Zero-Based Budgeting, continue to more than offset the cost of investing in food and packaging and the operating leverage impact of lower volume.

On our operating profit margin, we saw an acceleration of our already strong expansion, led by efficiencies and savings in SG&A. The SG&A improvement has been evident all year, aided by ZBB and Project K, but accelerated sharply in Q3 when we started to see the DSD overhead savings.

There is a portion of our operating profit that was timing-related. Specifically, we did delay some brand-building investment out of Q3. For instance, in U.S. Snacks, we increased our investment a little less than originally planned because we wanted to get further through the transition. This brand-building will be invested in Q4.

Nevertheless, we're obviously pleased with our operating profit growth in Q3, and our margin expansion remains very much on track. Also on track is cash flow, as shown on slide 14. Year-to-date, our cash flow is tracking ahead of last year. Our net income is higher and our core working capital improved as a percentage of sales year-over-year, driven by payables. So through the first nine months, we still feel good about hitting our full year cash flow target.

With that, let's turn to slide 15. Our Q3 results kept us well on pace towards our full-year guidance, so we are reaffirming our guidance for currency-neutral comparable net sales, operating profit and EPS, as well as cash flow.

Now, we recognize that our Q3 results may have been ahead of your expectations, so let me explain a few timing-related elements that you should take into account when considering our unchanged full-year guidance. First, on net sales, we had a couple of timing-related shipment benefits in Q3, as I mentioned earlier. Hurricane-related shipments are likely to come out of Q4. And we also benefited from some DSD-related pipeline fill shipments that we'd expected to come back in Q2, and that is now behind us as we progress to Q4.

Additionally, U.S. Snacks in Q4 will also have a full quarter of the list price adjustment. These factors mean our net sales will decline a bit more than they did in Q3. However, it's important to note that if you exclude these hurricane and DSD-related impacts, we expect to see continued sequential improvement in our underlying net sales.

On operating profit, here are some things to note. We did delay some brand-building into Q4, as I already mentioned. And on top of that, we are investing some of Q3's upside into incremental brand-building to help us improve our top-line performance going into next year. This should result in a double-digit increase on year-over-year brand-building.

So put this on top of an already difficult comparison and you can see why our Q4 operating profit growth will likely be smaller than our large Q3 gain. But again, smoothing out for timing, the underlying business delivery continues to improve, especially given the full quarter of DSD overhead savings.

So that's how we see phases and we have good confidence in our ability to deliver our full-year guidance. In fact, the only changes we are making today are to items outside our currency-neutral comparable performance, specifically: our upfront costs, which came down mainly because of curtailment gains related to pension-plan amendments; and currency translations, which have been trending more favorably. These two items are detailed in our press release.

And with that, I'd like to turn it over to Paul to give you an update on our North American business segments.

Paul T. Norman

Thanks, Fareed. We'll start with our transformation of U.S. Snacks and an update on our DSD transition on slide number 16. I'm very pleased with the execution of this extremely complex undertaking. Customer feedback has been very good, and our operational metrics are all on track. By the end of July, we were shipping completely via warehouse distribution to all customers and exiting our DCs, trucks and equipment and reducing the workforce. We are working diligently with our customer to ensure all details and issues are taken care of. And I'm extremely proud of how our organization has risen to this challenge.

From the standpoint of in-market performance, you saw the impact of the transition in our scanner data and we expected this. We pulled right back on promotional activity in order to facilitate the production and shipping of initial inventories to the warehouses of our customers. This resulted in sharp declines in incremental sales, promotional volume and number of displays. Our average number of items are down, too, reflecting our SKU rationalization.

Now, as we look forward, we will see momentum build behind a more focused assortment on-shelf and fewer, but bigger, displays with an emphasis on quality positions. All of this will be supported by significant increases in brand-building against our largest brands, as we move from push to pull. The net results of all of this will be an improvement in our in-market performance over the coming weeks and months.

From a financial perspective, the transformation of Snacks remains on track. We have already begun to boost our brand-building investment. And, as you can see in our Q3 P&L, the expected overhead reductions are coming through to the bottom line.

An undertaking of this magnitude isn't easy. We've come a long way and we still have work to do. But you're starting to see U.S. Snack's future taking shape. There is no question that this will become a stronger, more profitable business.

Snack's Q3 results, summarized on slide number 17, came in as expected. Net sales were impacted by the factors we've already discussed: the list price adjustment; the pullback in merchandising; and the rationalization of SKUs. Nevertheless, we also saw a strong increase in operating profit and operating margin. We did boost our brand-building investment in Q3, which bodes well for future performance. And this was more than offset by a ramp-up of overhead savings during the quarter, as we reduced our workforce and exited distribution centers, trucks and equipment.

In the fourth quarter, we're working to build momentum. We're increasing brand-building significantly, including in-market promotional support. And we expect to see an improvement in consumption. Meanwhile, we'll be close to a full overhead savings rate, boosting profit. We'll give back some benefits from Q3, including hurricane-related shipments and some brand-building timing, but profit growth will still be very strong.

Now, let's turn to slide number 18 and U.S. Morning Foods, where our top-line and in-market performance have been below our expectations. There are some things that have continued to work well. We've continued to gain share in kid-oriented brands like Frosted Flakes and Froot Loops, which have brought to market innovation and brand-building that have excited consumers. And we've continued to improve our profit margins through effective productivity initiatives.

Where we've fallen short is on bringing enough excitement to our adult-oriented health and wellness brands. This is the segment that is most holding down the entire cereal category's sales and especially ours. What we have to do is get back to running the playbook that worked well for us before this year and that is working well for our kid-oriented brands to-date.

So here's what we're planning for 2018. Firstly, we do have stronger commercial ideas. We have new media that will emphasize the health and wellness credentials of Mini-Wheats and Raisin Bran, two brands that simply didn't have strong enough brand-building this year. We also launched the next phase of the Special K Own It campaign, emphasizing the brand's inner strength credentials and positioning. And we've got great ideas for our kid-oriented brands, emphasizing out of breakfast snacking, for example.

Secondly, you will see a step change in innovation next year. We'll renovate and innovate against our core, with news on Frosted Flakes and Froot Loops as well as more fruit-filled Raisin Bran and Special K that moves into probiotics. This is bigger innovation activity than this year.

We'll also try some new things that are new to the category. These will lean into health and wellness and into convenience. And you will hear more about them in the months to come. Third, we'll drive bigger in-store excitement, with stronger properties and events and programs that leverage a total Kellogg go-to-market model now that U.S. Snacks is no longer in DSD. Imagine, for example, promotions and displays featuring Rice Krispies and Rice Krispies Treats together. We can now do that seamlessly for the first time.

We'll do these three things for Pop-Tarts as well. This brand will come to market with strong food news in January. And we'll follow that up with differentiated innovation around mid-year.

We know what needs to be done because we've done it before. Remember, we stabilized U.S. cereal in 2015 and 2016 and we've done it this year in our other three core cereal markets, all following the same playbook. For the rest of 2017, I don't see a change in trend for Morning Foods. But I am encouraged by the strength of our plans and expect much improved performance in 2018.

Now, let's talk about Specialty Channels shown on slide number 19. This business posted its ninth straight quarter of sales and profit growth in Q3, a reflection of continued good execution by our team. Sales growth in the quarter was led by both convenience and foodservice channels, Specialty segments like K through 12 schools and cafeterias, with an added pickup from hurricane-related orders.

The hybrid direct and broker approach we implemented early this year is giving us greater focus on key accounts and channels, while more economically expanding our reach to new customers. And it gives us confidence in the future growth potential for this business.

Margin expansion continued on the strength of ZBB and RGM efforts. These are important and growing channels for us. And our sustained momentum reflects our continued commitment and focus to winning wherever the shoppers shops.

Turning to slide number 20 and our North American Other segment, we had signaled an improved second half. And this segment certainly delivered, with a return to top line growth in Q3.

U.S. Frozen Foods sustained the momentum it started the previous quarter. Eggo accelerated its consumption growth and share gains on the strength of its removal of artificial colors and flavors and the success of Disney-shaped waffles. It also benefited from the exit of a competitor. This was skewed mostly to the east coast, and the brand grew even excluding this.

Our Morningstar Farms line has returned to consumption and share growth, too, reflecting focused marketing and in-store support on our core burger offerings during the summer grilling season.

Kashi Company continued its sequential improvement in the quarter, as anticipated. Whilst we haven't completely lapped some of the distribution declines on the Kashi brand, we are seeing strong momentum in cereal share led by Bare Naked, which is now the number one granola brand in the U.S. Meanwhile, our renovated snacks offerings are stabilizing share, as we had anticipated, with share getting back up to flat in the quarter.

In Canada, we generated continued improvement in consumption, with broad-based share gains in both cereal and snacks. This business has now lapped the elasticity impact of price increases executed last year and is showing consistent improvement as we invest behind strong commercial programming and innovation.

So to wrap up North America, I'm encouraged by the way we're executing post-DSD in Snacks. I'm delighted to see our North American Other businesses turning around. And we're sustaining good momentum in Specialty Channels.

Cereal is a tough category right now, but we have a stronger commercial plan in place, particularly as we get to 2018. And, of course, I like what we've done to our cost structure, which has driven continued margin expansion.

I'll now hand you back to John for a review of international business.

John A. Bryant

Thanks, Paul. Let's now discuss Europe, shown on slide 21. We had a much improved top-line performance in Europe in Q3. And as we had anticipated, it was driven by two key factors. The first was Pringles. You'll recall that our European Pringles business, which had been growing reliably at a mid to high single-digit rate in recent years, suddenly declined at a sharp rate in the first half. This negative swing reflected prolonged negotiations with customers regarding our price increase on reformulated product. While these negotiations were largely behind us by early Q2, our share of merchandising events was reduced significantly through the entire first half. As anticipated, we resumed promotional activity during Q3 and returned the brand to year-on-year sales growth.

The second major factor was UK cereal. This is a key business that has been declining for us in recent years, and that stabilization is something we called out as a major priority for us this year. And we're doing just that.

In Q3, our consumption and share sustained the year-on-year growth trend from earlier in the year. This is an impressive turnaround. It's being driven by several of our brands, achieved by executing the three things we know works in cereal: better commercial ideas; food news through renovation and innovation; and better in-store promotional events.

Corn Flakes is a great example. Through a great commercial idea asking consumers, what's your perfect bowl? It reminded them of this brand's tremendous versatility, and it gained share as a result.

As we go into the fourth quarter, we expect to see continued Pringles growth and UK cereal improvement, leading to sequential improvement as we head into 2018.

Let's talk about Latin America, which is shown on slide 22. It's been a disappointing year for us in Latin America, but really because of one single sub-region, Caribbean/Central America.

Recall that late 2016 distributor transitions built up trade inventories that created a significant overhang when consumption trends slowed sharply in the first half amidst macroeconomic pressures. This inventory overhang and consumption softness persisted in Q3, exacerbated by the damage wrought by Hurricanes Maria and Irma, with our big Puerto Rico business being most disrupted.

The good news is that we generated growth outside of Caribbean/Central America. This includes growth in our largest market, Mexico. It also includes good performance in [indiscernible] (31:32), where we posted particularly strong growth in Pringles despite a challenging economic climate.

We also continue to make good progress on integrating Parati, the acquisition we made in Brazil late last December, and that business continues to perform well. This acquisition will anniversary in December, so our comparable basis results will start reflecting it then.

Unfortunately, because of the issues we faced in Caribbean/Central America, 2017 is turning out to be a soft year for Latin America, but the fundamentals are in place for sequentially improving results as we head into 2018.

We'll finish up with Asia Pacific on slide 23. Asia Pacific had another strong quarter, with solid top-line growth and a substantial increase in operating profit. Pringles sustained its growth in the quarter, with continued share gains for the region. In cereal, we've spoken previously about the stabilization of our Australian business, and it continued to grow share during the third quarter.

We continue to grow cereal sales in Asia, with growth in most key markets led by Granola and eCommerce and an encouraging reacceleration of sales growth in India, which had been held back in recent quarters, first by demonetization and then by the rollout of the country's Goods and Services Tax.

Not included in our consolidated results are our joint ventures in West Africa and China. Once again, these operations posted strong double-digit net sales growth year-on-year, continue to build scale for us in these emerging markets. Our West Africa venture is growing on the strength of noodles, while our China venture is benefiting from Granola Cereal and rapid expansion in eCommerce. These joint ventures are a key element of our emerging market strategy, and their growth has been outstanding.

So Asia Pacific is carrying good momentum into the fourth quarter. And thanks to the benefits of Zero-Based Budgeting and Revenue Growth Management, Asia Pacific is also posting strong margin expansion, even in spite of a mix shift toward emerging markets.

Allow me to summarize with slide 24. First, we remain solidly on track to deliver our financial guidance for the year. Q3 features sequential improvement in sales, continued margin expansion, strong profit and earnings growth and higher cash flow.

Second, our single biggest transformational initiative this year, our transition out of DSD, remains on track. This was a large, complex and risky endeavor and has been executed extremely well. It's also essential to accelerating growth and margin expansion for our big U.S. Snacks business.

Third, our productivity initiatives are progressing well and giving us good visibility into cost savings for the next couple of years. And finally, we know we have to grow our top line and we are committed to doing so. We continue to progress on our building blocks for improving our top-line performance. We're stabilizing our core international developed cereal markets. Special K and Kashi continue to show signs of improvement. Pringles is growing globally. We returned our Frozen Foods brands to growth. We sustained growth in Specialty Channels. We continue to build scale in emerging markets. And our acquisition of RXBAR gives us a new on-trend platform for growth.

As usual, I'd like to extend my gratitude to our employees for their hard work and dedication. Let me turn it over to Steve for any final comments he might have.

Steven A. Cahillane

Thanks, John. I would just reiterate that I feel extremely confident about the potential of this company. Results are coming in as expected and there is a lot of energy around getting back to sustainable profitable growth.

I'm not in a position right now to give any guidance on 2018, as we are still evaluating our business units' plans. But I can tell you that there is a high degree of confidence in our expected cost savings and I'm very encouraged by the commitment of the organization to getting back to top-line growth. We are stabilizing soft elements of the business. We are gaining traction in growing elements of our business. And we have a lot of great ideas that can take us further.

With that, let's open it up for questions.

Q&A

Operator

We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Robert Moskow with Credit Suisse. Please go ahead. Mr. Moskow, your line is open on our end.

<Q>: Hi. Yes. This is [ph] Neil Kugurney (36:29) in for Robert Moskow. Just one question from me, I know you're not giving formal guidance for 2018, but could you comment at all on the gross margin targets with the new management at around 18%? Is there a chance of that remaining as is or any changes? Thanks.

<A - Steven A. Cahillane>: Yeah, [ph] Neil, (36:47) I'll take that question. This is Steve. We are not giving any formal guidance for 2018. What I would tell you, however, the time that I spent reviewing the businesses, there is tremendous visibility into our cost programs. There's a lot of momentum that's been happening around the transformation of this business. And even if you look at Q3 at 17.6% operating profit margin, we're well on track.

And so we'll be spending the next 90 days or so, Fareed and I, along with John, traveling around the businesses really understanding exactly where the opportunities are, so that we can strike the right balance between top-line growth and continued margin expansion.

<Q>: Got it. Thanks very much, Steve.

Operator

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

<Q - Kenneth B. Goldman>: Hey. Thanks. I'm going to follow-up on that by asking about 2018 as well. The company already has given operating margin guidance for 2018. Two summers ago, Kellogg said the operating margin will be up about 350 basis points from 2015. Is this guidance still on the table? I realize there's some headwinds in terms of sales not being quite as strong as what you would have thought, but there's an incremental, and a pretty big incremental, tailwind as well in terms of going to warehouse. So I'm just trying to get your sense of how strong that guidance line item still is.

<A - Steven A. Cahillane>: Again, just to reiterate, we're not going to give any 2018 guidance, but we are well on track to achieve those goals based on all the terrific work that's been happening around the transformation, around DSD, around Zero-Based Budgeting, Project K. So it gives us great momentum going into 2018. We just want to take the time, and for me to do exactly what you'd expect me to do, which is review all the businesses, look for the best opportunities to strike the right balance between top-line growth and what's continued to be excellent margin expansion.

<A - Fareed A. Khan>: And, Ken, it's Fareed. Just as a reminder, that 350 basis points, the key drivers behind that were Project K and ZBB, and both of those initiatives are well in flight. The DSD exit was the largest remaining element of Project K. And as you've heard, we've got a very good line of sight. So from a cost perspective, which was really underpinning it all, we have very high confidence in delivering the two big initiatives in that.

<Q - Kenneth B. Goldman>: Okay. Thank you for that. And then, one thing I wanted to make sure of, your biggest competitor in U.S. cookies and crackers, they talked about getting a little bit more aggressive in the fourth quarter, especially after some shelf resets, perhaps getting some incremental displays. I know you've talked in the past about losing some displays, perhaps in some parts of the store that maybe weren't critical to you in this category. I just wanted to get a sense, how much does your guidance for the fourth quarter, I guess, contemplate your competitors getting a little bit more aggressive than they were in the third quarter in that part of your business?

<A - Paul T. Norman>: Hey, Ken. It's Paul. Obviously, I'm not going to talk about competitors. We're pretty much focused on doing our job and that's rebuilding momentum. And I feel good about our plan and the strength of our plan in Q4. We're reinvesting in, obviously, significant amounts of brand-building here behind a pull model. We're reinvesting in in-store promotions behind a more focused assortment and we are driving more impactful, larger displays in key positions in stores.

When you exit DSD, you're always going to lose some tertiary and secondary displays, but the benefits of shipping through warehouse is that we can drive some big impact displays across our biggest brands as we build momentum into what will be a strong Q1 as well from an innovation point of view and our ability to leverage [ph] the Power of K (40:36) in-store going forward across one delivered platform. So we're focused on getting the momentum back in our brands. And our plans look very strong [ph] year-to-go. (40:44)

<Q - Kenneth B. Goldman>: Thanks. And, John, best of luck to you.

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

<A - Steven A. Cahillane>: Thank you.

Operator

The next question comes from Steve Strycula with UBS. Please go ahead.

<Q - Steven Strycula>: Hi, guys. A question for John and Paul, can you break down the revenue shortfall this year for U.S. Morning Foods relative to your initial plan as we started the year? Just want to get a feel for, in that specific business, our revenue velocity decelerated within U.S. cereal or are we seeing decreased category distribution? Just clarity into that and how we kind of exit and look to 2018 would be a helpful color. Thank you.

<A - Paul T. Norman>: Okay. Steve. As it regards Morning Foods and cereal, specifically, we're not seeing points of distribution or things happen at a category level, per se. We are, obviously, disappointed with our performance this year. And we're not hitting our plan. We're hitting our plan on many elements around kids and productivity. Where we're not hitting our plan has been around our biggest adult brands. And that shortfall on brands like Mini-Wheats and Special K and, to a certain degree, Raisin Bran, is what's driving a softer category performance this year. The category's going be down between 2% and 3%. And some of that, quite frankly, is on us.

We need to now pivot and reassert our health and wellness credentials on those adult brands, increasing claims, news and innovation around those brands as we go into next year. So I've mentioned probiotics on Special K. We have news coming on Raisin Bran. And one thing we'll talk to you about in coming months is some more transformational innovation coming to the category around the area of digestive health and convenience as we look to really stimulate adult growth within the cereal category.

As you go back over time, this category has always responded, over the past 50 years, to health and wellness, whether it was fortification, fiber, oat bran, low calorie, low fat in the 1990s and 2000s. We need to drive the health credentials of the category. And that's what our plan is as we go into next year, whilst continue to drive fun and taste and versatility, and, as John said, big consumer excitement engagement through big properties and fun in-store. So that's really where we're headed. And I'm very much focused forward right now on those things.

<Q - Steven Strycula>: Great. Thank you.

Operator

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

<Q - Andrew Lazar>: Good morning, everybody, and welcome, Steve.

<A - Steven A. Cahillane>: Thanks, Andrew.

<Q - Andrew Lazar>: I guess my question, Steve, is really more to try and dig in a little deeper as to why you decided to join Kellogg, kind of what brought you there. And I ask this a little bit tongue in cheek, of course, just because of all the negative sentiment on the food space, overall, questions about the viability of big brands and the sustainability of margin structures and all of that, not to mention a consumer that seems more benefit-driven maybe than brand-driven than ever before. So I'd love to just get a sense of what brought you here, as you sort of assessed your next potential opportunities, to get a sense of your thoughts on some of those things that I brought up. Thank you.

<A - Steven A. Cahillane>: Yes. No, thanks, Andrew. I think the pessimism around this category and U.S. food, I think, is overdone, in my estimation. There's going to be winners and there's going be those who don't win. And I think Kellogg is uniquely positioned to be one of the winners. You've got great brands, great food, great people here, a great culture. You're not going find a more iconic company than Kellogg.

And so the opportunity to come here was very humbling, but I also see tremendous opportunities for growth. And, as I've traveled around, I've seen those growth opportunities. They exist already. Look at Pringles globally and how well that's doing, what opportunities exist there. You hear Paul talk about the Frozen business, Eggo and Morningstar

Farms; terrific brands growing very well with lots of momentum.

The emerging markets and the opportunities in emerging markets and the JVs that we formed already, tremendous opportunities for growth. And you saw what we recently did with RXBAR, filling in a space that we weren't participating in with a terrific brand that's right on-trend.

And so, as I looked at the opportunity, I saw tremendous opportunity for growth, a wonderful opportunity to join the most iconic of American companies, a great culture, love the people that I met. And so I couldn't be happier with the choice, and I see really tremendous opportunity for us moving forward.

<Q - Andrew Lazar>: Great. Thank you for that and all the best, John.

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

Operator

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

<Q - David Cristopher Driscoll>: Great. Thank you. Good morning. John, thank you for all the assistance over the year and good luck with your next chapter and a welcome to Steve. My question is on U.S. Snacks. Can you guys give us some sense as to the size of the volume declines that occurred after the transition? And then, when do you expect to see the benefits from higher advertising and brand-building that you're going to execute on the snack operations?

<A - Paul T. Norman>: Hey, David. It's Paul. It's hard for me to give you a sense of the exact volume declines, but remember what we said coming into this. There is a [ph] 50% to 20% (46:12) SKU rationalization that will obviously not have that amount of impact on our business, but will have a limited impact. We hope to gain space on some of our core items to get a more powerful assortment there.

At the same time, we said and we knew we would get fewer displays as we came out of DSD but more impactful displays. And we pulled right back on promotions and display support through a period of three to four months here to be able to operate effectively in what is a new model for the Snacks team. We have now pivoted.

Brand-building was up in Q3 and will be up much more in Q4. Our investment in promotions and in-store support with our customers is now beginning to come to life as we reinvest behind these biggest brands, and that will continue as we go into next year.

I'm optimistic we will see consumption improvement in the coming weeks and months on this business. We have a strong innovation pipeline coming at the beginning of the year, so that will accelerate into next year from a consumption point of view.

So we're now, if you like, the transition is behind us in many ways. We're now very much focused on operating effectively in a warehouse-delivered model, which we think we can do because we do it across our other businesses.

<Q - David Cristopher Driscoll>: Paul, in one follow-up for me, do you have any concerns on your shelf space within the Snack business now that you're about three months since the DSD elimination? Do you have any concerns that you would lose shelf space larger than any expectation you previously had before you executed the transition?

<A - Paul T. Norman>: It's a good question, David. Our business is responding in the way we expected it to. So all of our key metrics are right where the team expected them to be. It takes a lot of work in-store to make sure tags and placement and compliance is there across 20,000-plus stores, which is we used to call on twice a week. But so far so good, and we'll continue to improve as we go forward.

So there's nothing outside of our assumptions in our business case at the moment that would worry us. Like I say, we're just focused on getting back to growth with our customers and then obviously working with our customers in a new delivered environment, where we can also help them from a cost to serve point of view as we're on one platform now and build those joint value-creating plans in ways that we couldn't before, which I think will be really important looking forward.

<Q - David Cristopher Driscoll>: Thank you.

Operator

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

<Q - Bryan D. Spillane>: Hey. Good morning, everyone. Just a follow-up on the questions around the Snacks business in the U.S., and I guess maybe I didn't understand this correctly, but part of what I thought or what I'm expecting is that as you pulled back DSD, so all of that distribution resource into large format retailers, it frees up some resources to maybe expand into some other channels where you're under-resourced. So I guess my question is just is that still true? And if it is, as we're thinking about the timing, I guess, over the next year or two, is there a level of reinvestment that we should be thinking about that goes into sort of building more channel diversity?

<A - Paul T. Norman>: Absolutely, Brian. When we laid out the business plan when we started this at the beginning of the year, this was really based on a set of consumer-based and shopper-based assumptions, which is exactly what you said. Investing money in a go-to market mechanism or operating model, the consumers don't see the benefit from, quite frankly, was not where we wanted to be. So those resources are now going into focusing on how and where the shopper shops. Whether that's brand-building in old-fashioned ways or new-fashioned ways from a shopper point of view, reaching those shoppers in whichever retail environment they choose to shop, that's exactly what we're doing.

We're also investing more resources, people resources, against where the growth channels are in our business. So we're seeing, for example, eCommerce in North America in Q3 grew over 60%. So like every company, winning where the shopper shops in new environments, be that pure play or click-and-collect is right up there on our agenda. And investing in capabilities, whether it be supply chain, marketing, sales in that environment, is where some of these dollars are going.

Also remember some of the highest growth potential brands in our portfolio, Pringles, Cheez-It, Rice Krispies Treats, these brands are going get significantly more brand-building, way up there in the double digits for the next year, as we look to accelerate those brands. Whether that's TV, media type investments, whether it's customer focused investments, whether it's capital into pack/price format investments to make sure that we have exactly the right offering in the right channel to fit the consumers and the shoppers' needs. What we said we're doing, we're going to do, and you'll see it come through in the months to come into next year.

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

Operator

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

<Q - Rob Dickerson>: Thank you very much. John, thanks for all. Steve, welcome. So, Steve, I was just wondering if you could give us maybe one or two examples of what you may be focused on as you step into the role at Kellogg for each of the brands and really as you think about brand investment allocation. And I'm simply asking you to see if there's anything you believe as you step into the new role, are there best practices that you can bring from your prior position to leverage Kellogg's win potential going forward? Thanks.

<A - Steven A. Cahillane>: Yeah, thanks, Rob. I certainly hope I can bring some new thinking in best practices, but I'm also humble enough to know that I'm joining the original health and wellness company, as I said before, very iconic with fantastic brands. And again, I see tremendous opportunities in many of the brands in all the categories. Some of the questions people ask is can cereal grow. And even within that, you see the kids' brands in the U.S. becoming stable. You see a great story in the UK with Corn Flakes return turn to double-digit growth on the back of really strong marketing programs. And I'm confident if we get the adult portfolio marketed properly around contemporary health and wellness, there's even opportunity there to continue to grow that.

And then you look back at some of the areas that are already growing that I mentioned, Pringles globally, the Eggo business, Morningstar Farms, emerging markets, there's a lot of opportunities to grow this business.

And it's not that there's a dearth of opportunities where we really have to search far and wide for that little gem. There's a lot. And so we have the opportunity to really evaluate where those opportunities are, make the right resource allocation decisions, and really put the pedal down on some of these areas of high growth.

This company is not without strong brands. In fact, there's many, many brands across many categories and geographies. So I'll be spending the next 90 days really evaluating all those opportunities, evaluating the business plans. John's been a tremendous partner. We've been traveling all around the world, along with Fareed, to really evaluate these plans.

And right about the fourth quarter call, we'll be talking about 2018, where we want to take 2018. And I'm looking forward to seeing all of you at CAGNY, where we'll be more fulsome about exactly where these opportunities are and where we believe we can really create long-term value for our shareholders.

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

Operator

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

<Q - John Joseph Baumgartner>: Good morning. Thanks for the question. Paul, just going back to U.S. cereal, you made comments around brand-building, but it feels as though that lever has been pulled a number of times on and off over the years with protein cereals, antioxidant cereals, and with, I guess, a fairly limited impact. So do you have a sense as to where maybe cereal share of voice is in the breakfast space relative to where it's been historically? And just given how the daypart's been bifurcating, are the brand-building levers also bifurcating, where any approach is maybe less incremental, in terms of its impact, overall? How do you think about the returns there on those efforts and where you invest going forward?

<A - Paul T. Norman>: Thanks, John. As I look forward on our portfolio, as I emphasized, it's less about absolute money or share of voice as it used to be. It's more about getting the right ideas behind the right brands. We have a great set of existing core brands, the Core 6, as we call them. They cover 70% of the needs when it comes to the category, number one. We have to up our game on brands like Mini-Wheats, Special K, and Raisin Bran to bring, as Steve said, contemporary health and wellness credentials to those brands. We're down the track on Special K. And we're seeing the brand begin to respond, not only in the U.S. but around the world. And we're bringing more, in the way of probiotics to Special K next year.

Raisin Bran and Mini-Wheats, we can do a lot more to pull out the wellness credentials of those brands and talk to consumers about them. This isn't category work, per se. This is brand work relevant to consumer needs, brand-on-brand.

I've spoken before about how the category's always been driven over time, actually through nutrition. Whether it was fortification back in the 1950s, fiber, oat bran in the 1970s and 1980s, and then for a long while here, low calorie, low fat drove the Special K brand in particular and the category for years.

Now, I believe gut health and science is coming back to nutrition and nutrition in the cereal category. We're well placed as a category to actually find tailwinds in nutrition in the months and years to come. It's good for cereal and it's good for our emphasis on health and wellness. You add the Kashi brands and the Kashi business to that as well and we have a on-trend set of brands, I think, for the 10 years to come.

The critical thing, though, is finding great commercial ideas, renovation and innovation that can bring to life those trends in unique ways for our brands. Our portfolio and our category is uniquely placed to do that. It's incumbent on us to do it. So that's really where our focus is.

35%,36% of the cereal consumption in the U.S. today happens outside of the breakfast occasion. That trend's only increasing and will only continue to increase as you think of demographics and age cohorts going forward here. And so we are agnostic to what time of day we communicate the benefits of our foods. And we'll communicate to everybody, wherever they are throughout the day, these benefits. We've had great success with some of our kid brands against millennials in certain dayparts, like the evening, and we will continue to drive our portfolio where it makes sense to fit people's days.

The final thing I'll mention is we do need to still bring transformational innovation to cereal, okay, and to the breakfast occasion, which means investing more, maybe, in new alternatives in the area of digestive health and/or convenience. And we're working hard on that. And hopefully, you'll see some transformational innovation ideas come out of our company over the next few months here that show that we are investing to grow our business across these key categories.

John Renwick, CFA

Operator, because we're at the end of the call, we want to bring it back to John Bryant for some final comments.

John A. Bryant

Thank you for your questions, everybody. On a personal note, I'd like to thank all of you in the investment community for your support and engaging discussions over the years. You're in very good hands with Steve, who I firmly believe will transform and successfully lead this great company into the future. Have a great day, and feel free to call John Renwick with any follow-up questions. Thank you.

Operator

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